THE TA FORUM

BEST PRACTICE STATEMENT

Industry Error Liability Limitation

Overview

This document aims to provide industry guidance in respect of the stance on liability acceptance on errors made and is one of many initiatives that the TA Forum are looking at in order to promote best practice and provide clear guidance framework that our members can adopt within their own operational procedures.

In the past no specific guidance has been given by the industry as to a framework regarding liability acceptance. Much of the accepted procedures and processes have been developed over time through specific instances, which have established precedents influencing future discussions and decisions.

A number of scenarios have been considered through this paper:

- Telephone Dealing call backs
- Delays in identification of errors by other parties
- The position of the other party in our industry and the knowledge they may have

Whilst a strengthening of the stance will reduce the risk of significant financial loss, a number of potential implementation strategies have been documented for discussion with our members and other interested parties.

For each of the scenarios, analysis has been completed detailing the issue, the risk and importantly the way such risks can be reduced.

- Telephone Dealing – Enforce call backs so that details called back to and confirmed by the caller stand.
- Delays in identification – with the exception of retail investors, delays in excess of an agreed period to be the responsibility of the third party.
- Box decisions - within regulatory constraints Fund Managers to be supportive in seeking changes to Trustee decisions to reduce or eliminate potential risks.

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Influencing Factors

Commercials

Each deal, which requires amendment, will usually result in a profit or loss to one of the following:

- The Administrator
- Fund Manager
- Third Party / Investor

1.1. Regulation

Whilst the Financial Services and Markets Act (FSMA) has no direct power to impose responsibilities on consumers, the FSMA requires that, in deciding the appropriate level of protection for consumers, we are to be guided by the general principal that consumers should take responsibility for their actions. This is in addition to having regard to:[1]

- The needs that consumers have for advice and accurate information
- The differing degrees of experience and expertise that consumers may have in relation to different kinds of products or services; and
- The differing degrees of risk in investments or other transactions
- The general principal that consumers should take responsibility for their decisions

With this in mind the proposals contained within this paper aim to take into account the above points in defining areas of responsibility and when parties should be involved in the process. It is also noted that the FSA has previously adopted client categorisation as a means of achieving segregation within the conduct of business requirements.

Indeed in a speech in 2006 the then FSA chairman noted the importance of the role of the consumer. He said:

"*Were the FSA to aim to relieve consumers of all adverse consequences, an environment would be created in which they no longer needed to weigh up the reasonableness of their financial decisions. No market can work effectively without involved customers. To*

[1] FSA discussion paper 08/5

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relieve consumers of retail financial services of the consequences of their actions would destroy this as an effective market.

Consumer responsibility is therefore vital to the effectiveness of financial markets"

We believe that the proposals within this paper reflect the fact that responsibility to accurately place an investment instruction does not lie solely with the financial institution once the order is placed but both advisors and end consumers still have a responsibility to ensure that the outcome is as expected.

1.2. The legal position

In considering our position within this paper we have also considered common law as it applies to financial services transactions.

The following is taken from the FSA's consumer responsibility discussion paper:

Reasonableness

- The overriding principle is that the consumer should act reasonably. To decide whether a consumer has acted reasonably or made a reasonable effort, the court will consider what it would expect an average person of his kind to do.
- In its application to an individual the common law is partly subjective (taking account of what kind of person he is) but also objective (expecting him to act as the judge would expect a person of that kind to act).
- If a consumer acts unreasonably and so contributes to the loss that he or she suffers as a result of a financial services transaction, the court is likely to impose a proportionate limit on the amount they can recover.

Participation

- The consumer should play his part in the transaction.

Action

- The consumer should act properly and in time on advice received. This includes, for example, taking reasonable steps to mitigate or limit any loss, which he or she suffers as a result of a transaction that goes wrong.

It is with these in mind that we look to introduce a framework to allow the industry to act together in this and ensure that we are all treating customers fairly.

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1.3. The Fund and Trustee position

A number of the incidents that this paper seeks to cover are often discovered within a short period post the initial closure of the Fund on that day of trading.

Within the regulations, there is the facility to amend Trustee decisions after the initial communication has been completed.

Within the regulations the period during which amendments has been extended to settlement date, although not all Fund Manager have taken advantage of this change in regulation.

The relationship between Fund Manager and its Trustee is an important one and very often Fund Managers are protective of that.

Some Fund Managers are reluctant to allow these changes although well within the regulations and Trustees are also inconsistent in their allowance of these procedures.

It is often said that Trustees are resistant to allow the use of these regulations more than a couple of times a year as it would show a pattern of errors being made that would require further investigation.

We do not believe this to be the case as quality rates within the industry are well publicised, especially across the nominee world where these errors would normally occur with a number publishing league tables of Fund Manager Performance.
This shows that error rates are well below 1% and in any manual trading environment this would be considered satisfactory.

We are therefore proposing that common practice is adopted across Fund Managers and Trustees to allow full use of the regulations in this area.

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2
Proposed Changes

In order to minimise both financial and reputational exposure a number of changes/enhancements to the existing processes/working methods are being proposed.

2.1. Telephone Dealing

It is proposed that where telephone trades are then repeated back to the investor, the call scripts are amended to formally recognise that what is then repeated forms the legally binding contract between the parties and that any amendment to the details of a trade called back correctly (see scenarios below) will be at the third party's own cost.

Scenario 1

3rd Party requests UK Equity
Trade keyed as US Equity
Trade confirmed US Equity
3rd Party agrees

If 3rd Party requests a change to UK Equity it would be at their own cost

Scenario 2

3rd Party requests UK Equity
Trade keyed as US Equity
Trade confirmed UK Equity
3rd Party agrees

If 3rd Party requests a change to UK Equity it would be accepted subject to time constraints discussed further in this paper.

To reinforce this policy clarity at the beginning and towards the end of the call would be prudent as detailed below:

Beginning

The message at the start of all calls should be amended to for example: "Once placed all deals will be read back to you, please ensure you listen carefully as any errors subsequently identified will only be amended at your own cost".

End

Prior to all call backs the following statement should be read out "I am about to read back the deal that has been placed for you. What I am about to call back will form a binding contract, please listen carefully as any subsequent amendment will be at your own cost.

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2.2. Identification and Notification of Errors

Whilst a large percentage of errors are picked up internally, the manual nature of the process means that errors will, regardless of how well things are checked, slip through.

Where errors are made no specific agreed procedures exists limiting the time in which such errors should be identified and the liability accepted by the Fund Providers or the deal originator.

Increasingly, higher value trading and the increased market volatility have increased the ongoing risk of significant financial loss. This increased risk has not been mitigated against in some regard by the TA's through increasing our manual dealing fees, which in the main have stayed static for a number of years.

To apportion this risk appropriately between the parties involved, without the need to specifically increase related dealing fees clear understanding of roles, responsibilities and liabilities must be established.

It is therefore proposed that any error however made should be identified and communicated to the Fund Provider within a specified period.

The acceptability of this period will depend on the method and timing by which the trade was confirmed to the investor.

There are three types of end investor that should be considered:

1. Institutional
2. Advised Retail
3. Direct Retail

With all of the scenarios it should also be explicit within the scheme document and also the contract notes as to how liability is limited.

2.3. Institutional

Items that should be considered are:

- Whether the trade was confirmed electronically via EMX, Calastone or other STP systems
- If and when a paper contract note was sent to the client.
- If and when a reconciliation report was available to the client.

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The overriding factor would be the electronic deal confirmation or the paper contract note. Once that has been sent only a few days should be allowed to rectify any error made.

It is therefore recommended that liability be accepted for a maximum period of 4 working days after the trade has been dealt. This will then match with our proposals on Trustee decision amendment and negate losses.

Detailed below are 2 worked examples to demonstrate how the above methodology might be applied:

Scenario 1

20th Jan
Instruction received by post to Buy 1000 UK Equity units
Instruction keyed to Sell 1000 UK Equity units
Deal confirmation report sent confirming days trades

21st Jan
Paper contract note sent via Royal Mail

1st Feb
Reconciliation report available detailing all trades placed for the previous month.

4th Feb
Client contacts Fund Provider identifying trading error.

In this scenario liability should only be accepted until 24th Jan (Deal + 4 days)

Scenario 2

20th Jan
Instruction received via EMX to Buy 1000 UK Equity units
Instruction not processed
Electronic contract note not returned as expected once pricing complete

1st Feb
Reconciliation report available detailing all trades placed for the previous month.

4th Feb
Client contacts Fund Provider identifying trading error.

In this scenario liability should only be accepted until 24th Jan (Deal + 4 days)

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2.4. Advised retail

Items that should be considered are:

- Whether the trade was confirmed electronically via EMX or other electronic means
- If and when a paper contract note was sent to the client and the agent.
- If and when a reconciliation report was available to the agent.
- When the client or agent received a statement

We believe that the agent has a duty of care to the end investor as part of the contract between them to ensue that the instructions have been completed correctly.

We would suggest that as both the agent and client should see the contract note this should be the overriding factor. Once that has been sent only a few days should be allowed to rectify any error made.

It is therefore recommended that liability be accepted for a maximum period of 5 working days after the trade has been confirmed (electronically or by paper)

In the case of paper contract notes a reasonable period (3 days) should be allowed for these to have been delivered.

Detailed below as a worked example to demonstrate how the above methodology might be applied:

Scenario 1

20th Jan
Instruction received by post to Buy 1000 UK Equity units
Instruction keyed to Sell 1000 UK Equity units
No electronic deal confirmation available

21st Jan
Paper contract note sent via Royal Mail to both client and agent.

4th Feb
Client contacts Fund Provider identifying trading error.

In this scenario liability should only be accepted until 29th Jan (Paper contract note + 3 days + 5 days)

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2.4.1. Direct Retail

Items that should be considered are:

- If and when a paper contract note was sent to the client.
- If and when a distribution has been paid on the fund and advice notes sent.
- When the client received a statement

This is the least experienced type of investor to look at but there are still legal requirements that can be enforced to limit liability.

As previously covered within this paper we believe that the client has to take some responsibility in ensuring that the instructions were carried out correctly.

We would suggest that once the client has been in receipt of a notice that shows what the investment made was then this should be sufficient for them to have spotted the error and informed the Fund Provider.

It is therefore recommended that liability be accepted up to 30 days post the arrival of the first notice delivery. This position has already has been upheld by the ombudsman in a number of rulings.

Detailed below are 2 worked examples to demonstrate how the above methodology might be applied:

Scenario 1

20th Jan
Instruction received by post to Buy 1000 UK Equity units
Instruction keyed to buy 1000 US Equity units

21st Jan
Paper contract note sent via Royal Mail

1st Feb
Distribution advice sent (Monthly Paying Fund).

1st March
Distribution advice sent (Monthly Paying Fund).

4th March
Client contacts Fund Provider identifying trading error.

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In this scenario liability should be accepted until 21st Feb (First advice point + 30 days)

Scenario 2

20th Jan
Instruction received via post to Buy 1000 UK Equity units
Instruction keyed to Buy 1000 US Equity units

21st Jan
Paper contract note sent via Royal Mail but returned as undelivered

1st Feb
Distribution advice sent (Half yearly paying Fund) but returned as undelivered

1st March
Client contacts Fund Provider with new address details

25th April
Statement sent to client.

4th August
Client contacts Fund Provider identifying trading error.

In this scenario liability should only be accepted until 25th May (Statement being first advice + 30 days)

2.5. The Fund and Trustee position

Within the regulations and the individual service agreements between Fund Managers and Trustees it is possible to amend decisions within the settlement period.

As detailed previously many Fund Managers are reluctant to request such amendments.

It is therefore recommended that formal agreement be obtained to utilise the regulations and the service agreements between Fund Managers and Trustees.

These formal agreements will document an agreed process whereby errors are identified and if within the settlement period the amendment request is accepted.

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