

HORIZON

from
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HIGHLIGHTS

- May's 'Spotlight' feature focuses on the stance US Regulators are starting to take in charging companies for misleading ESG disclosures (page 3).
- After the collapse of 'stablecoin' Terra earlier this month, the regulatory focus on *Crypto* has been turned up yet another notch (page 2).
- There were several notable *Audit* articles in May, including two sanctions levied on KPMG by the Financial Reporting Council, and more widespread Audit news (page 2).

CATEGORY OVERVIEW

It was a HORIZON record for *Regulatory Updates* in May with almost half of the articles featured in The SKADI Sammendrag falling into this category. This covered a wide range of stories but there was notable focus on crypto regulations (15% of Regulatory Updates) and ESG (6%). *AML* related news was down again in May as the Russian invasion of Ukraine continues.

Last month was also the largest share of financial news for *Audit Focus* since we started collating data in October 2021. This was largely the result of EY announcing their plans to potentially separate their audit and consulting businesses. In addition, two unrelated sanctions levied on KPMG by the Financial Reporting Council made up audit headlines. On the final day of the month, the UK government announced sweeping reforms for the audit sector.

Figure 1: SKADI Sammendrag Articles by Category

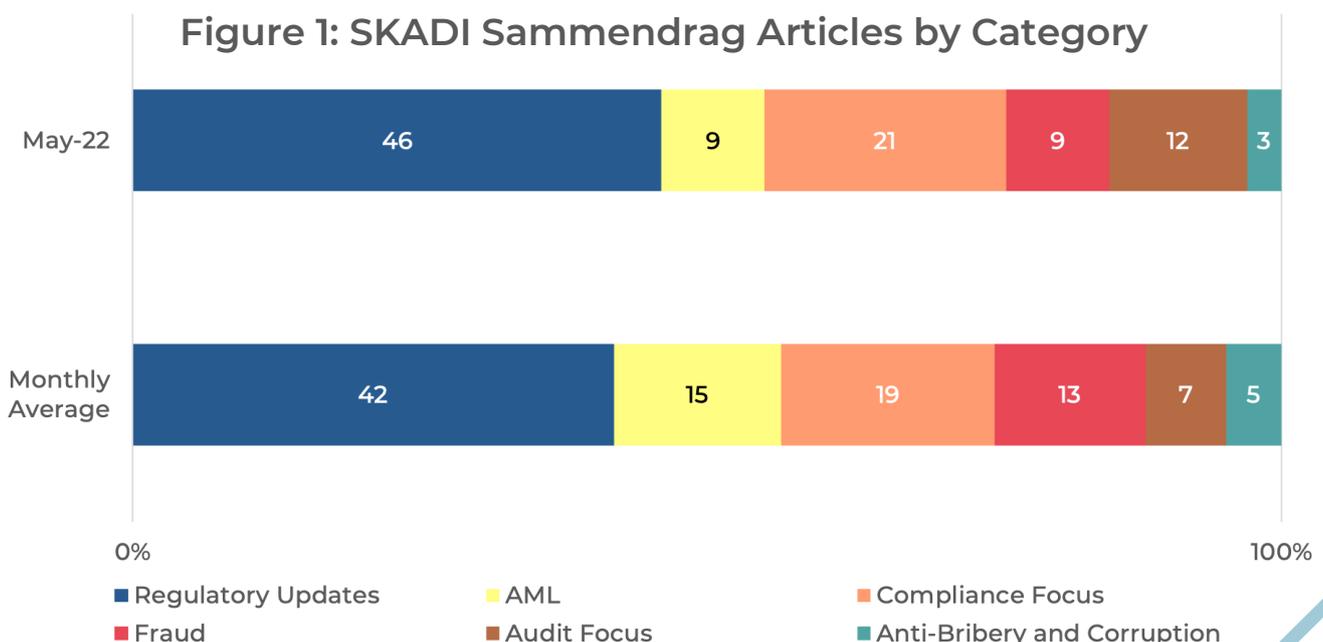
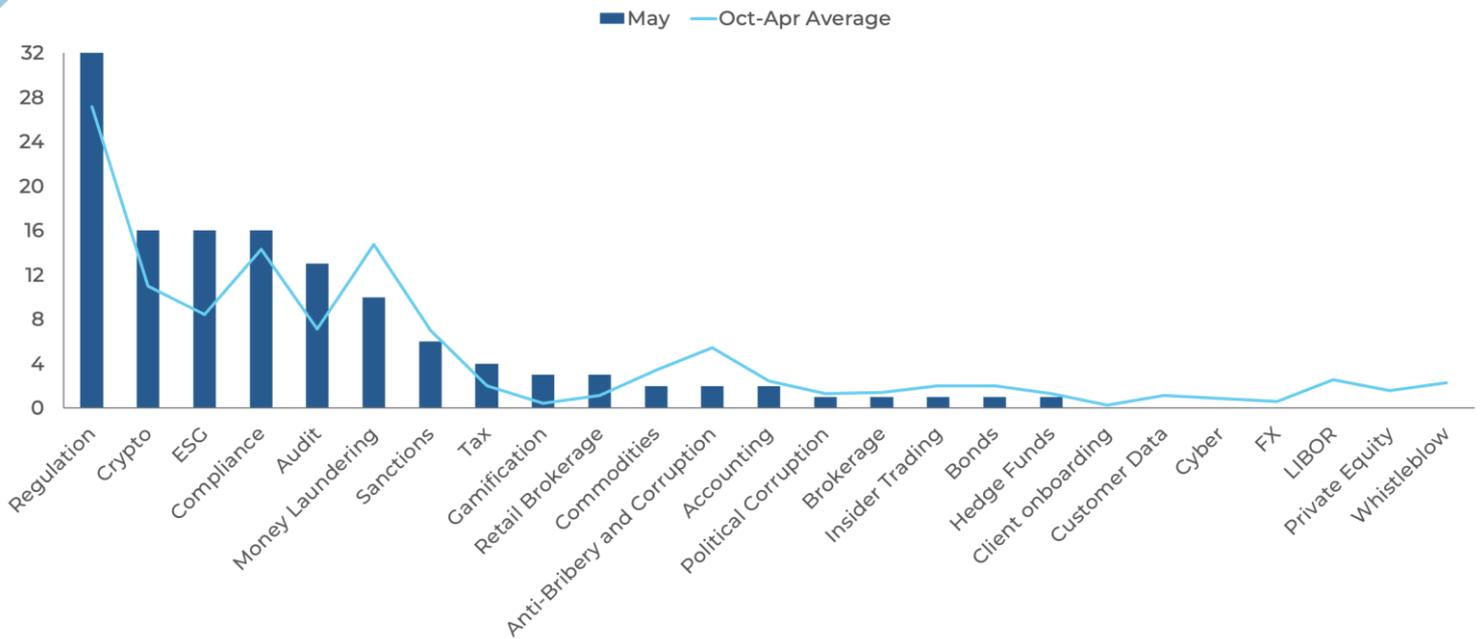


Figure 2: SKADI Sammendrag Articles by Topic



TOPIC DETAILS

As shown above, of the six major topics covered in The SKADI Sammendrag, only *Money Laundering* fell below its long-term monthly average. This fall was to be expected after the initial scrutiny of sanctions following Russia's invasion of Ukraine. There were fifteen AML articles across March and April relating specifically to Russia, compared to just two in May. Sanctions were tightened further in the UK with the [Economic Crime Bill](#) passed in March. This legislation allows the UK government to move faster imposing sanctions against oligarchs, it includes a new register of overseas entities forcing foreign companies owning UK property to reveal their beneficial owners.

Gamification and *Retail Brokerage* also regained attention in May, following several unrelated developments in the meme stocks surge from January 2021. Last month, Investment Management firm [Melvin Capital announced they are closing their funds](#) and returning cash to their investors after suffering vast losses sixteen months ago. Similarly, Retail brokerage firm [TradeZero America was charged by the US Securities and Exchange Commission](#) for deceiving customers about meme stock trading halts. TradeZero restricted investors from purchasing the group of highly volatile stocks for around 10 minutes. A public statement was then issued, falsely stating that no restrictions were ever in place. News also broke in May that [Robinhood Markets Inc. have reached a deal in principle to resolve investor litigation](#) arising from blocking the trading of stocks in March 2020.

Crypto

As [April's Spotlight feature](#) noted last month, financial regulators across the globe have started developing detailed plans for regulation in the crypto space. After Bitcoin's price fell by nearly 20% in May, and the 'stablecoin' Terra collapse wiped out USD 200 billion in the process, the issue is now being addressed with even more urgency. Indeed, 15% of all regulator-related news featured in May's SKADI Sammendrag related to crypto.



At the start of the month the SEC announced they were hiring twenty more officials to crack down on crypto. In coordination with the CFTC they also announced they are [considering their own plan to regulate crypto if there is not clear direction from Congress](#).

Finally, last month regulators in Argentina, Panama, Portugal and Estonia (previously seen as a crypto trailblazer) all announced plans to slow down the sector and implement more stringent regulations, citing concerns over money laundering, consumer risk and financial instability.

Audit

KPMG received two significant sanctions from the Financial Reporting Council. On 12-May news broke of a [£14 million fine](#) (one of the largest in UK audit history) for forging documents related to the Carillion audit scandal. This was followed twelve days later by a [£3.3 million fine](#) for shortcomings in their audit of Rolls-Royce in 2010. The plans announced by EY to separate their audit and advisory operations worldwide also occupied several headlines last month. Whilst the plans are still under development, they represent a seismic shift in the approach taken by the Big Four accounting firms, which could set the standard for a sector dogged by conflicts of interest for decades.

The month of May saw [US and Chinese regulatory officials engage in talks](#) to try and settle the disputes over the auditing obligations for US-listed Chinese firms. Whilst these talks have been running over the course of the month, time is running out without a resolution being reached. If a deal cannot be reached, Chinese firms will be delisted from US exchanges, which could happen as soon as March 2023.

On the final day of May, the Financial Reporting Council (FRC) welcomed the UK Government's announcement of [replacing the Financial Reporting Council with a new watchdog](#). The new regulator; the Audit, Reporting and Governance Authority (ARGA) will be given more enforcement powers to provide protection to investors and suppliers from the impact of corporate failure. However, the FRC believes the Government's decision to drop a proposal requiring directors to sign off on internal controls, a form of Sarbanes-Oxley reporting, as a missed opportunity.

ADRs

May's spotlight story looks at the SEC tightening ESG regulatory focus, including their fine against a Brazilian miner: Vale SA, for misleading investors through reporting to the SEC, under Vale's level III ADRs listed on the NYSE. Level II and Level III ADRs are required to file annual reports to the SEC under Form 20-F, whilst Level I ADR's account for most listings, subject to minimum SEC reporting requirements. Other categories exempt from strict SEC reporting and registration include 144A issues only made to Qualified Institutional Buyers (QIB's), and REG S issues covering offerings outside the US to non-US persons.

Conversion between ADRs and local shares is usually permissible and can be exchanged as quickly as T+1. Transfers are subject to a conversion fee of up to USD 0.05 per ADR, however this can be negotiated with sponsors, having to compete with cross book facilities which swap ADRs and the underlying shares. Restricted 144A and REG S offerings are fungible, with exchanges between the different lines subject to a conversion fee.



SPOTLIGHT: MISLEADING ESG STATEMENTS / DISCLOSURES AND THE SEC

Historically corporations falling short of their ESG promises or making misleading ESG disclosures have been 'encouraged' to change their ways by activism or court proceedings. In financial services however you will generally be regulated by someone, to ensure you don't mislead investors, and that someone is much more likely to 'encourage' you to change your ways with a nice big fine.

The SEC has been a particularly active regulator in this area over the past month. In their latest release (25th May) the [SEC has proposed enhanced ESG disclosures](#) rules for certain investment advisers and investment companies. The proposed amendments seek to categorize certain types of ESG strategies broadly and require funds and advisers to provide more specific disclosures in fund prospectuses, annual reports, and adviser brochures based on the ESG strategies they pursue, allowing investors to "look under the hood" of the actual investment strategies undertaken.

While these rules changes are currently only proposals, the SEC are now providing some more clarity on what levels of disclosures might be required in the future. The European Union (EU) developed the Sustainable Finance Disclosure Regulations (SFDR) to improve transparency and prevent 'greenwashing' and it distinguishes between three types of product classifications under its article's 6, 8 and 9. It remains to be seen if the SEC's final rules will follow similar principles.

What is clear is that improvements in ESG reporting need to be made, currently investors do not fully trust company ESG disclosures and they do not trust companies to deliver on the ESG promises being made, according to a survey published by [Edelman \(the Edelman Trust Barometer Special Report\)](#).

The SEC has also started taking action against corporations it considers to have misled US investors through their ESG disclosures and marketing materials. On 23rd May they announced they had charged [BNY Mellon Investment Adviser Inc. for Misstatements and Omissions](#) relating to their funds ESG considerations. The SEC's order said that BNY Mellon I.A. "implied in various statements that **ALL** of the investments in the funds had undergone an ESG quality review" and it turns out that not **ALL** of the investments were subjected to this ESG review. That one little word proved to be quite a costly one for BNY Mellon I.A. as they have now agreed to pay US\$1.5M to settle these charges.

And on the 28th April the US [Securities and Exchange Commission \(SEC\) charged Brazilian Mining Company Vale S.A. with misleading investors](#), through their ESG disclosures, about the Brumadinho dam's safety prior to a collapse that killed 270 people. The collapse also caused immeasurable environmental and social harm, and led to a loss of more than \$4 billion in Vale's market capitalization. The SEC was able to charge Vale S.A. with misleading investors as the company has a Level III Sponsored American Depository Receipt (ADR) listed on the New York Stock Exchange (NYSE).

All publicly listed companies now need to consider the additional risk that their ESG disclosures, which more and more investors are relying upon to make their decisions, could be viewed as unfair or inaccurate by regulators. Especially if some unforeseen negative event materially impacts performance and their share price. The SEC has made it clear that it will scrutinise ESG disclosures from ANY corporations with US market listings and other regulatory bodies will be closely monitoring the progress of this particular case.



HORIZON Takeaway Points for Audit and Control Teams

- Looking forward as the data continues to confirm that inflation is rising, the pressure to raise rates will continue. Structurally volatility will continue to be supported, and credit will widen. The rate of change is unpredictable and we would urge control functions to look at inputs and assumptions to models, that are seeing the first significant test in over a decade, as we move away from an environment with interest rates close to zero.
- SKADI advise revisiting Risk limit frameworks to ensure they are fit for the new phase of the interest rate cycle, and the consequent impact on volatility.
- With crypto experiencing volatility and subsequent calls with a sense of urgency for regulation, we anticipate this story to develop over the coming months.
- We encourage operational and outsourced governance teams to review oversight controls, analysing the knock-on effect from Russian sanctions. Not limited to SWIFT payment screening and client due diligence, less obvious operational risks such as Russian bond coupons paid in Roubles rather than US Dollars need to be managed.
- With the SEC's introduction of ESG fund and disclosure rules, extending to capture ADRs, along with the fining of Investment Adviser BNY Mellon and evolving events at large European Asset Manager DWS, we hope to see more clarity in funds rules and disclosure and expect ESG to continue to be a hot topic over the coming months.

What is it we're doing here?

Released every morning, The SKADI Sammendrag covers headlines to assist Compliance, Internal Audit and control teams. In this monthly research document, HORIZON, we collate and analyse these 100 or so articles, finding themes and areas of focus for control functions.

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