SEC Fines Private Equity Adviser for Repeated Late Distribution of Audited Financials

On July 17, 2018, the Securities and Exchange Commission ("SEC") announced a settlement with registered investment adviser New Silk Route Advisors, L.P. ("NSR") for failure to timely deliver audited financial statements to its fund investors as required by Rule 206(4)-2 (the "Custody Rule") under the Investment Advisers Act of 1940 (the "Advisers Act").[1]

The Custody Rule provides that, among other things, advisers with custody of client funds and securities must undergo a "surprise exam" at least annually, by engaging an independent public accountant to conduct a verification of the client funds and securities by actual examination at a time chosen by the accountant without prior notice or announcement to the adviser. As an alternative to satisfying the surprise exam requirement, advisers to pooled investment vehicles may instead comply with the "audit provision" of the Custody Rule by, among other things, distributing the audited financial statements of their pooled investment vehicles to all beneficial owners within 120 days of the pools' fiscal year ends.[2] In response to a frequently asked question, the Division of Investment Management has issued guidance stating that it would not recommend enforcement action against an investment adviser relying on the audit provision if the adviser failed to distribute a pool's audited financial statements within 120 days under certain "unforeseeable circumstances," provided that the adviser reasonably believed that the audited financial statements would be distributed within the 120-day deadline.[3]

NSR advises two private equity funds (the "NSR Funds") and attempted to rely on the audit provision from 2012 to 2017. Although the NSR Funds received unqualified opinions for each of those years, NSR failed to distribute the audited financial statements to investors within the requisite 120-day period, delaying the delivery in each year by 6 to 245 days. The SEC noted that despite its continued late distribution of audited financial statements to investors, NSR did not make material changes to its audit processes. As a result, the SEC found that NSR's late delivery of audited financial statements was not due to

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1 In the Matter of New Silk Route Advisors, L.P., Release No. IA-4970 (July 17, 2018), *available at* https://www.sec.gov/litigation/admin/2018/ia-4970.pdf.

2 Rule 206(4)-2(b)(4)(i).

3 *See* Staff Responses to Questions About the Custody Rule, Question VI.9, *available at* https://www.sec.gov/divisions/investment/custody_faq_030510.htm (the "Custody Rule FAQ").

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"unforeseeable circumstances," and that therefore, NSR could not rely on the relief set forth in the Custody Rule FAQ. NSR was censured and ordered to pay a civil money penalty of $75,000.[4]

Clients often ask about the consequences of failing to deliver audited financial statements within the required timeframe. This settlement serves as a reminder that it is imperative for registered investment advisers complying with the audit provision to timely deliver audited financial statements to fund investors. To the extent an adviser fails to deliver the audited financial statements within the required timeframe due to unforeseeable circumstances, the adviser may rely on the Custody Rule FAQ and make changes to its audit processes in order to prevent the delay from recurring. This settlement makes clear, however, that advisers that are repeatedly delayed in delivering audited financial statements to investors are not eligible for the relief provided in the Custody Rule FAQ. Advisers should ensure that their compliance policies and procedures are reasonably designed to comply with the Custody Rule, including the delivery requirements under the audit provision.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its contents. If you have any questions about the contents of this memorandum, please call your regular Fried Frank contact or an attorney listed below:

[4] The SEC found that NSR violated the anti-fraud provision in section 206(4) of the Advisers Act, the Custody Rule, and Advisers Act rule 206(4)-7, which requires registered investment advisers to adopt and implement policies and procedures reasonably designed to prevent violation of the Advisers Act and Advisers Act rules.

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