

MEMO# 32985

December 16, 2020

SEC Issues ADI Addressing Risk Disclosure for Funds Investing in Emerging Markets

[32985]

December 16, 2020 TO: ICI Members SUBJECTS: Audit and Attest

Compliance

Disclosure

Fund Accounting & Financial Reporting RE: SEC Issues ADI Addressing Risk Disclosure for Funds Investing in Emerging Markets

The Division of Investment Management's Disclosure Review and Accounting Office (DRAO) recently released an Accounting and Disclosure Information addressing registered funds' risk disclosure relating to investments in emerging market securities.[\[1\]](#)

The ADI notes that in many emerging markets there is significantly less information about public companies due to differences in regulatory, accounting, auditing, and recordkeeping standards. There may also be limits on investor rights and recourse and the ability to pursue shareholder claims that are common in the US. Regarding index funds, the lack of relevant data may contribute to incorrect weightings and computational errors in index values.

The ADI indicates that it is designed to highlight current findings from the staff's review of funds' emerging markets risk disclosure. Staff has observed a range of practice in the level and quality of risk disclosure in this area. Funds may wish to consider the following factors and how the factors can affect the fund when drafting disclosures:

- Risks related to lack of liquidity, market manipulation, limited access to capital, political risk, and foreign investment structures;
- Whether risks arising from differences in regulatory, accounting, auditing, and recordkeeping standards could impede the adviser's ability evaluate companies or impact the fund's performance;
- Any limitations on rights and remedies available to the fund against portfolio companies;
- If an index fund, whether the index provider will have less reliable or current information;

- If an index fund, any limitations on the adviser's ability to assess the index provider's due diligence process over index data; and
- Whether the limitations above could affect the fund's stated investment objective.

Finally, the ADI indicates that funds should consider the potential risks related to the PCAOB's inability to inspect auditors in China. Funds investing in emerging markets should carefully consider the regulatory environment in which a company operates in assessing whether the company has sufficient controls, processes, and personnel to address its financial reporting obligations. These unique operating considerations and any material limitations on PCAOB oversight of companies' auditors should be considered and reflected in risk disclosures of funds that have significant exposure to emerging markets.

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endnotes

[1] ADI 2020-11, *Registered Funds' Risk Disclosure Regarding Investments in Emerging Market Securities* (December 15, 2020) is available at www.sec.gov/investment/accounting-and-disclosure-information/principal-risks/registered-funds-risk-disclosure.

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