SPOTLIGHT ON

State Registration Requirements for
“Small” Investment Advisors

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Investment advisors must typically register with the Securities and Exchange Commission (“SEC”) or the states in which they maintain their principal office unless they only manage private funds or have a limited number of clients and relatively few assets under management (“AUM”).

We summarized these registration rules in our Spotlight on Registration Requirements and Filings for Investment Advisors and Their Employees. As we explained in that Spotlight, federal rules cover so-called “large” advisors (those with more than $100 million AUM), requiring them to register with the SEC. Federal rules also address so-called “mid-sized” advisors (those with between $25 million and $100 million AUM), generally providing that they should register with the state in which they have their principal office.

So-called “small” advisors (those with less than $25 million AUM) are not required under SEC rules to register with either the SEC or a state. But these advisors may be required to register in states in which they have offices or have more than a specified number of clients.

This Spotlight provides an overview of the state registration rules applicable to these “small” advisors, including state de minimis rules, and how to determine who counts as a “client” when applying these rules.

Please keep in mind that, while the federal rules focus on the assets managed by the advisor, state registration rules are based primarily on the number of clients an advisor has in that state and not the amount of assets managed.

State registration rules for “small” advisors

Under state law, advisors that manage less than $25 million generally must register in two sets of states. First, advisors must register in the state where they have their principal office and place of business (i.e., their home state) and, in most cases, any state where they have an office, regardless of the number of clients they have there. Second, advisors must also register in any other state(s) where they have more than five clients (or, in a few cases, a higher number set by the state).

Registration Rules for Advisors in their Home States

Most states require advisors to register in the state where the advisor has its main office. Many states also require advisors that have any in-state place of business (whether it is a principal office or not) to register. This is generally true regardless of the number of clients the advisor has in that state, i.e., advisors with a place of business in California must register in California **before** having **any** California clients.

However, some states – like Georgia, Illinois, New Jersey, and New York – allow advisors with a place of business or presence in the state to have 5 clients before requiring them to register.
Pennsylvania allows in-state advisors that do not hold themselves out to the public as advisors to have up to 5 total clients (i.e., clients located in Pennsylvania or another state) before the advisors must register in Pennsylvania. Similarly, Louisiana requires any advisor that holds itself out to the public as an investment advisor to register, but lets advisors that do not hold themselves out to the public have up to 15 clients before requiring them to register.

Registration Rules for States Where an Advisor Does Not Have an Office

The states apply different rules, however, to advisors who do not have an office (i.e., a place of business) in that state, generally letting these "out-of-state" advisors have 5 clients before requiring them to get registered but requiring "in-state" advisors with any clients in that state to register

How many clients can an out-of-state advisor have before it must register with a state?

The National Securities Markets Improvement Act of 1996 ("NSMIA") created a national de minimis standard setting limits on when states can regulate investment advisors without a place of business in the state. (This federal law – codified in section 222(d) of the Investment Advisers Act – preempts state laws.) It prohibits states from requiring an advisor to register if the advisor:

(a) does not have a place of business in the state; and

(b)) had fewer than 6 clients who are residents of the state in the prior 12 months.

In other words, a state cannot require out-of-state advisors with fewer than 6 clients in the state during the previous 12 months to register in that state. A few states, however, have set different standards. Specifically, Louisiana and Florida allow advisors that do not hold themselves out to the public as investment advisors to have up to 15 in-state clients during the previous 12 months before requiring them to register.

Please keep in mind that, even if an advisor is not required to register with a specific state, the advisor may still need to make certain filings and pay filing fees in that state. For instance, Texas requires out-of-state advisors with no place of business in the state but that have any Texas

clients to file a Form ADV and Form U4 for the firm's representatives and to pay filing fees.

Who counts as a client?

First, some types of clients do not count toward the number of clients an unregistered advisor may have. A number of states exclude certain types of clients – other investment advisors, broker-dealers, depository institutions, investment companies, insurance companies, governmental agencies or instrumentalities, employee benefit plans with assets of at least $1 million, and certain types of institutional investors – from the types of clients that count toward this 5-client limit. A few states also exclude "accredited investors" (as defined in 17 CFR §230.501) from the calculation.

Second, some families or corporate entities count together as one client. Whether an account counts as a separate client for purposes of the de minimis standard and state registration requirements hinges on the definition of a "client" in an SEC rule, 17 CFR 275.202(a)(30)-1. (Like the federal de minimis standard, the states are required to follow this rule.)

The SEC rule treats each of the following individuals and personal investment vehicles as a single "client":

- **A natural person, and:**
  - Any minor child of the natural person, whether or not he or she shares the same principal residence as the natural person;
  - Any relative, spouse (or spousal equivalent), or relative of the spouse who has the same principal residence; and
  - All accounts and trusts of which the natural person and/or the relatives discussed above are the only primary beneficiaries.

The SEC rule also contains the following criteria for counting the number of organizational clients an advisor has:

- An advisor may treat as a single "client" **two or more corporations, partnerships or other legal entities that have identical shareholders, partners or beneficiaries** and to which the advisor is providing investment advice based on the organization's investment objectives. (An owner of any of these legal entities may also be a separate client, but only if he gets investment advisory services separate from the legal entity.)
- An advisor must count as a client **any limited partnership or limited liability company** for which the advisor acts as a general partner, managing member, or investment advisor.
- In most instances, a **private fund** with multiple investors is considered to be a single client, although there may be instances in which the advisor will need to count the individual fund investors as clients if they receive advisory services separate from the fund.

Notably, the SEC chose not to exclude non-paying clients (those who do not pay the advisor for advisory services) from the 6-client de minimis limit. But some states (such as Connecticut) have done so, making clear that only paying clients count toward the registration limit.

When does an advisor have a place of business in a state?

As we noted above, investment advisors with a place of business in a state typically have to register with that state's securities regulator but, under the national de minimis standard, advisors that do not have a place of business in a state only need to register in states where they have more than 5 "clients." Therefore, it is important that advisors analyze where they have a place of business.

For purposes of the de minimis standard, an investment advisor has a place of business in any state where the advisor maintains:

- An office where the advisor regularly provides investment advisory services, solicits, meets with, or otherwise communicates with clients; or
- Any other location the advisor holds out to the general public as one where the advisor provides investment advisory services, solicits, meets with, or communicates with clients. 17 C.F.R. § 275.222-1(a).

Generally, advisors are found to have a place of business in a state if they have a physical presence there, whether it is a formal office, a branch office, a home office or even a temporary office. For instance, in Wisconsin, an advisor's place of business is any location the advisor advertises as a business location — whether through business cards, stationery, a yellow page or online listing, or formal media advertisement — even if it is a hotel or a restaurant. The advisor must register as a branch office any place to which it invites people to discuss becoming a client, recommendations, investment plans, portfolio performance, etc.

Advisors often ask whether having a general website means they must get registered in all the states from which their website can be accessed. The answer is typically no. Merely having a general website does not mean an advisor is transacting business in each state where people could access the website, or every advisor with a website would be doing business in all 50 states. But some states require advisors to include disclosures or disclaimers on the firm's website making clear that the advisor will need to be registered or exempt from registration in each state before transacting business in the state, and to implement mechanisms (including firewalls) to ensure that registration requirements are followed before the advisor communicates directly with prospective customers or clients from the state.

Please keep in mind that the different states' registration rules for small advisors can differ substantially, and can be complex and fact-specific. They may also change over time. Advisors should review the specific laws of the state(s) where they have a place of business, have clients, or do any investment advisory business to determine whether they need to register with those states.

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