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Legal Update

SEC and PCAOB Statement on Emerging Markets Risks: An Essential Disclosure Resource

On April 21, 2020, US Securities and Exchange Commission ("SEC") Chairman Jay Clayton, PCAOB Chairman William D. Duhnke III, SEC Chief Accountant Sagar Teotia, SEC Division of Corporation Finance Director William Hinman, and SEC Division of Investment Management Director Dalia Blass (the "Authors") published a joint statement regarding emerging markets investment risks (the "Publication"), noting the increasing exposure that US investors have to companies that are based or have significant operations in emerging markets countries.

> The Publication serves as a valuable resource for drafting new emerging markets risk disclosures and evaluating and updating existing emerging markets risk disclosures for prospectuses and other offering documents as well as for Form ADV.[1]

The Publication states that the SEC's ability to promote and enforce disclosure and financial reporting standards in emerging markets is limited and "is significantly dependent on the actions of local authorities—which, in turn, are constrained by national policy considerations in those countries." This leads to an increased risk that "disclosures will be incomplete or misleading and, in the event of investor harm, substantially less access to recourse, in comparison to U.S. domestic companies."

The Publication clearly states that it should not be viewed as an effort to restrict access to emerging markets investments and recognizes that "[i]nvestor choice has long been a core component of our capital markets regulatory framework, and emerging market investments, including as a component of a diversified portfolio, have proven to be beneficial to many investors."

With this background, the Publication discusses emerging markets risks and related considerations, which registrants might want to consider for purposes of evaluating their own emerging markets risk disclosures and similar communications.

Emerging Markets Risk Disclosures Generally

The Publication states that companies that have operations in emerging markets, and investors in those companies, often face greater risks and uncertainties (including idiosyncratic, industry-specific and jurisdiction-specific risks) than in more established markets.

The Authors recommend that the environment in which the company operates be carefully considered in assessing whether the company has sufficient controls, processes and personnel to address accounting or financial reporting issues. The Publication cautions that while the form of disclosure from such a company may appear substantially the same as that provided by US issuers, it can often be quite different in scope and quality. Furthermore, the scope and quality of disclosure can significantly vary from company to company, industry to industry, and jurisdiction to jurisdiction. The Authors expect issuers to present these risks prominently and in plain English and discuss them with specificity.

For issuers based in emerging markets, the Authors recommend that they consider providing a US domestic investor-oriented comparative discussion of matters such as (1) how the company has met applicable financial reporting and disclosure obligations and (2) regulatory enforcement and investor-oriented remedies, including as a practical matter, in the event of a material disclosure violation or fraud or other financial misconduct more generally.

The Authors believe that the above risks should be clearly disclosed to investors and that funds investing in emerging markets should ensure that their material risk disclosures are adequate and in compliance with federal securities laws. The Publication reminds registered funds in particular, including those investing in emerging markets, that they must disclose in their prospectuses the principal risks of investing in the securities they hold and that this disclosure should be presented in plain English and with specificity as to the fund's investments. The Publication warns that boilerplate disclosures generally are not useful or sufficient in these circumstances.

The Publication also suggests that investors, through appropriate disclosures, should be able to understand that these risks:

- often are significant,
- vary from jurisdiction to jurisdiction and company to company, and
- are just some of the factors that may contribute to effective investment decision making, including portfolio and index construction.

Financial Information, Requirements and Standards

The Publication recommends that investors and financial professionals carefully consider the nature and quality of financial information, including financial reporting and audit requirements as well as other disclosure risk, when making or recommending investments regarding companies that are based in, or have significant exposure to, emerging markets.

According to the Publication, these risks vary significantly depending on a variety of factors. In addition, the frequency, availability and quality of financial information about potential emerging markets investments may vary. By way of example, the Publication states that, while a US broker may be able to process an order for shares of a company that only trades on an emerging markets securities exchange, these foreign-traded companies are not likely to file reports with the SEC. The

information available about these companies, and its reliability, generally is significantly less than the information available about companies that file reports with the SEC, and these companies generally are not subject to the same regulatory, accounting, auditing or auditor oversight requirements applicable to companies that file reports with the SEC.

The Authors believe that it is important to understand the critical role that issuers, audit committees, auditors and regulators each play in the US financial reporting system, specifically the series of "checks and controls" that promote high-quality, reliable financial information. Similarly, the Authors believe that investors and other stakeholders should clearly understand how any limitations on the scope of these roles impact the information provided.

As another example, the Publication highlights the vital role that audit committees of operating companies and funds reporting to the SEC play through their oversight of financial reporting and the external, independent audit process. The Publication specifically calls out the Sarbanes-Oxley Act's requirements regarding the role of audit committees in financial reporting, including the independent audit committee requirement. The Publication observes that not all jurisdictions mandate independent audit committees or have similar requirements. The Authors believe that investors should understand the impact of a company's corporate governance structure, including the role of the audit committee or similar oversight, when making investment decisions in emerging markets.

Further, the Authors believe that issuers should ensure that relevant financial reporting matters are discussed with their independent auditors and, where applicable, audit committees and should disclose related material risks. To promote high-quality financial reporting and reliable audits for issuers reporting with the SEC, the SEC and staff continue to meet with those involved in the financial reporting system—including investors, preparers, audit committees and auditors—to listen to stakeholder concerns, understand emerging issues and risks, answer questions, and share views on current financial reporting matters. The Authors believe that investors should understand that this type and level of engagement may not occur in emerging markets.

Limited Ability of US Authorities to Bring Actions in Emerging Markets

According to the Publication, the SEC, US Department of Justice ("DOJ") and other authorities often have substantial difficulties in bringing and enforcing actions against non-US companies and non-US persons, including company directors and officers, in certain emerging markets (including China). The Authors believe that issuers should clearly disclose the related material risks.

The Authors also believe that investors, including individual investors, funds and companies, should understand potential limitations on enforcement actions when making investment decisions in emerging markets. They state that the SEC, DOJ and other US authorities may be limited in their ability to pursue bad actors, including in instances of fraud, in emerging markets. As an example, the Publication discusses that in China, there are significant legal and other obstacles to obtaining information needed for investigations or litigation and that similar limitations apply to the pursuit of actions against individuals, including officers, directors and individual gatekeepers, who may have engaged in fraud or other wrongdoing. In addition, local authorities often are constrained in their ability to assist US authorities and overseas investors more generally. There are also legal and other obstacles to seeking access to funds in a foreign country.

The Authors believe that issuers should clearly disclose the related material risks and financial professionals should consider these risks when making or recommending investment decisions.

Limited Shareholder Rights and Few Practical Remedies in Emerging Markets

The Publication observes that shareholder claims that are common in the United States, including class action securities law and fraud claims, generally are difficult or impossible to pursue as a matter of law or practicality in many emerging markets.

The Authors believe that issuers should clearly disclose any material limitations on shareholder rights and that investors should understand legal and practical differences affecting their ability to protect their interests when making emerging markets investment decisions. The limitations and differences discussed in the Publication include the following:

- Where investors purchase a security can affect whether they have, and where they can pursue, legal remedies against the foreign company or any other foreign-based entities involved in a transaction.
- Investors in emerging markets may not have the ability to seek certain legal remedies in US courts as private plaintiffs.
- Even if investors sue successfully in a US court, they may not be able to collect on a US judgment against a company, entity or person, including company directors and officers, in an emerging market, particularly when the company's assets and those of its directors and officers are located in an emerging market.
- As a practical matter, investors may have to rely on domestic legal remedies that are available in the emerging market.
- These remedies often are limited and difficult for international investors to pursue.

The Authors believe that issuers should make clear disclosures regarding these risks, including highlighting these limitations as a risk factor.

PCAOB Inability to Inspect Audit Work Papers in China

The Authors believe that investors and financial professionals should consider the potential risks related to the PCAOB's lack of access to inspect PCAOB-registered accounting firms in China. They further believe that issuers should clearly disclose the resulting risks to investors and that auditors should have appropriate quality controls in place related to executing quality audits.

The Publication explains that the Chairman of the SEC and the Chairman of the PCAOB, as well as staff from the SEC and the PCAOB, have on various occasions reminded investors of the significant risks related to investments in China due to the inability of the PCAOB to inspect audit work and practices of PCAOB-registered accounting firms in China (including Hong Kong, to the extent their audit clients have operations in China) with respect to their audit work of US reporting companies.

The Authors believe that investors should understand the potential impact of the PCAOB's lack of access when investing in companies whose auditor is based in China. They warn that even when the auditor signing the audit report is not based in China, if the company has operations in China, investors should consider whether significant portions of the audit may have been performed by firms in China and the potential impact of the PCAOB's inability to access such audit work papers.

The Authors want issuers with operations in China to make clear disclosures regarding these risks, including highlighting these limitations as a risk factor.

Passive Investing Strategies Do Not Take Account of These Risks

The Authors believe that investors should understand that index funds tracking a specific emerging markets index generally do not select securities based on investor protection considerations or the risks discussed above. The Authors believe that investors in index funds and other passively managed funds should understand the potential impact of the fund's passive investing strategy on the investor's exposure to emerging markets risks. They also believe that investors and financial professionals should consider index construction decisions and the related risks when making or recommending investment decisions in such funds.

Investment Advisers and Other Financial Professionals Should Consider Emerging Markets Risks

The Authors believe that financial professionals generally should consider limitations on the quality or availability of information, as well as the other risks described above, when recommending emerging markets investments. They further believe that funds investing in emerging markets should consider whether they have adequate risk disclosure about the unique risks and uncertainties that companies with significant operations in emerging markets often face, noting that boilerplate disclosures generally are not useful or sufficient in these circumstances.

The Authors warn that, in addition to the general considerations for investors above, investment advisers and funds should be mindful of their obligations under the Investment Advisers Act of 1940 ("Advisers Act") and Investment Company Act of 1940 with respect to emerging markets investments.

The Publication reminds investment advisers (including advisers to funds) that they have a fiduciary duty to their clients under the Advisers Act, including a duty of loyalty and a duty of care. The Publication then discusses the duty of care, echoing the recent interpretive release regarding the fiduciary duty of investment advisers under the Advisers Act:[2]

> The duty of care includes a duty to provide investment advice that is in the best interest of the client. In order to provide such advice, an adviser must have a reasonable belief that the advice is in the client's best interest based on the client's objectives.

The Authors believe that this duty imposes an obligation on the adviser to consider whether investments are recommended only to those clients who can and are willing to tolerate the risks and to conduct a reasonable investigation into the investment, sufficient so as to not base its advice on materially inaccurate or incomplete information.

The Authors then suggest that investment advisers who are recommending emerging markets investments "may" want to consider, as part of their due diligence, whether there are limitations on the quality or availability of financial information with respect to these investments or limitations on investors' legal remedies. Interestingly, the Authors recommend that investment advisers also consider the effect of market closures on their clients' investments and ability to gain access to their assets (a subject not discussed elsewhere in the Publication).

With respect to registered funds, the Authors reminded such funds that they are required to disclose their principal risks in the prospectus, evaluated in light of their investment objectives, strategies, holdings and structure.[3] The Authors also reminded private fund advisers that they must state all material facts necessary to make the statements made to any investor or prospective investor in the fund not misleading. The Authors then state that if a fund invests or "may consider" investing a "significant portion" of its assets in emerging markets, it should disclose the principal risks related to the quality or availability of the financial information of such investments, the impact of any potential market closures and other related risks.

Conclusion

Although the Publication makes clear that the views set out therein do not alter or amend applicable law, have any legal force or effect, or create any new or additional obligations, the Publication certainly does express the Authors' views regarding the importance and expected content of emerging markets risk disclosures. Advisers and funds should carefully consider these views and re-evaluate their existing emerging markets risk disclosures in light of these views. In addition, advisers and funds would be wise to use this Publication as a checklist of sorts when drafting new emerging markets risk disclosures for their disclosure or similar documents.

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Endnotes

[1] The Publication also includes citations and links to additional resources, statements and guidance regarding the subjects discussed therein.

[2] *Commission Interpretation Regarding Standard of Conduct for Investment Advisers*, Investment Advisers Act Release No. 5248 (June 5, 2019).

[3] For additional guidance on this subject, see Accounting and Disclosure Information No. 2019-08, *Improving Principal Risks Disclosure*, *available at* https://www.sec.gov/investment/accounting-and-disclosure-information/principal-risks/adi-2019-08-improving-principal-risks-disclosure.

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