





# SEC Custody Rule: Two Paths to Compliance

# Overview

*With growth comes responsibility.* When a private fund advisor's assets under management exceed \$150 million, they are required to register with the SEC and become subject to the Investment Advisers Act, including the Custody Rule. For advisors to pooled investment vehicles holding non-transferable privately offered securities, there are two paths to compliance with a key requirement of the rule—managers of pooled investment vehicles holding such securities must either:

**1**  Submit to an **annual surprise examination** and place your assets with a **qualified custodian**.

**2**  Undergo an **annual full financial audit**.

Both the surprise examination and the full audit must be conducted by a PCAOB-registered independent public accountant but with a different scope.



## OPTION 1

# Surprise Examination and Qualified Custodian

The first option allows managers to forego a full, distributed audit and instead elect to use a qualified custodian to hold client assets and to submit to a surprise examination annually. As noted in its name, the surprise exam is an unannounced inspection conducted at random times chosen by the accounting firm. The purpose of the surprise examination is to verify that the advisor is safeguarding client assets as required by the Custody Rule.

This tends to be a more cost-effective and less burdensome solution and is ideal for smaller funds and Series LLC/SPV structures. Rather than a complete financial statement audit, it focuses on verification of assets. The accountant selects a sample of the advisor's records to reconcile with those of its clients and custodians to verify assets' existence and activity. The report will identify the procedures performed and express an opinion on management's compliance with the requirements.

This option is often preferred because it limits the disruption of business operations and is less expensive than a full audit. In addition, investors receive more immediate transparency from quarterly fund statements than from annual audit reports delivered well after the end of the fiscal year.

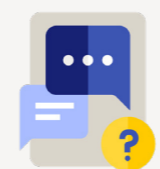
### Key requirements of this option include:



Assets must be in the custody of a **qualified custodian**.



The custodian must distribute **quarterly fund statements** to investors. These statements report on fund holdings and may include: valuations, transactions, and cash flows.

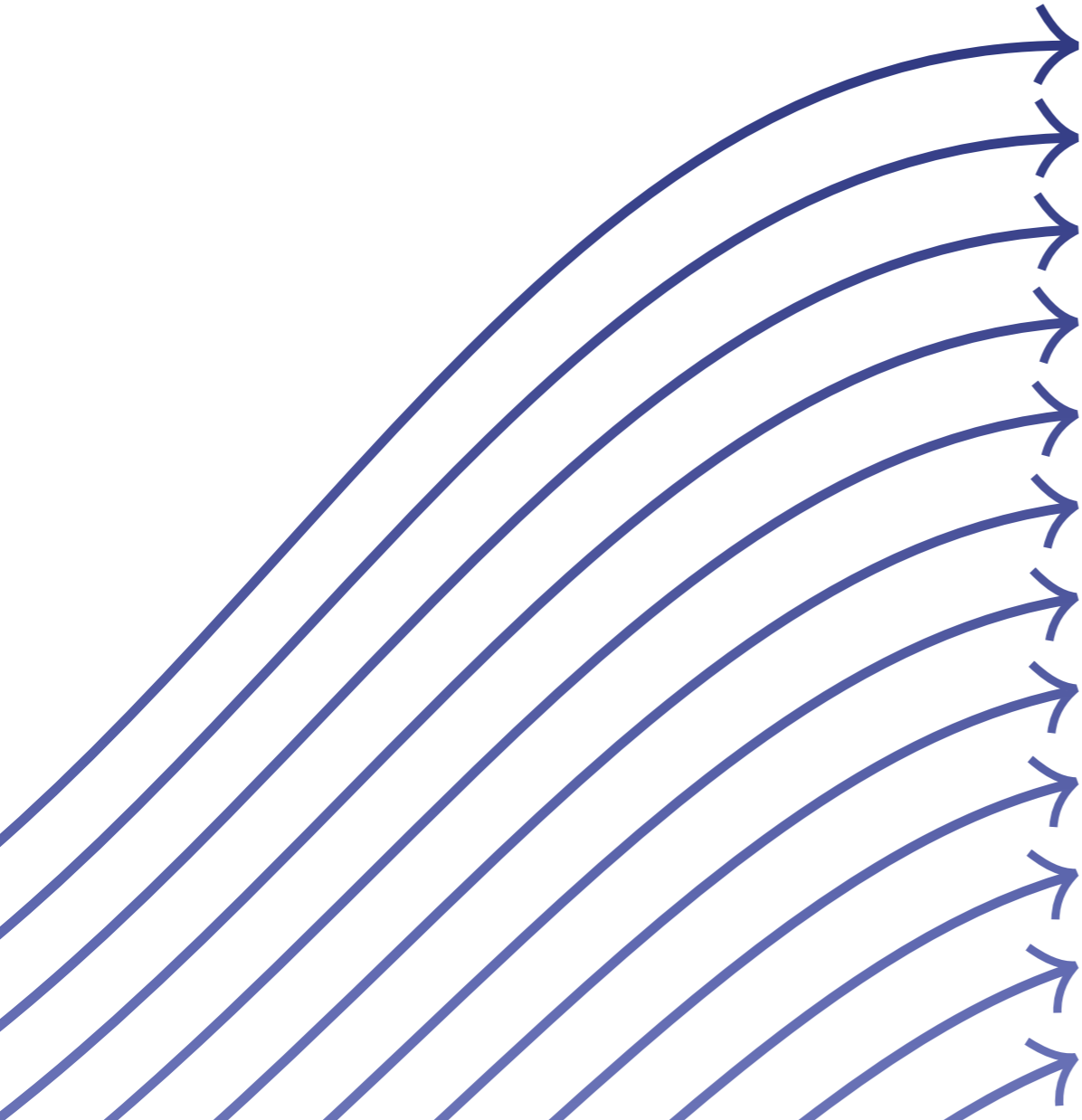


If **material discrepancies** are found, the accountant must notify the SEC within one business day.

## OPTION 2

# Annual Financial Audit

The second option involves undergoing a full annual financial audit prepared in accordance with U.S. GAAP, that is then distributed to all investors. This approach provides an independent verification of the fund's financial condition and operational integrity. However, a full annual audit may cost more than the use of a qualified custodian in conjunction with a surprise examination.



## To comply with the Custody Rule under this option:

1

The audit must be **performed on a consolidated basis**, encompassing the fund and all subsidiary entities.

2

Audited financials must be distributed to all investors **within 120 days** of the fund's fiscal year-end.

3

The audit must cover a **complete set of financial statements**, including the balance sheet, statement of operations, cash flows, and changes in partners' or members' capital.

# Choosing the Right Option

Both compliance paths meet the requirements of the SEC Custody Rule, which is fundamentally designed to safeguard client assets from misappropriation and misuse, and to promote transparency. Fund managers should evaluate both options carefully to determine which approach best aligns with their fund structure, investor expectations, and long-term compliance strategy.

|                              | Option 1: Surprise Examination/Qualified Custodian   | Option 2: Full Audit  |
|------------------------------|--|---|
| <b>Scope</b>                 | Focuses on safeguarding of assets; confirms existence  | Comprehensive audit of financial statements   |
| <b>Timing</b>                | Random (surprise) audit  | Performed at fiscal year-end  |
| <b>Regulatory Basis</b>      | Satisfies Custody Rule requirements when qualified custodian distributes quarterly statements to investors | Satisfies Custody Rule when annual financials are distributed to investors  |
| <b>Auditor involvement</b>   | Limited to verifying asset existence   | Full audit prepared in accordance with GAAP   |
| <b>Cost</b>                  | An audit focused on verifying the existence of assets will have a lower cost                               | Broader scope covering a comprehensive review of financial statements, internal controls, and operations will cost more |
| <b>Investor Transparency</b> | Quarterly investment statements from the qualified custodian   | Audited financials distributed 120 days after end of fiscal year  |
| <b>Target Audience</b>       | Small Funds, Series LLCs, and SPVs   | Large Funds   |

[Learn more about institutional custody solutions](#)

## Questions about fund custody services?

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