Global Risk Management Advisors
Investment Risk Management

WHITE PAPER

Key Operational and Risk Management Considerations for Complying with N-PORT Reporting

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On October 13, 2016, the US Securities and Exchange Commission (SEC) approved new and comprehensive rules to address liquidity risks for mutual funds. In addition, the SEC adopted new mutual fund reporting rules and an optional "swing pricing" rule.

Key elements of the liquidity risk management rule include:

- *Liquidity Risk Management programs:* All mutual funds and open-end ETFs (except for money market funds and unit investment trusts) must implement a formal program for liquidity risk management which includes risk assessments of liquidity risk, a "highly liquid investment minimum" and liquidity classifications for investment funds.

- *Disclosure Requirements:* There are increased disclosure requirements for policies to meet redemptions. Specifically, Form N-PORT will require funds to provide detailed liquidity information to the SEC, including position-level liquidity classifications that will remain private and aggregate liquidity information that will be made public.

- *Breach Reporting:* Funds will be required to inform the SEC on Form N-LIQUID any time they breach their 15% illiquid investment threshold and of any breaches of their highly liquid investment minimum that continue for more than seven consecutive days. Any breaches must also be reported to the fund's board of directors.

N-PORT Reporting

Form N-PORT, an integral part of the SEC's new liquidity risk management rule, requires registered management investment companies and ETFs organized as unit investment trusts, (other than registered money market funds or small business investment companies) to electronically file monthly portfolio investment information with the SEC. Form N-PORT also requires that a fund reports the liquidity classification of each of its positions in a portfolio investment and identify its highly liquid investment minimum.

Funds with more than $1b in AUM are required to submit starting June 1, 2018 while those falling below that threshold begin one year later.

Submissions for Form N-PORT must be filed no later than 30 days after the close of each month. While N-PORT must be submitted monthly, only the fund's fiscal quarter end reports will be publicly available after a 60-day delay. Liquidity classification information and information on a fund's highly liquid investment minimum will be considered confidential by the SEC with the exception that aggregate statements of a fund's holdings in each of the four liquidity categories will be publicly available.

The purpose of new reporting requirements such as N-PORT are intended to assist SEC staff with assessing funds' regulatory compliance, identifying funds for examination, pursuing enforcement actions against funds, and monitoring risks of individual funds, as well as industry-wide trends and risks. Furthermore, the SEC anticipates that the data gathered will be useful to inform policy-making decisions.

In addition, the SEC has stated that institutional investors and third-party providers that offer services to investors may find Form N-PORT disclosures useful for assessing a funds' investment practices. The data from N-PORT can be used by investors to better understand a funds' investment strategies and risks and to compare funds of similar strategies.

Major Governance Issues Related to N-PORT Reporting

Under the new liquidity risk management rule, a fund's investment adviser or officers administering the fund's liquidity risk management program are required to submit written reports to the fund's board concerning the adequacy and effectiveness of the fund's liquidity risk management program and its highly liquid investment minimum. This new regulation places the onus on the fund itself to have proper governance and processes in place for a liquidity risk management program which includes N-PORT reporting to the SEC.

The SEC defines "liquidity risk" as the risk that a fund might not meet requests to redeem shares issued by the fund "without significant dilution of remaining investors' interests in the fund." Since the SEC has put the burden on funds to decide how to interpret their definition of liquidity risk, a fund's management and the Board will need to make a number of assumptions and key decisions about governance and implementation before they can proceed with satisfying these new regulatory requirements.

For example, a fund will need to tackle the following issues:

- *Highly Liquid Investment Minimum:* The fund will need to determine its own highly liquid investment minimum, taking into account the liquidity risk factors such as investment strategy, fund flows and fund redemption policies.

- *"Significant Dilution":* A fund will need to define what the term, "significant dilution" in the rule means. Funds will need to define thresholds that are reasonable in the context of their fund's investment holding from a market place standpoint, as well as defensible from a regulatory review or examination perspective.

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- *Liquidity Buckets:* Given that each of the rule's four classification categories turns on whether an investment can be converted to cash within a given period without "significant change" in the market value of the investment, a fund will need to establish a sound and reasonable methodology for determining "price impact" for the purposes of bucketing their investments into one of the four prescribed liquidity categories.

- *"Stressed" Markets:* The requirement to assess a fund's strategy and portfolio liquidity both in normal and reasonably foreseeable stressed conditions was not defined by the SEC. Therefore, a fund will need to develop parameters for what they consider to be "stressed" versus "normal" market conditions in coming up with their liquidity bucketing and risk management.

Key Recommendation: Given the short compliance timeframe for funds holding more than $1b in AUM, we recommend simultaneously developing a governance plan while starting operational work to fulfill N-PORT requirements. For smaller firms, however, we recommend that a fund first create a governance plan for liquidity risk management, as well as associated policies and procedures, and only begin operational work to fulfill the N-PORT regulatory reporting requirements once that initial governance work is done.

Key Operational and Risk Management Considerations for N-PORT Reporting

Once a fund has put in place its governance plan and policies and procedures for liquidity risk management, there are a number of considerations from an operational perspective that should be taken into account before a fund begins to work on N-PORT reporting to the SEC.

Key Recommendations

- *Data Sources/Aggregation:* A fund will need to assess where its investment data resides (e.g. data warehouse, accounting system, etc.). The fund will need to decide how it will extract, aggregate and normalize its investment data for the purposes of N-PORT reporting.

- *Data Curation and Risk Calculations*: Investment data will need to be properly tagged and curated for reporting. The fund will need to develop proper assumptions and methodology for liquidity risk, including defining "normal versus stressed markets," determining reasonable price impact tolerance levels, and defining a threshold for "significant dilution." The fund will need to decide what software or systems they will use to calculate their liquidity risks.

- *Reporting Logistics:* The fund will need to develop workflows and coordinate the logistics among various groups within the firm that may be involved in N-PORT reporting (e.g. accounting, risk management, operations).

- *Monitoring:* The fund will need to develop appropriate process for monitoring liquidity levels, especially for investments that have been designated as "highly liquid." In addition, appropriate reporting that fulfills the "on-going" monitoring requirement for management and the Board must be developed to ensure that a fund is fully in compliance with these regulatory requirements.

- *Review/Check:* The fund will need to develop proper protocols to perform a review of their monthly N-PORT filing before creating XML-upload file and submitting to the SEC.

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Internal versus External Approach for N-PORT Reporting

There are pros and cons associated with undertaking N-PORT reporting internally versus using qualified external service providers to perform this reporting for a fund on a managed services basis. Before deciding which path to pursue, a fund should consider the following points:

Key Recommendations on How to Approach N-PORT Reporting

- *Self-Assessment:* A fund should perform an honest self-assessment to determine whether it has qualified and experienced risk management, operations, accounting and IT staff and systems to perform N-PORT reporting. If the results from this self-assessment are not resoundingly positive, a fund should consider obtaining assistance from qualified and experienced external providers which can establish a sound and repeatable process for liquidity risk management and N-PORT reporting.

- *Comparative Analysis:* There are a number of distinct advantages in choosing external service providers to help with some or all of the work associated with N-PORT reporting. A fund cannot "outsource" its responsibilities for liquidity risk management and N-PORT reporting, but there is value in leveraging quality service providers who have the staff, systems and subject matter expertise to perform this reporting. Such providers are typically more cost effective and efficient than the fund and provide a valuable independent perspective. We highly recommend that funds perform this comparative analysis—internal versus external—before deciding which approach to liquidity risk management and N-PORT reporting best serves them.

- *Piecemeal Approach Should Be Avoided:* If a fund does decide to use external service providers to help with N-PORT reporting, ideally it ought to opt for a single vendor which can provide all the key aspects of regulatory requirements: liquidity risk analytics, governance plan, policy and procedures for the liquidity risk program and process and controls for liquidity risk management. If such a 'one-stop-shop' cannot be found and multiple vendors are required to provide essential services, the fund should equally avoid taking on too many vendors, as an overly disaggregated approach to liquidity risk management could compromise the integrity and coherence of oversight.

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