Trade Errors, Omissions, & Breaches – Pursuing Operational Excellence

A Guide for Allocators and Investment Managers

1. Introduction

'Trade errors' occur in the normal course of an investment business and can affect the overall performance and integrity of investment portfolios. They can arise in investment processes due to human error (such as buying the wrong security, or because an individual failed to perform a specific task or action) as well as operational/technical failures.

The term "trade errors" is not well defined, a narrow definition may only focus on failures to execute trading instructions correctly, whilst a broader definition may also extend to errors, omissions, and breaches (of mandate). They may occur actively (i.e., trading through a risk limit or threshold) or passively (i.e., risk limits being breached due to market moves and volatility).

The discussion of trade errors, omissions, and breaches between managers and investors is often perceived as sensitive given that trading is not a "zero failure" environment. These errors, omissions, and breaches can and do occur frequently. The issue is primarily one of risk allocation and who bears the cost, and/or profits from the gains, of such incidents when they occur.

However, investors and managers are aligned in wanting to reduce this operational risk. Hence, a more constructive and open-minded approach to engaging on this topic is required to create an operational environment that reduces the frequency and magnitude of trade errors, omissions, and breaches, to protect the investor and the manager from losses.

This memo explores the difficulty in defining 'trade errors', regulatory considerations, the key features of a robust trade error framework, the spectrum of approaches for compensation, and practical questions for due diligence teams to discuss with managers.

2. Defining Trade Errors: Broad or Narrow Interpretation?

There is no consistent industry or regulatory definition of what constitutes a trade error, though it is generally accepted failures in the execution process are considered trade errors – rather than for example: breaches of the investment mandate[1], or (for systematic managers) model errors. The table below outlines several common actions, or inactions, that may be classified as trade errors.

Examples of incidents that may be categorised as trade errors:

- Narrow Interpretation: failure to correctly execute instructions
    - Buy order entered instead of a sell order, or vice versa
    - Wrong security purchased or sold
    - Security purchased or sold in incorrect amount or price

[1] Depending on the jurisdiction, investment mandate breaches may be referred in a defined way to denote specific regulatory treatment or actions to be taken to rectify an error.

- Trade executed for wrong account
- Failure to execute a transaction
- Executing a transaction at the wrong time
- Allocation errors, such as misallocating a trade to an incorrect client or fund
- Duplicating a transaction (e.g., due to communication error)

- Broad Interpretation: other breaches and failures* that would not consistently be considered trade errors include:
  - Trading outside the scope of the investment mandate
  - Trading outside the scope of applicable law
  - Insufficient funds resulting in order failure
  - Hedging errors

**Some managers may analyse failures of systems, infrastructure, or near misses in a way that is very similar to traditional trade errors. This has the effect of blurring the lines between incidents which are traditionally thought to be trade errors and broader operational risk concerns. This paper does not aim to endorse one approach or the other, but one should be aware of the broad spectrum of definitions and methodologies for recording and communicating trade errors that managers can implement.*

3. Regulatory Considerations

Global regulations directly and indirectly address trade errors.

For US-based investment managers, the **Investment Advisers Act of 1940 (Advisers Act)** defines the role and responsibilities of investment advisers. While the Act does not contain explicit sections on the treatment of trade errors, several of its provisions indirectly set expectations on how they should be handled.

- *Fiduciary Duty (Section 206):* This section prohibits investment advisers from engaging in deceptive or manipulative actions. An adviser must deal fairly with clients, seek to avoid conflicts with its clients and, at a minimum, make full disclosure of any conflict or potential conflict. The fiduciary duty includes acting in the best interest of clients.
- *Compliance Procedures (Rule 206(4)-7):* This rule requires investment advisers to establish and enforce written policies and procedures designed to prevent violations of the Advisers Act by the adviser or its supervised persons. While trade errors are not mentioned explicitly, the requirement for policies and procedures to prevent violations would generally be expected to extend to the management of trade errors.
- *Books and Records (Rule 204-2):* This rule requires investment advisers to make and keep true, accurate, and current books and records. This would generally be expected to include keeping records of trade errors and the actions taken to correct them.

Form ADV Part 2A requires Securities and Exchange Commission (SEC-)registered investment advisers to create narrative brochures containing information about the advisory firm, including item 8 (*Methods of Analysis, Investment Strategies, and Risk of Loss)* where investment advisers can describe the risk associated with trade errors and item 12 *(Brokerage Practices)* which can cover a firm's approach to trade errors. Form ADVs are publicly available, so clients of, and investors in pooled vehicles that are managed by, SEC-registered investment advisers can review and compare the practices of managers.[2]

[2] All Forms ADV Part 2A are publicly available at: https://adviserinfo.sec.gov/ and https://www.sec.gov/foia/docs/form-adv-archive-data

In its **09-2023 Risk Alert**, the SEC's Division of Examinations has listed trade errors as an area covered in its typical initial requests for documents and information.[3] Typical actions by SEC examiners might include: (a) requesting a list of the firm's trade errors and how they were addressed, (b) questioning whether such errors were handled in accordance with the adviser's policies and fiduciary duties, (c) scrutinizing trade records for unreported trade errors, or (d) referring material violations to the SEC's Division of Enforcement.

In the EU, **Markets in Financial Instruments Directive (MiFID)** investment firms are required under *Organisational Requirements – Article 16*, to have adequate policies and procedures and effective procedures for risk assessment, although these do not directly address treatment of trade errors.[4]

For UK-based managers, the **Financial Conduct Authority (FCA)[5]**, similar to its global peers, has not codified specific treatments for remediating trade errors. The FCA's principles-based approach instead focuses on whether investment managers have appropriate systems and controls to adequately manage the operational risk they are exposed to. Investment managers should have regard for *"the importance of monitoring indicators of process or system risk (including reconciliation exceptions, compensation payments for client losses and documentation errors) and experience of operational losses and exposures".*[6] The FCA did however clarify in its feedback on *Discussion Paper DP05/4 Hedge Funds: A discussion of risk and regulatory engagement* whether liability for the cost of trading errors should be borne by the fund manager or the fund. It concluded that *"if the trading error has been caused by the hedge fund manager's carelessness, in the first instance we would expect liability (any claim for breach of duty can be founded in both tort and contract) to be established against the manager, for any errors for which it is responsible. That position can be varied or reversed, however, should the relevant contractual documents between the parties include an appropriately worded exclusion clause".*[7]

In lieu of explicit EU or FCA guidance, the treatment of trade errors will typically depend on (i) treatments set out in any offering memorandum, (ii) bilaterally negotiated terms via an investment management agreement or side letter, or (iii) an investment managers stated policy on trade errors which should be consulted during any operational due diligence review.

In 2019, the **Central Bank of Ireland (CBI)** published a consultation paper *CP130: Treatment, Correction and Redress of Errors in Investment Funds*.[8] The consultation outlined an approach for a new regulatory framework based on the guiding principle that where an error occurs, the Fund Management Company is responsible for ensuring that the fund and/or the investor is *Appropriately Rectified,* including reporting of errors, notification to investors, and *Payment of Redress*[9] obligations. The proposed framework differentiates how an error should be *Appropriately Rectified* depending on the type of error concerned, with four error types defined as follows:

- NAV Error: an error in the calculation of the Net Asset Value (NAV);
- Fee Error: an error related to the overpayment of a fee;

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[3] SEC Division of Examinations Risk Alert (6 September 2023), *Investment Advisers: Assessing Risks, Scoping Examinations, and Requesting Documents*, accessible here: https://www.sec.gov/files/risk-alert-ia-risk-and-requesting-documents-090623.pdf (see p.6: Typical Initial Information Examiners Request of Investment Advisers; Brokerage and trading)

[4] Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments, accessible here: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:02014L0065-20220228

[5] In this instance, it was the FCA's predecessor: Financial Services Authority (FSA)

[6] Financial Conduct Authority Handbook, Section SYSC 13.7 Processes and Systems (31/12/2006), available here: https://www.handbook.fca.org.uk/handbook/SYSC/13/7.html

[7] Financial Services Authority (FSA, predecessor to the FCA) Feedback on DP05/4 Hedge Funds: A discussion of risk and regulatory engagement, accessible here: https://www.finextra.com/finextra-downloads/prdocs/fsa.pdf (Section Liability for error trades and exemption clauses 3.42, 3.43)

[8] Central Bank of Ireland (CBI) CP130 Treatment, Correction and Redress of Errors in Investment Funds (2019), accessible here: https://www.centralbank.ie/docs/default-source/publications/consultation-papers/cp130/cp130-treatment-correction-and-redress-of-errors-in-investment-funds.pdf

[9] *Payment of Redress* refers to a payment to return the affected fund / investor to the position that it / they would have been in had the relevant issue not arisen.

- Investment Breach Error: an error relating to the investments of a fund and non-compliance with the applicable investment restrictions;
- Control Breach Error: errors which do not fall into the above three categories.

In order to determine the materiality of errors, the CP proposes an approach that takes account of quantitative and qualitative materiality factors, which can "*result in an error being re-categorised as material, notwithstanding that it did not reach a pre-determined quantitative threshold"*. The proposed quantitative thresholds are 10bps of NAV for money market funds and 50bps of NAV for other investment funds. For the qualitative materiality factors, the CBI was planning to set out further guidance on the considerations to take into account such as control failures, repeat errors, or failures to rectify errors. A follow up consultation by the CBI was expected to take place with requirements and guidance to follow, however as of the date of this publication no further progress has been made. The proposals made by the CBI build on existing local market established practices with divergence possible in some areas.[10]

However, the lack of explicit guidance on what constitutes a Control Breach Error has caused confusion, with some industry professionals taking the view that the consultation paper doesn't explicitly cover what would be traditionally thought of as 'trade errors' as they are not defined specifically in the paper, whilst other industry professionals have taken a broader interpretation and view the paper as having application to trade errors in the traditional sense under the definition of 'Control Breach Errors'. Irish Funds (the representative body of fund management industry in Ireland) have outlined this, noting that *"The consultation paper does not directly address situations that occur, which lead to i) a Transfer Agency error or ii) an Investment Management trade error. It is implied that such errors would fall into the 'Control Breach Error' category. (…) Industry would recommend that the framework or guidance provide a list of error types that should be included in the Control Breach Error category."*[11]

In 2002, the **Commission de Surveillance du Secteur Financier (CSSF**) [Luxembourg] published *Circular CSSF 02/77 Protection of investors in case of NAV calculation error and correction of the consequences resulting from non-compliance with the investment rules applicable to undertakings for collective investment*[12]*.* The Circular refers to two broad types of errors, *(i) those resulting from the incorrect calculation of the net asset value ("NAV") or (ii) from non-compliance with the investment rules applicable to* undertakings for collective investment ("*UCIs"). In most cases, non-compliance is caused either by investments which are not in compliance with the investment policy which the UCIs define in their prospectus or because of a breach of the investment or borrowing restrictions provided for by law or their prospectus.* Whilst this policy covers errors that result in breaches of a defined investment policy or regulatory obligation, it does not cover some of the more mundane examples of incidents which some may categorise as trade errors which we have previously alluded to in this document ('Defining Trade Errors'). For example, a manager who trades an instrument not explicitly allowed for in the UCI's prospectus would need to take corrective action as set out in the policy. However, the policy is silent as to the action to take if the manager was to trade an incorrect security or the wrong amount of that particular security even if it was permitted by the UCI's prospectus. The CSSF followed up with an *FAQ on Circular CSSF 02/77* providing guidance related to treatment of NAV calculation errors and correction of breaches of the investment rules applicable to undertakings for collective investment (UCIs).[13]

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[10] William Fry Asset Management & Investment Funds Update (October 2019), accessible here: https://www.williamfry.com/docs/default-source/articles-insights-william-fry-news-pdfs/25168198_1(central-bank-to-introduce-rules-for-dealing-with-fund-errors-amp-other-briefings---october-2019).pdf?sfvrsn=2

[11] Irish Funds response to Consultation Paper 130 – Treatment, Correction and Redress of Errors in Investment Funds – 9 December 2019

[12] Commission de Surveillance du Secteur Financier (CSSF) - Circular CSSF 02/77 - Protection of investors in case of NAV calculation error and correction of the consequences resulting from non-compliance with the investment rules applicable to undertakings for collective investment https://www.cssf.lu/wp-content/uploads/cssf02_77eng.pdf.

[13] CSSF FAQ on Circular CSSF 02/77, accessible here: https://www.cssf.lu/wp-content/uploads/FAQ-02-77.pdf

Separately, the **Financial Market Standards Board (FMSB)**, a standard setter for the wholesale banking industry, has published a voluntary *Secondary Market Trading Error Compensation Standard* for the Wholesale Fixed Income, Currencies and Commodities Markets.[14]

4. Key Features of a Robust Trade Error Framework

A Trade Error Framework will include clear processes, policies, and procedures for identifying and addressing trade errors, which is usually documented in a formal policy. The policy can include an approach for researching and reporting trade errors to a firm's compliance, risk, and/or operations department.

Trade Error Policy Document – examples of areas covered:

- Definition of trade errors: managers should provide clarity of what does and does not constitute a trade error
- Overview of detailed actions that personnel should take to record, analyse, and resolve errors
- Investment manager personnel should be compelled to notify a control function representative or senior manager as soon as practically possible when an error occurs or when it is first identified
- Reporting lines to senior personnel (e.g., Chief Compliance Officer, General Counsel, Investment Committee, Operations or Risk Department, etc.)
- Specification of contents of Trade Error Report, or Trade Error Reporting Form (e.g., error date, report date, nature of error, affected funds / accounts, trader / personnel involved, cause of error, amount, how the error was discovered, proposed resolution,…)
- Review of whether legal or regulatory notification requirements apply
- Process to determine whether fund board or investors need to be informed
- Assessment if compensation is due and to whom, based on predefined compensation parameters (where applicable), e.g., are materiality thresholds applied

More general steps investment managers can take to help prevent occurrence of errors with regards to trading activity include, but are not limited to:

- Maintaining policies and procedures that provide supervision over order entry and execution
- Review of systems and controls following an error or incident, to assess whether these can be altered to prevent reoccurrence
- Providing adequate training and education to staff with regards to dealing with and recording trade errors
- Use of limits and restrictions within trading infrastructure to seek to ensure that mandate breaches cannot occur, and limits cannot be breached
- Expedite affirmation, confirmation, and reconciliation of trades where possible
- Performance of end of day trade recaps
- Straight-through processing and eradication of manual interventions where possible

In order to capture a wider set of risk events, managers might wish to broaden their data collection beyond trade errors to issues affecting them which are outside their control, such as execution platform errors, errors resulting from stale data, cyber incidents and other failures impacting their service providers, such

[14] Financial Market Standards Board (FMSB) Secondary Market Trading Error Compensation Standard, accessible here: https://fmsb.com/wp-content/uploads/2019/01/Secondary-Market-Trading-Error-Compensation-Standard.pdf

as exchanges, counterparties, etc. Systematic capture and separate classification of this information will enable further analysis and strengthening of controls in relation to external providers.

5. Approaches to Compensating for Trade Errors

There is no standard way to rectify trade errors unless required by regulations in specific jurisdiction (see section "Regulatory Considerations") and the approach is usually set out in the funds' offering documents or the relevant investment management agreement.

Spectrum of Approaches

	Manager bears the risk	Neutral	Investor bears the risk
Approach	• Investors retain any gains from trade errors and investment managers make investors whole for any losses	• *Error Accounts* – gains are netted against losses over a defined time period • *Caps* – Investment managers agree to set 'caps', below or above, which the manager may or may not reimburse a fund or investor • *Materiality* – Materiality qualifiers can be used to define situations where compensation is payable. Materiality thresholds may also be used to determine if disclosure is required to a regulatory body or investor	• In an extreme scenario, investors bear any losses and do not retain any gains from trade errors • In many cases investors will retain gains but also bear losses • This could be qualified by providing that the investment manager compensates for losses if it has breached its duty of care

Challenges	• As with all trade errors, investors are reliant on the investment manager to make them aware when trade errors have occurred and that they have been compensated for the loss • Where the manager carries all of the risk, there is a chance that trading becomes risk averse and investors miss out on monetary gains, in particular in periods of market turbulence, fast moving markets, and/or fast paced trading environments[15]	• Multiple challenges arise with these approaches such as the timing of investors entering and leaving commingled funds, and determining the period across which trade errors will be aggregated, netted, and settled • Cannot net gains and losses in different funds • Cannot net with ERISA investors	• Determining whether an investment manager has breached its duty of care is difficult, proving 'gross negligence or wilful misconduct' is a high threshold • Simple 'negligence' rather than 'gross negligence' would reduce the threshold • If the manager bears limited or no risk, there is less incentive for the manager to reduce the frequency of errors[16]
	Other challenges that are not specific to the treatment deployed include: • Opportunity cost / out of market exposure • Accurate calculation of impact: are brokerage costs and commissions also considered? • If not dealt with in a timely manner, does additional compensation need to be offered via interest etc.?		

6. Conclusion: More Open and Transparent Conversations are Needed

Managers and investors are aligned in wanting to reduce trade errors – a constructive and open-minded approach to engaging on the topic is required.

For investors, it should be acknowledged that:

(i) Errors and failures are likely to occur in the normal course of business,

(ii) Investors may never be made aware of a trade error unless it is disclosed by the manager,

(iii) Transparency on trade errors should be welcomed and embraced,

(iv) Differing industry approaches may make comparison of investment managers difficult without understanding the exact definition of trade errors and the level of transparency involved.

For investment managers, it should be acknowledged that:

(v) Attempting to avoid scrutiny of process or procedure that leads to trade errors does not benefit the manager in the long run,

(vi) Attempting to deflect from questions on this topic potentially weakens trust between managers and their investors,

(vii) Taking an analytical approach to understanding how and why errors occur will be viewed positively.

[15] Note: the benefit speedier execution is hard to measure. It accrues to investors.

[16] Managers might still have alignment through co-investment in the fund, performance fees align the manager in maximising performance by minimising trading costs/errors.

7. Further Considerations

Insurance

Investors should be mindful of how investment manager insurance coverage, specifically Errors & Omissions (E&O) policies, can help reduce any monetary impact due to a trade error. It is considered good practice for investment managers to carry E&O insurance, and the majority of managers have such coverage in place. Many institutional investors will require their investment managers to acquire or hold insurance coverage as a condition of receiving an allocation. There is no industry standard of what an appropriate amount of insurance coverage is and for smaller managers, having a policy at all is considered a positive. Investment managers should consult their insurance brokers in each market to understand the spectrum of coverage that is available.

Disclosure

Investors must remain mindful that there is a reliance on investment managers to be transparent about trade errors and their disclosure to investors. Without being explicitly aware of a manager's trading intention, it is very hard to determine if the trade executed was as intended. When mistakes are made, investors rely on their managers to disclose this information in a timely manner and with sufficient detail. Legal and contractual terms should be scrutinised to ensure that investors are fully aware of what details will be provided and under what circumstances. Review of existing Trade Error Policies should be part of any basic due diligence process.

Trading Volumes & Investment Strategies

Investors need to assess a manager's infrastructure and human resources supporting the investment activity, and assess the frequency of trade errors against overall trading volume and approach:

- Some strategies have very low trade volumes and long lead times to execution, which allows for significant periods of reflection and monitoring as the investment process continues towards execution – giving rise to only a very limited number of trade error data points (if any) to draw meaningful conclusions.
- For strategies with higher daily trade volumes, infrastructure and systems can reduce risk of errors via straight through processing. However, human touch points and interventions can increase the risk of trade errors occurring.

In general, where there is a systems trail, trade errors are easier to identify (and prove). Trade errors are tougher to identify (and prove) in a discretionary trading environment, where it is more difficult to retroactively ascertain the actual trading intention.

8. Practical Questions for Due Diligence Teams to Discuss with Managers

Policies and Procedures:

1. How do you define a trade error?
2. Can you explain your trade error policy?
3. What are the types of trade errors you would expect and what efforts do you take to avoid them?
4. How do you identify and correct trade errors?
5. What is the escalation process for trade errors? Who are trade errors reported to and who is involved in the decision-making process to rectify trade errors?
6. How are trade errors documented? Can investors have access to these records?
7. How does your trade error policy comply with regulatory guidelines?
8. How are employees trained to prevent, detect, and handle trade errors?
9. How often do you review and update your trade error policies and procedures?
10. Can you provide examples of how trade errors have been handled in the past?
11. How many material trade errors have occurred over the prior three years (absolute amount, and percentage of overall trading volume) and what was the monetary impact?

Investor Notification:

12. Will the investor be notified if a trade error occurs in one if its accounts or the comingled fund?
13. Do you impose thresholds below which you will not notify the investor of errors?

Financial Liability Impacts:

14. Who bears the financial liability for trade errors?
15. What happens if a trade error results in a loss?
16. What happens to any gains resulting from trade errors?

Insurance:

17. Do you have an Errors & Omissions insurance policy? If so, what is the amount of the coverage? Does the policy cover trade errors?
18. Have you ever had to claim against your insurance policy for a trade error? If so, what were the circumstances?
19. Does the policy coverage extend beyond a named comingled fund to other structures such as managed accounts?