

MEMO# 32748

September 9, 2020

President's Working Group Submits Report on Protecting US Investors from Certain Risks of Emerging Markets Investing

[32748]

September 9, 2020 TO: ICI Members

ICI Global Members SUBJECTS: Audit Committees

Compliance

Disclosure

Fund Accounting & Financial Reporting

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Intermediary Oversight

International/Global

Investment Advisers

Risk Oversight RE: President's Working Group Submits Report on Protecting US Investors from Certain Risks of Emerging Markets Investing

Last month, the President's Working Group on Financial Markets (PWG) released its *Report on Protecting United States Investors from Significant Risks from Chinese Companies* (the "report").^[1] The report includes five recommendations directed to the SEC that are meant to strengthen protections for investors and promote the integrity of US capital markets by addressing certain risks of investing in emerging markets, including China.

Background

In recent months, SEC staff have highlighted certain risks associated with investing in emerging markets, including China.^[2] The April statement emphasized the SEC's and the PCAOB's commitment to high-quality disclosure standards for both U.S. issuers and foreign private issuers (which includes oversight and enforcement), and also identified certain limitations on their ability to promote and enforce these standards in emerging markets because of certain legal and policy constraints in those countries. The April statement noted that these constraints substantially increase risk that disclosures will be incomplete or misleading and substantially reduce recourse in the event of investor harm, particularly in comparison to US domestic companies.

In June, the President issued a memorandum raising concerns that the Chinese government

has prevented Chinese companies and companies with significant operations in China from abiding by the investor protections that apply to all companies listing on US stock exchanges (e.g., by refusing to allow audit firms registered with the PCAOB to provide audit working papers to the PCAOB so that it can inspect audit work and enforce audit standards).[\[3\]](#) The memorandum tasked the PWG with issuing a report with recommendations that the executive branch, SEC, PCAOB, or any other federal agency may or should take to protect investors in US financial markets.

Summary of the Report

The report notes that certain jurisdictions do not currently provide the PCAOB with the ability to inspect public accounting firms, including sufficient access to conduct inspections and investigations of audits of public companies, or otherwise do not cooperate with U.S. regulators (“Non-Cooperating Jurisdictions,” or “NCJs”).[\[4\]](#)

The report’s five recommendations are all directed to the SEC and include the following:

- **Enhanced Listing Standards for Access to Audit Work Papers.** Enhancing the listing standards of US exchanges to require as a condition to initial and continued exchange listing:
 - PCAOB access to work papers of the principal audit firm for the audit of the listed company; or
 - Companies that are unable to satisfy this standard as a result of governmental restrictions on access to audit work papers and practices in NCJs may instead provide a co-audit from an audit firm with comparable resources and experience where the PCAOB determines it has sufficient access to audit work papers and practices to conduct an appropriate inspection of the co-audit firm.[\[5\]](#)
- **Enhanced Issuer Disclosures.** Requiring enhanced and prominent issuer disclosures of the risks of investing in NCJs, including issuing interpretive guidance to clarify these disclosure requirements to increase investor awareness, and more general awareness of the risks of investing in such companies.[\[6\]](#)
- **Enhanced Registered Fund Disclosures.** Reviewing the risk disclosures of registered funds that have exposures to issuers from NCJs to enhance the disclosures by these funds, including issuing interpretive guidance to clarify the disclosure requirements to increase investor awareness of the risks of investing in such funds.[\[7\]](#)
- **Greater Due Diligence of Indexes and Index Providers.** Encouraging or requiring registered funds that track indexes to perform greater due diligence on an index and its index provider, prior to the selection of the index to implement a particular investment strategy or objective.[\[8\]](#)
- **Guidance for Investment Advisers.** Issuing guidance to investment advisers with respect to fiduciary obligations when considering investments in NCJs, including China.[\[9\]](#)

Conclusion

While the SEC has invited comment from the public on these matters,[\[10\]](#) it is unclear how the SEC or staff might act on these recommendations.

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endnotes

[1] Available at <https://home.treasury.gov/system/files/136/PWG-Report-on-Protecting-United-States-Investors-from-Significant-Risks-from-Chinese-Companies.pdf>. The PWG is chaired by the Secretary of the Treasury, and includes the Chairman of the Board of Governors of the Federal Reserve System, the Chairman of the SEC, and the Chairman of the CFTC.

[2] The SEC staff hosted a roundtable dedicated to these issues in July (its webpage is available at www.sec.gov/page/emerging-markets-roundtable). See also SEC Chairman Jay Clayton, Public Company Accounting Oversight Board (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, *Emerging Market Investments Entail Significant Disclosure, Financial Reporting and Other Risks; Remedies are Limited* (Apr. 21, 2020) (“April statement”), available at www.sec.gov/news/public-statement/emerging-market-investments-disclosure-reporting.

[3] *Memorandum on Protecting United States Investors from Significant Risks from Chinese Companies* (June 4, 2020), available at www.whitehouse.gov/presidential-actions/memorandum-protecting-united-states-investors-significant-risks-chinese-companies/.

[4] The report explains that the Sarbanes-Oxley Act of 2002 was enacted to strengthen corporate governance standards; that that statute created the PCAOB to oversee the accounting profession; and that any accounting firm, whether in the US or abroad, that prepares or issues an audit opinion with respect to any issuer of securities in the US is required to produce the underlying audit work papers related to that audit work at the request of the PCAOB or the SEC.

[5] To reduce market disruption, the report indicates that new listing standards could provide for a transition period until January 1, 2022 for currently listed companies from NCJs to come into compliance. The new listing standards would apply immediately to new company listings once the necessary rulemakings and/or standard-setting are effective.

[6] The report notes that while companies registered with the SEC already provide risk disclosures, “a more specific listing standard or disclosure requirement could further highlight for investors the risks of investing in an issuer from an NCJ.”

[7] The report states that “SEC staff will continue to focus on reviewing the risk disclosures of registered funds that have exposure to emerging markets for adequacy.” It further states that “the Commission or the staff could issue additional interpretive guidance to clarify requirements about disclosure of relevant risks, including PCAOB inspection and enforcement limitations with respect to issuers based in NCJs. ... such guidance could promote enhanced disclosure regarding limitations on a fund adviser’s ability to oversee an index provider’s due diligence process over index data prior to its use in index computation,

construction and/or rebalancing. The disclosure could further acknowledge that the rights and remedies associated with investments in a fund that tracks an index comprised of foreign securities, particularly emerging market securities, may be different from those of a fund that tracks an index of domestic securities.”

[8] The report states that “enhanced due diligence should take into account the index provider’s process for index construction, including with respect to index rebalances. In particular, due diligence should address whether the process takes into account any potential errors in index data, index computation and/or index construction if the information from issuers based in NCJs, including China, is unreliable or outdated or if less information about such companies is publicly available due to differences in regulatory, accounting, auditing and financial recordkeeping standards. It should also take into account the potential effects of such differences on the fund’s performance.” Further, “The SEC could also encourage or require index funds to provide disclosure regarding their due diligence in their registration statements, reports to shareholders or other disclosure documents.”

This recommendation appears to be an indirect way of encouraging index providers to consider “these differences in standards more carefully, and possibly alter[] how they construct indexes.” The report notes that unlike other jurisdictions (e.g., the EU and the UK), the SEC and other federal regulators do not have authority to directly regulate the activities of index providers.

[9] The report states generally that “an adviser should consider whether investments are recommended only to those clients who understand the risks and provide informed consent, and should conduct a reasonable investigation into the investment sufficient not to base its advice on materially inaccurate or incomplete information.” More specifically, it states, “With respect to investments in China and other NCJs, an investment adviser should consider differences in local regulatory, accounting, auditing and financial recordkeeping standards and the effects of those differences on the ability to accurately select investments that meet the client’s investment objectives and goals. Accordingly, investment advisers that are recommending investments in these jurisdictions may want to consider, as part of their reasonable investigation, whether there are limitations on the quality or availability of financial information with respect to these investments, as well as possible limitations on investors’ legal remedies in such jurisdictions.”

[10] See *Statement on SEC Response to the Report of the President’s Working Group on Financial Markets* (Aug. 10, 2020), available at www.sec.gov/news/public-statement/statement-presidents-working-group-financial-markets.