

Central Bank of Ireland Consultation on Errors in Investment Funds

The Central Bank has published a consultation on a regulatory regime to include new rules and guidance on treatment, correction and redress of errors in investment funds.

On 9 September 2019, the Central Bank of Ireland (“**Central Bank**”) published a **consultation paper** on *Treatment, Correction and Redress of Errors in Investment Funds* (the “**Consultation Paper**”). The Consultation Paper makes clear the Central Bank’s intention to introduce a regulatory framework, comprised of both rules and guidance in this area. While the Central Bank acknowledges that Irish Funds has published guidance on the treatment and compensation of errors and breaches (see Irish Funds Guidance Paper 6 on Breaches, Errors, Compensation and Reporting) it notes that this guidance has been neither sanctioned nor approved by the Central Bank. While the industry guidance has been widely adopted and applied, the Central Bank states that there are a number of areas that require attention, including in relation to reporting.

Proposed Regulatory Framework

The Consultation Paper states that fund management companies (UCITS management companies, alternative investment fund managers (“**AIFMs**”), self-managed UCITS and internally managed alternative investment funds (“**AIFs**”) that are authorised AIFMs) are ultimately responsible for ensuring that where an error occurs, any necessary action is taken to restore the fund / investor to the position that it / they would have been in had the relevant issue not arisen. This is referred to in the paper as being “Appropriately Rectified”. The Central Bank states that the depositary also has a role in ensuring that this is the case.

The proposed regulatory framework would have the following components:

- **Treatment** – how errors should be treated when they arise, including when such errors should be considered as material;
- **Correction** – how errors should be corrected, including what reporting and notification obligations should apply; and
- **Redress** – how the fund and / or its investors should be Appropriately Rectified following an error.

Four types of error are defined under the framework as follows:

- **NAV Error** – error in the calculation of net asset value;
- **Investment Breach Error** – error relating to the investments of the fund and non-compliance with applicable investment restrictions;
- **Fee Error** – error related to the overpayment of a fee; and
- **Control Breach Error** – errors which do not fall into the above three categories.

Materiality

Where an error occurs, the fund management company and depositary will have to assess the materiality of the error as this will affect the treatment of the error in terms of reporting, notification and redress. The Central Bank is of the view that there may be qualitative materiality thresholds as well as quantitative materiality thresholds, so that accompanying circumstances may be taken into account. This approach could result in an error being re-categorised as material, notwithstanding that it did not reach a pre-determined quantitative threshold.

In relation to quantitative materiality thresholds, the Central Bank is proposing to apply different thresholds depending on whether the fund is a money market fund or other type of fund so that the following thresholds would apply:

Money Market Funds 0.10% of NAV

Other investment funds 0.50% of NAV

Qualitative factors that may be taken into account even where an error is deemed not to meet or exceed the quantitative materiality threshold include: (i) the circumstances which resulted in the error (eg, inadequate controls); or (ii) the duration of the error. The Central Bank proposes to issue guidance in this area. This guidance would provide that a series of errors may have a cumulative impact that should be taken into account when determining if an error is material.

The Central Bank proposes to maintain its current approach regarding inadvertent breaches, so that, where there is a material error, irrespective of whether the error is deemed to be inadvertent or not, the fund management company will have to ensure that the error is Appropriately Rectified.

Reporting

Under the Central Bank's current requirements, fund management companies are required to report any breach of relevant legislation, whereas depositaries are generally required to report any material breach of investment funds legislation and regulatory requirements, including breaches of provisions of the prospectus. The Consultation Paper proposes that reporting will be required by both the fund management company and the depositary with respect to material breaches only.

Fund management companies will be required to: (i) report errors to the depositary, relying on the depositary to meet the fund management company's reporting obligations to the Central Bank in respect of individual funds; or (ii) report any material error which has not been reported by the depositary to the Central Bank. Both the fund management company and the depositary will be required to maintain a written record of all errors that occur.

Notification

The Central Bank proposes the introduction of a requirement for fund management companies to notify investors of any error found to be material irrespective of whether redress is required or not. To date, the general approach adopted by industry has been to notify investors in respect of material errors where investors are directly affected by the error and are due to be paid redress.

Redress

The Consultation Paper seeks views as to whether de minimus limits (ie, thresholds below which redress is not provided) should be applied, the rationale for a differentiated approach for retail and

institutional investors and what might be appropriate thresholds if de minimus limits are to be applicable. The current industry standard is that de minimus limits are applied at €50 for retail investors and €500 for institutional investors but that Central Bank states that these current limits “appear excessive”, particularly for institutional investors.

In the case of material NAV Errors or Control Breach Errors, the Central Bank proposes that the payment of redress should be made in all circumstances.

The Central Bank proposes that payment of redress should be required in all cases (regardless of materiality) where the error is an advertent investment breach. In the case of an inadvertent investment breach (either material or non-material), the Central Bank states that it would appear appropriate that redress should generally not be payable except where otherwise deemed appropriate by the depositary. Payment of redress should be made in all circumstances where there is a Fee Error. The Consultation Paper sets out elements of the Central Bank’s proposed guidance in relation to payment of redress.

Next Steps

The Central Bank states that the Consultation Paper is part one of a two part process. Through our engagement with Irish Funds, we understand that the Central Bank will hold two workshops, one for promoters and service providers and one for investor groups in the next two months. The Central Bank will formulate draft rules and guidance having considered the feedback from the Consultation Paper and the workshops and will consult further on the regulatory framework in Q1 or Q2 2020. It is anticipated that the new framework will be in place towards the end of 2020.

Responses to the consultation are requested by 9 December 2019. Matheson will be involved in the Irish Funds response to the consultation and may also submit our own response and we would be happy to receive any feedback to be incorporated into those responses.

Please get in touch with your usual Asset Management and Investment Funds Department contact or any of the contacts listed in this publication should you require further information in relation to the material referred to in this update.

Full details of the Asset Management and Investment Funds Department, together with further updates, articles and briefing notes written by members of the Asset Management and Investment Funds team, can be accessed at www.matheson.com.

Contacts



Tara Doyle

PARTNER

T +353 1 232 2221
E tara.doyle@matheson.com



Michael Jackson

MANAGING PARTNER

T +353 1 232 2000
E michael.jackson@matheson.com



Dualta Counihan

PARTNER

T +353 1 232 2451
E dualta.counihan@matheson.com



Anne-Marie Bohan

PARTNER

T +353 1 232 2212
E anne-marie.bohan@matheson.com



Shay Lydon

PARTNER

T +353 1 232 2735
E shay.lydon@matheson.com



Liam Collins

PARTNER

T +353 1 232 2195
E liam.collins@matheson.com



Philip Lovegrove

PARTNER

T +353 1 232 2538
E philip.lovegrove@matheson.com



Elizabeth Grace

PARTNER

T +353 1 232 2104
E elizabeth.grace@matheson.com



Oisín McClenaghan

PARTNER

T +353 1 232 2227
E oisín.mcclenaghan@matheson.com



Michelle Ridge

PARTNER

T +353 1 232 2758
E michelle.ridge@matheson.com



Barry O'Connor

PARTNER

T +353 1 232 2488
E barry.oconnor@matheson.com



Donal O'Byrne

PARTNER

T +353 1 232 2057
E donal.o'byrne@matheson.com



Brónagh Maher

PROFESSIONAL SUPPORT LAWYER

T +353 1 232 3757
E bronagh.maher@matheson.com

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