

## Emerging Markets Risks: Disclosure Considerations for Funds and Advisers

In a [previous post](#) we covered the [April 14, 2020 statement](#) from the SEC's Division of Investment Management encouraging registered funds to assess and, as appropriate, update their prospectus risk disclosures in light of the COVID-19 pandemic. Now, Dalia Blass, Director of the Division, has joined with the Chairman of the SEC, the PCAOB Chairman and others at the SEC to release a joint public statement discussing how [Emerging Market Investments Entail Significant Disclosure, Financial Reporting and Other Risks; Remedies are Limited](#) (the "Statement"). The Statement highlights challenges that the SEC and the PCAOB continue to observe in emerging markets. Corporate data flow in emerging markets can be significantly limited for political and other reasons, which can impact the valuation and risk assessment of emerging market companies. The Statement reminds investment advisers and registered and private funds of their disclosure obligations generally, and posits key disclosure and other considerations around emerging market investments.

### Special Considerations for the Asset Management Industry

The Statement's broad observations are summarized below along with the Statement's targeted guidance for funds and advisers.

- **Emerging Markets Risk Disclosures are Important.** Investors in companies operating in emerging markets often face greater risks and uncertainties than investors in more-established markets. Funds investing in emerging markets should ensure that their principal risk disclosures include appropriate jurisdiction- and industry-specific risks. Disclosure should be prominent and clear and "presented in plain English and with specificity as to the fund's investments." As the SEC's old refrain goes, "boilerplate disclosures are generally not useful or sufficient."
- **Quality of Financial Information, Requirements and Standards Vary Greatly.** "In many emerging markets," the Statement explains, "there is substantially greater risk that disclosures will be incomplete or misleading...in comparison to U.S. domestic companies." Accordingly, asset managers should carefully consider local financial reporting and audit requirements and the nature and quality (i.e., reliability) of financial information when making or recommending investments in emerging markets. Advisers should be sure to engage in fulsome due diligence around such issues to ensure investment decisions/recommendations are not based on materially inaccurate or incomplete information and that applicable risks are ferreted out and fully disclosed.
- **The Ability of U.S. Authorities to Bring Actions in Emerging Markets May Be Limited.** The SEC, the U.S. Department of Justice and other authorities often face significant obstacles to identifying and enforcing U.S. securities law violations against non-U.S. persons. "In addition, local authorities often are constrained in their ability to assist U.S. authorities and overseas investors more generally. There are also legal or other obstacles to seeking access to funds in a foreign country." Advisers should be sure to understand and clearly disclose the possibility of such risks to investors. Generally, it is incumbent on advisers to recommend emerging markets investments only to clients "who can and are willing to tolerate the risks."
- **Shareholders Have Limited Rights and Few Practical Remedies in Emerging Markets.** Shareholder claims that are common in the United States and other developed markets are often difficult (or

impossible) to pursue in emerging markets. And, "even if investors sue successfully in a U.S. court, they may not be able to collect on a U.S. judgment...particularly when the company's assets and those of its directors and officers are located in an emerging market." Advisers should ensure that their risk disclosures clearly note any material limitations in the rights of investors in emerging market companies. Advisers should also consider "the effect of market closures on their clients' investments and ability to gain access to their assets."

- **An Emerging Market Index Fund Does Not Necessarily Consider or Weigh Investor Protection.** Passive emerging market index funds should make clear to investors that the composition of their emerging market index is made "on a jurisdiction-wide basis...based on the index provider's specific weighting methodology (e.g., based on market capitalization)...[and] may or may not weigh the jurisdiction as a whole on the basis of investor risk or other factors in addition to market capitalization." Disclosures should also address the related risks, including those described above, of investing in passive emerging market index funds.

## Conclusion

While emerging markets investments were once relatively unique, [U.S. investors are now broadly exposed to emerging markets](#) and their attendant risks through holdings in companies based in or with significant operations in emerging markets. The Statement cautions that it is not intended as an exclusive list of factors for effective investment decision-making and should not be misconstrued as an attempt to restrict access to emerging market investments. Funds and their boards, as well as adviser CCOs and investment professionals, should assess their current disclosures against the Statement as we wait to see how the COVID-19 pandemic will affect the migration of U.S. corporate operations and investor assets to emerging markets.

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