FSC Standard No. 17

Errors in Pricing/Crediting Rates when Determining Scheme Interests – Correction and Compensation

July 2018

FINANCIAL SERVICES COUNCIL

FSC Standard No. 17

Errors in Pricing/Crediting Rates when Determining Scheme Interests – Correction and Compensation

July 2018

[NOTE: This version of Standard 17 incorporates changes to accommodate the introduction of FSC Standard 8A on "Crediting Rates". For further information or to obtain a marked up copy, please contact David McGlynn, FSC Senior Legal Counsel, on (02) 8235 2534 or dmcglynn@fsc.org.au.]

FSC Membership this Standard is most relevant to:	This Standard applies to FSC Members generally and in particular Members who are Operators of a Scheme using Crediting Rates.
Date of this version:	1 July 2018
History (prior versions) of this Standard:	This Standard was issued on 19 July 1999 and updated in October 2006.
Main Purposes of this Standard:	The main purposes of this Standard are as follows: (a) to set minimum requirements and principles (i) for occasions when incorrect prices or incorrect crediting rates have been calculated and transacted upon, and used to allocate Interest in a Scheme; and (ii) for determining when compensation is required that arises as a result of incorrect unit prices or crediting rates; (b) to assist Scheme Operators in dealing with and compensating for errors in relation to the incorrect pricing of scheme units or incorrect calculation of crediting rates.

This Standard is to be read in conjunction with Standard 2, Standard 6, Standard 8, Standard 8A, Standard 9, Standard 10, Guidance Note 1, Guidance Note 25, Guidance Note 26, Guidance Note 29, Guidance Note 31, Guidance Note 34, Guidance Note 38.

FSC Standard No. 17

Table of Contents

FSC Standard No. 17

1 Title

1.1 This Standard may be cited as FSC Standard No. 17 ‘Errors in Pricing/Crediting Rates when Determining Scheme Interests - Correction and Compensation’.

2 Application

2.1 This Standard must be applied by the Operator of a Scheme (“Scheme Operator”) (whether offered for public subscription or otherwise) in relation to the Scheme.

2.2 Where there is a conflict between the requirements of this Standard, applicable legislation, and the Constituent Documents, the requirements of this Standard must, having regard to the purpose of this Standard (refer to paragraph 3.1), be modified appropriately.

2.3 It is recognised that Constituent Documents, while complying with applicable legislation, vary. Where a requirement of this Standard cannot be met (because to comply would conflict with the applicable legislation or with any Constituent Document) a Scheme Operator must, as far as practicable, comply with the requirements of this Standard.

2.4 This Standard may not cover every situation of incorrect pricing or incorrect crediting rates faced by a Scheme Operator. Where a situation is not covered, a Scheme Operator should have regard to the principles set out in this Standard and the Statement of Principles in particular in paragraph 3.1.

3 Statement of Purpose

3.1 The main purposes of this Standard are as follows:

(a) to set minimum requirements and principles:

(i) for occasions when incorrect prices or incorrect crediting rates have been calculated and transacted upon and used to allocate Interest in a Scheme; and

(ii) for determining when compensation is required that arises as a result of incorrect unit prices or crediting rates;

(b) to assist Scheme Operators in dealing with and compensating for errors in relation to the incorrect pricing of scheme units or incorrect calculation of crediting rates.

3.2 This Standard has been prepared by reference to the Joint ASIC and APRA Unit Pricing Guide to Good Practice issued November 2005 and updated in August 2008 (refer to ASIC Regulatory Guide 94).

3.3 FSC Standard No. 8 “Scheme Pricing” covers the determination of Scheme prices and FSC Standard 8A covers the determination of crediting rates. Scheme prices and crediting rates are calculated following a valuation of Scheme assets determined in accordance with FSC Standard No. 9 'Valuation of Scheme Assets and Liabilities'.

3.4 The duty of the Scheme Operator extends to taking all reasonable steps, and exercising due diligence, to ensure the Scheme is correctly priced/crediting rates are correctly calculated.

3.5 The appropriate treatment of incorrect pricing/crediting rates has been a recurring administrative problem amongst Scheme Operators.

3.6 The Scheme Operator has a fiduciary duty to act in the best interests of Scheme Investors, and must exercise discretion in accordance with this duty in any particular case. FSC has issued this Standard to provide requirements for Scheme Operators to ensure that they act in the best interests of Scheme Investors on a consistent basis. However, the requirements are not intended to be exhaustive.

4 Application of Materiality

4.1 This Standard applies to the treatment of errors in the pricing/crediting rates to determine interests in a Scheme. In forming a policy for managing such errors, a Scheme Operator may choose to use a level of materiality to assess whether an error requires compensation to be considered for Investors in a Scheme, or the Scheme itself.

For the purposes of this Standard, the materiality used for such an assessment must be no more than 0.3% of the Interest in a particular Investment Option in a Scheme.

4.2 The size of a unit pricing/crediting rate error can be assessed by measuring the size of the variance between an Investor's incorrect Interest and their correct Interest, as a percentage of the correct Interest, at a particular point in time. The calculation must allow for all known errors present in the unit price/crediting rate at the time of calculation. Where the size of the unit pricing/crediting rate error is above the adopted materiality threshold, it is then necessary to look at the implications of the incorrect price/crediting rate to determine what compensation is required.

4.3 The Scheme Operator must also consider whether it is appropriate to apply a materiality test to the effect of the error on Investor benefits. This may be appropriate, for example, where the size and direction of a unit pricing/crediting rate error has been variable, but the error has not resulted in any Investor's Interest being wrong by more than the adopted materiality threshold.

4.4 In setting materiality thresholds, the Scheme Operator must consider:

(a) The nature of the assets of the Scheme;
(b) The nature of the error; and
(c) Any other circumstances or obligations which may suggest that a lower materiality threshold is appropriate.

4.5 A situation where a lower materiality threshold may be appropriate is a Scheme that only holds cash assets, where a reasonable materiality threshold for a Scheme may be 0.05%.

4.6 Where the Scheme Operator has financially benefited from an error, the Scheme Operator must pay compensation such that the Scheme Operator does not retain the financial benefit.

4.7 Where compensation is payable under paragraph 4.6, the compensation may be payable to the Scheme, or to past and present Investors, based upon the materiality threshold adopted as per paragraph 4.1 and taking into account the legislative obligations of the Scheme Operator.

4.8 A sample Decision tree has been provided as Appendix 1 to this Standard to provide guidance to FSC Members in managing and assessing pricing and crediting errors.

5 Definitions

5.1 In this Standard:

- 'Associate' has the same meaning as in FSC Guidance Note No. 5 "Industry Terms and Definitions";
- 'Compensatable Error' means a unit pricing/crediting rate error where the impact of the error on any Investor's Interest is greater than the materiality threshold adopted in accordance with paragraphs 4.1 and 4.2, and where compensation must be paid as described in section 9 of this Standard;
- 'Constituent Documents' of a Scheme means the material governing documents and governing rules for a Scheme, including but not limited to, the Product Disclosure Statement, Constitution, Trust Deed or Information Memorandum or other relevant disclosure document relating to the a Scheme;
- 'Entry Price' means the Scheme price at which an Investor acquires an equitable interest in a Scheme;
- 'Exit Price' means the Scheme price at which a Scheme Holder realises an interest in the Scheme;
- 'Interest' means an undivided portion of the equity of a Scheme;
- "Investment Option" means a unique offering comprising a pool of assets from a number of Investors, which are invested with a common investment mandate, and share a common set of fees and conditions. Therefore each Investment Option will have its own unique returns. Individual investment options available within a fund or product will comprise

separate investment options, and different classes within a fund or product will comprise separate investment options;

- within a fund or product will comprise separate investment options;
- 'Investors' has the same meaning as in FSC Guidance Note No. 5 "Industry Terms and Definition";
- 'FSC Member' refers to a 'Full Member' as defined in FSC's Constitution;
- 'Non-Compensatable Event' means a unit pricing error/crediting rate error where the impact of the error on any Investor's Interest is less than the materiality threshold adopted in accordance with paragraphs 4.1 and 4.2;
- 'Operator' has the same meaning as in FSC Guidance Note No. 5 "Industry Terms and Definitions".
- 'Prices', in relation to a Scheme, together mean the Entry Price and the Exit Price of that Scheme;
- 'Scheme' has the same meaning as in FSC Guidance Note No. 5 "Industry Terms and Definitions"; and
- 'Scheme Assets' means the assets and liabilities of the Scheme, the valuation of which is determined in accordance with FSC Standard No.9 "Valuation of Scheme Assets and Liabilities".

6 Principles for the Assessment and Compensation of Errors in the Pricing /Crediting rates to determine interests in a Scheme

6.1 A Scheme Operator's processes for the assessment and compensation of errors in pricing/crediting rates must meet the following criteria:

- they must be documented and transparent;
- they must individually rectify past and present Investors that have been affected by a materially incorrect unit price/crediting rate;
- they must consider the obligations of Scheme Operators under relevant legislation;
- they must not result in any residual benefit to Scheme Operators; and
- they must be regularly reviewed.

7 Pricing Controls by Scheme Operators

7.1 It is required that the Scheme Operator complies with all FSC Standards related to the valuation of Scheme Assets and liabilities and Scheme pricing/crediting rates, in particular FSC Standard No. 9 'Valuation of Scheme Assets and Liabilities' and FSC Standard No 8 'Scheme Pricing', and FSC Standard 8A 'Crediting Rates'.

7.2 Legislative and fiduciary responsibilities require Operators to operate a Scheme in a professional manner for the benefit of Scheme Investors. The responsibilities include having adequate controls and systems in place to ensure that all elements of the valuation of Scheme Assets and pricing/crediting rates for determining Scheme Interests are conducted in an accurate, timely and consistent manner. Adequate documentation regarding source data, calculations and outputs must be maintained. Scheme Operators must also ensure that outputs from the valuation and pricing/crediting rate functions are monitored, with appropriate indicators and benchmarks in place which will signal any possible errors.

7.3 Where the pricing/crediting rate function is delegated to a third party ("**the pricing/crediting rate agent**"), the Scheme Operator will need to satisfy itself that the pricing/crediting rate agent's systems are robust and will procure accurate results. The Scheme Operator must continuously review the outputs from the pricing/crediting rate agent to satisfy itself that the pricing/crediting rate agent remains competent to carry out the function, and that it has taken reasonable care to ensure that the pricing /crediting rate agent has carried out its duties in a competent manner.

8 Documented and Transparent Assessment and Compensation of Errors in Pricing/Crediting Rates when Determining Scheme Interests

8.1 FSC Members must have a policy framework in place that documents the adoption of the Principles for the Assessment and Compensation of Errors in calculating Pricing/Crediting Rates. The policy framework must include, at a minimum:

- delegated authorities for policy approval;
- reporting requirements;
- processes to confirm the completeness of and compliance with policies;
- training requirements for policy awareness;
- the alignment of procedures to policies;
- ongoing review of policies and procedures; and
- outsourcing arrangements (where appropriate).

8.2 The Scheme Operator's policies governing the assessment and management of errors in calculating Pricing/Crediting Rates must, at a minimum, include documentation of:

- the Scheme Operator's definition of what constitutes an error in unit pricing/crediting rates;
- the principles adopted by the Scheme Operator in assessing and rectifying errors in unit prices/crediting rates;
- error notification, recording and reporting protocols;
- delegated authorities and approvals for compensation payments;
- the size of, and basis used to determine, any materiality thresholds used in assessing errors in Scheme unit prices/crediting rates; and
- communication protocols regarding errors in Scheme unit prices/crediting rates to Investors and regulators.
- A Scheme Operator's error assessment process will include a determination of whether an error is a Compensatable Error or a Non-Compensatable Event, based on the materiality thresholds adopted in accordance with paragraphs 4.1 and 4.2 (also refer to Appendix 1 of this Standard).

8.3 From time to time, adjustments may need to be made to unit prices/crediting rates as a result of approximations or estimates being updated to actual figures as they become known, or due to a change in methodology or policy. Such an adjustment is not considered to be an error under this Standard where the adjustment to unit prices/crediting rates occurs as a result of the consistent application of sound policy. Conversely, if policy or estimates are found to be inappropriate, or application of policy has been deficient, adjustments to unit prices/crediting rates may be errors requiring compensation.

8.4 An example of a decision tree that may be used to differentiate between unit pricing/crediting rate adjustments, Compensatable Errors, and Non-Compensatable Events is included as an appendix to this Standard.

8.5 Scheme Operators may disclose information to Investors about how errors in Scheme unit prices/crediting rates would be assessed and managed in the event that they occur, including information about materiality thresholds that may be adopted in the error assessment and compensation process.

8.6 Errors must be reported to the appropriate level of management within the Scheme Operator. All errors must be recorded and action taken to minimise the risk of recurrence.

8.7 When an error in unit pricing/crediting rate occurs and compensation is payable to past and/or present Investors, the Scheme Operator must make reasonable efforts to communicate to affected Investors and describe the nature of the error, how the error will be rectified, and how the affected Investor will be compensated for the error.

9 Compensation of Errors in Pricing of Scheme Units/Crediting Rates

9.1 Where a Compensatable Error has been identified, compensation to or from past and/or present Investors or the Scheme will be required where the Investors or the Scheme have been disadvantaged as a result of the Compensatable Error.

9.2 Where incorrect prices have been calculated and transacted upon, or, for crediting rate schemes, where incorrect crediting rates have been calculated and used to allocate Interest in a Scheme, and the errors is more than the materiality threshold adopted under paragraph 4.1, it is required that the Scheme and/or Investor be compensated to the extent that they have been disadvantaged.

9.3 The Scheme Operator may choose to recover amounts from Investors who have been advantaged by a Compensatable Error.

9.4 The Scheme Operator may conclude that an effective means of compensation is to re-book applicable transactions using the correct unit price (or reapply the correct crediting rate(s)). In doing this, Scheme Operators should have appropriate regard to any backdating implications of these amended entries, and should consult FSC Standard No. 8 “Scheme Pricing” or FSC Standard No. 8A “Crediting Rates” for further guidance.

9.5 Where there is more than one factor at any one time which causes an incorrect price/crediting rate to be calculated, compensation will be required whenever, and so long as, the combined effect on any one day results in a Compensatable Error.

9.6 Under certain circumstances, Scheme Operators may elect to set a minimum dollar compensation amount before compensation will be paid to an Investor. Where such a threshold is adopted, the maximum amount of such a threshold is $20.

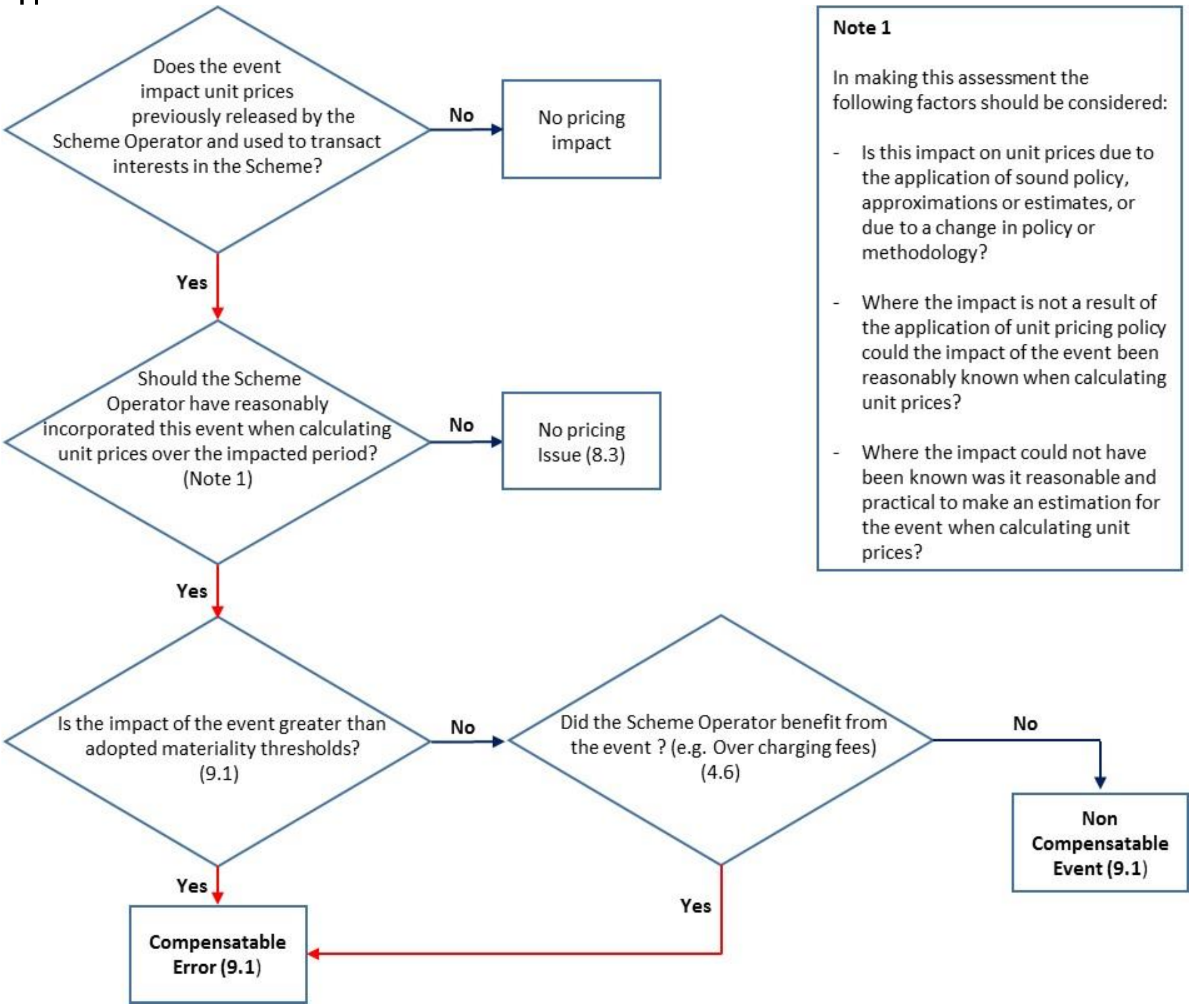
9.7 In choosing whether to adopt a threshold for compensation payments, the Scheme Operator must consider:

- legislative obligations;
- the possible effects on Investors in the Scheme of costs associated with the payment of small amounts of compensation; and
- the obligations of the Scheme’s Constituent Documents.

9.8 Where a Non-Compensatable Event has occurred, consideration must be given to whether any further action is required to correct the pricing or crediting rate of the Scheme.

9.9 Examples of further action that may need to be taken could include (but is not limited to) processing a transfer of funds between investment options in a superannuation fund, adjustment of an accrual within a unit price, or adjustment of a tax provision or crediting rate, superannuation fund, adjustment of an accrual within a unit price, or adjustment of a tax provision or crediting rate.

Appendix 1


Does the event impact unit prices previously released by the Scheme Operator and used to transact interests in the Scheme?
No
No pricing impact
Yes
Should the Scheme Operator have reasonably incorporated this event when calculating unit prices over the impacted period? (Note 1)
No
No pricing Issue (8.3)
Note 1
In making this assessment the following factors should be considered:
- Is this impact on unit prices due to the application of sound policy, approximations or estimates, or due to a change in policy or methodology?
- Where the impact is not a result of the application of unit pricing policy could the impact of the event been reasonably known when calculating unit prices?
- Where the impact could not have been known was it reasonable and practical to make an estimation for the event when calculating unit prices?
Yes
Is the impact of the event greater than adopted materiality thresholds? (9.1)
No
Did the Scheme Operator benefit from the event ? (e.g. Over charging fees) (4.6)
No
Non Compensatable Event (9.1)
Yes
Yes
Compensatable Error (9.1)