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Autumn Legal Update: Duties and Trade Errors

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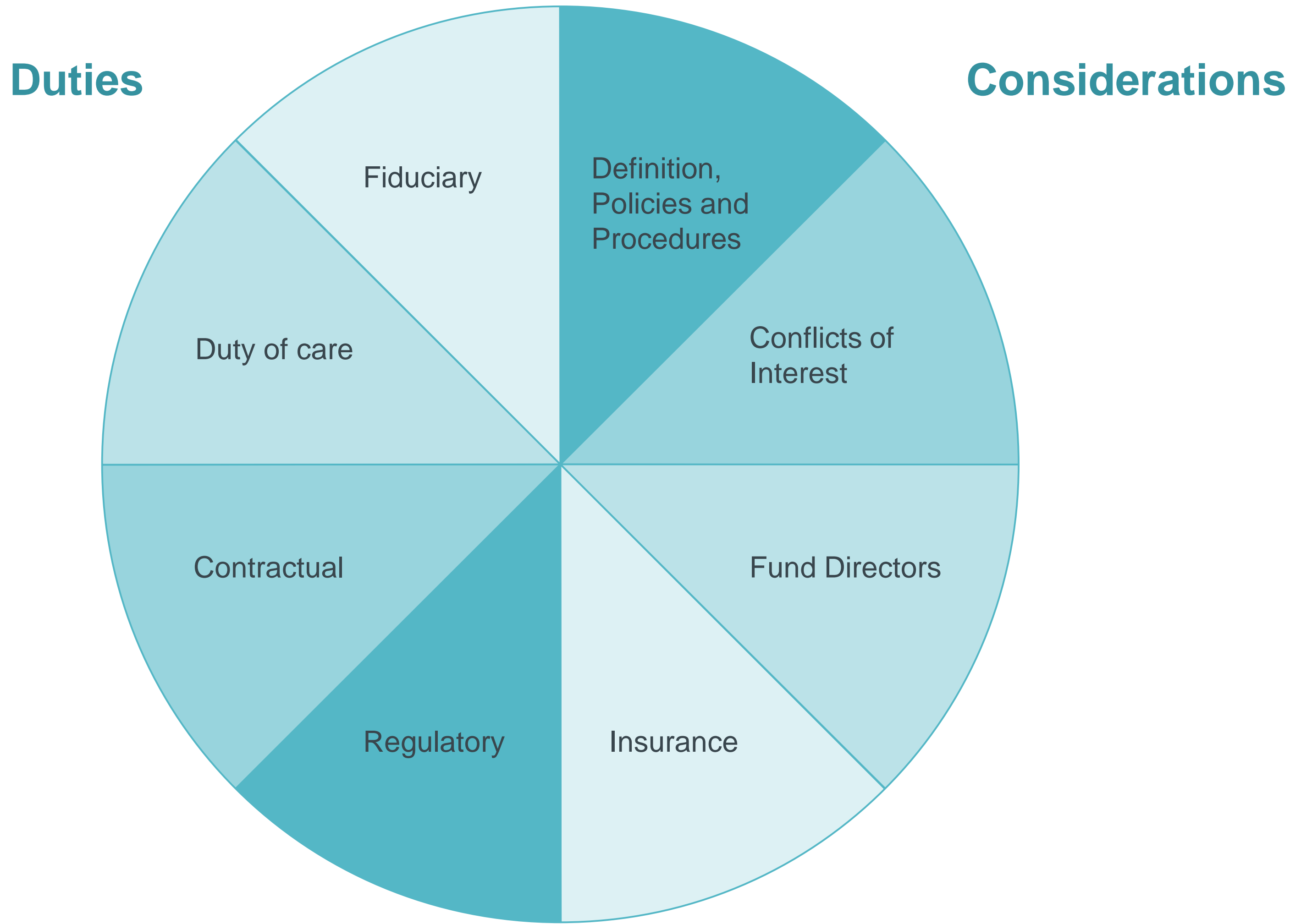
Introduction



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Definition

- There is no agreed market definition of what constitutes a trade error and practice varies between managers
- However, usually covers:
  - a clerical entry error (a so-called “fat finger” error)
  - trading outside the scope of the mandate
  - trading outside the scope of applicable law
  - trading in the wrong instrument
  - duplicating a transaction
  - failing to execute a transaction
  - executing a transaction at the wrong time
  - misallocating a trade to an incorrect client or fund
  - hedging errors
- The definition used is important in the context of (1) internal policies and procedures governing the reporting, investigation and remediation of trade errors (2) liability and (3) the scope of any applicable insurance policy

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Definition (2)

- Distinctions of potential significance
  - errors of an individual for which the firm is responsible (vicarious liability)
  - errors of the firm, including in not picking up the “inevitable” errors of individuals
  - timing of identification and correction
- Running errors
  - free standing second investment decision?
- “Black box” errors

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Duties impacting how trade errors are handled

Fiduciary duties and errors

- A Fiduciary relationship arises where two parties agree that one will act on behalf of the other in circumstances which give rise to a relationship of trust and confidence
- The Fiduciary duties relevant to trade errors include:
  - no profit
  - no conflict
  - undivided loyalty
- There is no Fiduciary duty not to make errors, and a Fiduciary is not subject to a higher standard of care
- Discharge through disclosure (nb. regulator concerns re over-reliance)
- Modification by contract

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Duty of Care (tortious duty)

- The regulators view:

  2005 – DP 05/04 "Hedge funds: A discussion of risk and regulatory engagement"

  "*There appears to be no common understanding among hedge fund managers on whether trading errors should be borne by the fund manager or the fund. We think that the hedge fund manger, as a matter of law, must bear the costs of any errors for which it is responsible, in dealing with fund assets.*"

  2006 – FS 06/02 "Feedback on DP/05/04"

  "*In…the DP we…set out our thinking on whether liability for the cost of trading errors should be borne by the fund manager or the fund. We did receive an enquiry about our summary of the position, making the point that trading errors might very well not lead to liability as a matter of law. In particular, the respondent asked us to clarify that it is open to a hedge fund manager to protect itself from what it would otherwise be legally responsible for by an agreement reached between the contracting parties to include an appropriately worded clause in the fund documents in which the fund/investor agrees to an exclusion of liability clause.*

  So for the sake of clarity, our view is 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."

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Duty of Care (2)

- Short point: liability at law for negligent errors, but not for non-negligence errors – though other considerations mean many managers remediate and compensate in any event
- Liability depends on: breach of duty of care + loss, caused by the breach
- The standard: *to exercise the reasonable skill and care to be expected of a manager of the relevant type and experience*
- The inevitability point: in any organisation executing hundreds / thousands / millions of trades, even with the exercise of due care, errors are inevitable
- Whether the standard has been breach may depend on the circumstances – e.g. fast-moving and volatile market, extreme events
- Why that is? "*The law makes allowance for the difficulties in circumstances in which professional judgements have to be made and acted upon*" (*Lord Diplock, Saif v Mitchell & Co* [1980] AC 198 (HL))

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Contractual duties

- Freedom of contract means that duties and the consequences of breach can be adjusted
- The nature of the client and the impact of bargaining power – some managers able to carve-out substantial liability for trade errors, but not others
- The impact of the views of regulators when negotiating such carve-outs – a reasonable carve-out is likely to vary for different investor categorisations – and the importance of disclosure
- The mandate may specifically stipulate whether trade error losses and/or profits are passed on from the manager to the fund or it may indirectly be covered by the standard limitation/exclusion of liability provisions
- Gross negligence: will be given effect within limitation of liability clauses

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Regulatory duties

- While there are no specific FCA rules on trade errors, they fall within the FCA's principles/rules relating to conflicts of interest contained at Principle 8 and SYSC 10
- Under FCA rules, a firm must take all reasonable steps to identify conflicts of interest between (1) the firm and a client and (2) one client and another client
- The core FCA requirements with regards to conflicts of interest are:
  - have a comprehensive and written conflicts of interest policy that identifies the activities/services potentially giving rise to conflicts and the specific procedures/mitigants to manage those conflicts
  - over-reliance on disclosure is discouraged
- In a thematic review of conflicts of interest (2012), the FSA (as it then was) found that *"Most firms had clear arrangements for handling errors, but some were too reliant on contractual limitations to avoid reporting the cost of errors to customers"*
- Examples of good practice:
  - having reporting procedures and systems in place, with encouragement to report and compliance/board-level review
  - not permitting counterparties to accommodate error correction costs
  - having a "make whole" policy where customers are entitled to gains with limited exceptions (such as netting or where the customer rejects the trade)

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Policies and procedures – Allocation

- The most significant policy consideration for managers is to choose their preferred approach to allocating the profits and losses arising from trade errors
- The approach to trade errors may not be specifically contemplated in the mandate – however, the approach may already be pre-determined through a wider limitation/exclusion of liability and indemnity provisions in the IMA
- Definitional and carve-out options:
  - materiality thresholds
  - offsetting gains and losses
  - running errors
  - omissions to trade
  - timeframes e.g. T+1
- A 2016 hedge fund industry (NY and UK) survey revealed:
  - the majority of hedge funds adopted a policy where the fund received the profits from trade errors but was either fully responsible for losses or responsible except in cases of gross negligence, wilful misconduct and fraud by the manager
  - a large majority did not have a materiality threshold for categorising trade errors
  - only a small percentage did not have a trade error policy in place

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Policies and procedures – Other considerations

- Key drivers:
  - the definition of a trade error
  - responsibilities and escalations for reporting, investigating and remediating trade errors
  - whether employees have a responsibility to report trade errors (and whether sanctions are appropriate in the event of a failure to report)
  - the existence of an effective second line of defence to detect errors (e.g. end of day reconciliations)
  - the methodology used to calculate the value of trade errors (and any netting)
  - insurance requirements
  - record keeping

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2012 Conflicts thematic + recent regulatory focus

- 2011-2012 thematic review of conflict of interest management by asset managers
  - the principal concerns included trade errors
- Focussed on the allocation of costs of trade errors between manager and fund
- Key finding:

  "*Most firms had clear arrangements for handling errors, but some were too reliant on contractual limitations to avoid reporting the cost of errors to customers*"
- Good practice examples:
  - Reporting procedures/systems, encouragement to report plus compliance/board level decision review
  - Counterparties not permitted to accommodate error correction costs
  - Make whole policy; customer entitled to gains with limited exceptions (netting, customer rejects trade)
- Bad practice example
  - Non-reporting of errors to client where firm decided it was not liable

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Trade error policies – key issues

- Defining what a trade error is
- Approach to reimbursement
  - discretion vs automatic outcome
  - netting of gains vs losses
  - running an error – when does the loss period end?
  - materiality
- Reporting
  - internally
  - to Fund/other client

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Conflicts of interest and fund directors

- Conflict of interest inherent in any determination as to whether or not to reimburse
- Managing that conflict:
  - who decides
  - reviews on a client neutral / P&L neutral basis
  - fund reporting / fund review
- Fund directors' duties to the fund / investors when reviewing error allocation - particularly where a manager is responsible for determining whether or not it (the manager) acted negligently
- Common fund director concerns
  - can I / should I take advice?
  - who from?
  - how can I decide?
  - how hard do I have to look?
  - might I be liable?

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The Error Trade Document Trail

- Transactional document trail – concept to internal reporting of execution
- Identification escalation and diagnostics
- Review and consideration
- Reporting and Board Review
- Error log

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Insurance considerations

- Errors and Omissions ("E&O") policies may provide coverage for trade errors – coverage may be triggered when a claim is brought against the manager or a covered employee of the manager for the alleged error.

- In the US insurance market, Cost of Corrections Coverage ("CoC") may also be available – which amends the trigger in an E&O policy so that it arises when the trade error occurs and does not require a claim to be brought. This may become more prevalent in the UK in the future.

- The type of coverage available may depend on fund type – a high frequency strategy may make CoC coverage difficult to obtain.

- It is important to consider the interplay between the insurance cover protecting the manager and any limitations/exclusions in the mandate. If the limitations/exclusions are considerably more restrictive than the insurance cover, this may be queried by the investors.

- It is also important to ensure that all necessary notifications are made in a timely manner and the terms of the policy are taken into account before remediating trade errors (*e.g.* would immediately remediating the error invalidate the insurance cover?)

- A 2016 survey into the approach of hedge funds to trade errors revealed that more than 80% of managers had some form of insurance policy covering trade errors.

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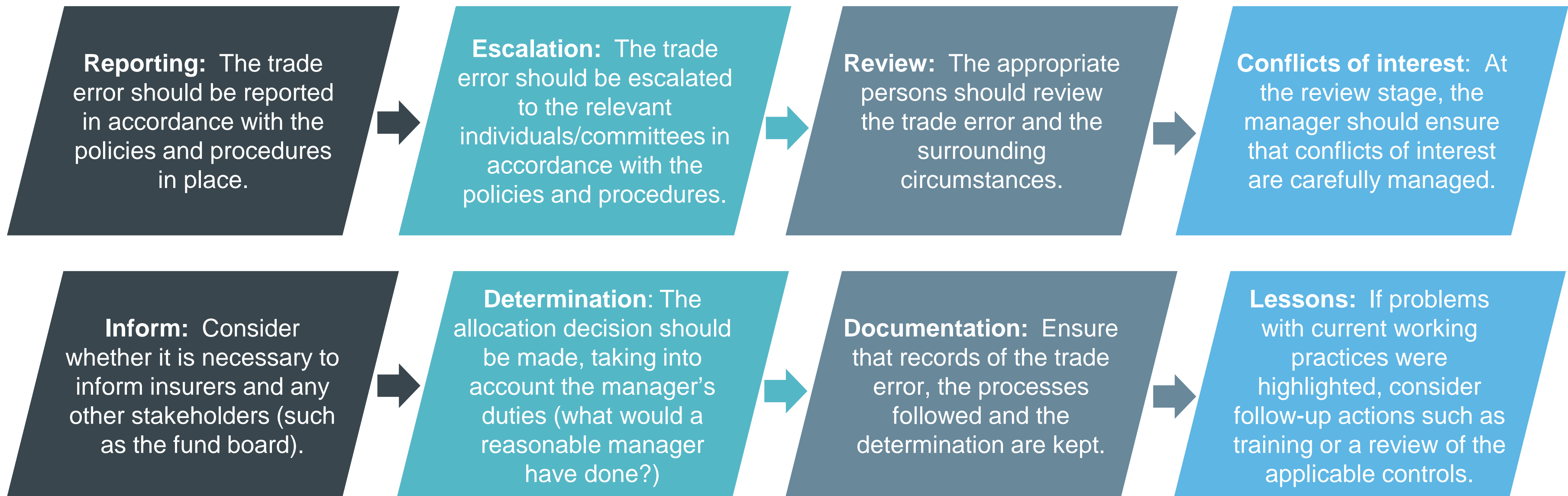
Worked examples

Worked examples

- **Example 1:** When purchasing equities, a trader inadvertently makes a keyboard input error which results in a significantly larger order being placed. After the order is fulfilled, the trader realises the mistake which has, at that point, resulted in a loss. The trader determines to run the position and it ultimately results in a small net profit.
- **Example 2:** A trader shorts a packaged product which includes a Greek security, resulting in a net short position on that security. A short selling ban on the Greek security came into effect the day before. The error is noticed later the same day by a second trader.
- **Example 3:** A trader crosses a trade between two funds without obtaining pre-approval and without obtaining a competitive external price. The error is noticed during the end of day reconciliation process.



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Thank you

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