STRADLEY RONON

Investment Management Client Alert |
September 12, 2024

SEC Prunes Use of Hedge Clauses

The U.S. Securities and Exchange Commission (SEC) settled charges on September 3 against a registered investment adviser (RIA) finding, among other things, that the RIA's use of liability disclaimer language, or "hedge clauses," in the RIA's investment advisory agreements and private fund governing agreements violated Section 206(2) of the Investment Advisers Act of 1940 (Advisers Act).[1] The settlement is the latest of several recent statements by the SEC on the use of hedge clauses not only in retail advisory agreements but also by advisers to private funds. Unlike some other recent precedents,[2] this SEC order provides a significant amount of detail regarding the hedge clause language in question, along with facts and circumstances that the SEC considered noteworthy.

Hedge Clauses in Retail Advisory Agreements
The SEC cited, in detail, the hedge clauses contained in two forms of the RIA's standard advisory agreements. The SEC noted that most, if not all, of these advisory agreements were with retail clients.

One form of the RIA's standard advisory agreement disclaimed liability to clients for any action or inaction if the RIA believed in good faith that its conduct was in the best interests of the client and the conduct did not constitute gross negligence, willful misconduct or a breach of applicable law. A second form of advisory agreement similarly disclaimed liability absent gross negligence, willful malfeasance or violation of applicable law for any action performed or omitted or for any errors of judgment in managing the client's account. Each agreement had a "savings clause" or "non-waiver" disclosure stating that the indemnification or limitation of liability would apply only to the extent not prohibited by law or that the provision would not constitute a waiver of the client's rights under federal or state securities laws.

Hedge Clauses in Private Fund Governing Documents
The SEC also cited, in detail, the hedge clauses contained in two forms of the partnership and

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[1] *In the Matter of ClearPath Capital Partners*, Investment Advisers Act Rel. No. 6672 (September 3, 2024).

[2] See, e.g., *In the Matter of Global Predictions*, Investment Advisers Act Rel. No. 6574 (March 18, 2024) (not including specific examples of the text at issue, but noting only that the hedge clauses "purported to relieve [the adviser] from liability for 'any claim or demand' regardless of the theory of liability, and purported to cause the client to broadly indemnify and hold [the adviser] harmless from any third-party claim or demand arising out of the client's use of [the adviser's] services"). Compare with Auchincloss & Lawrence, SEC Staff No-Action Letter (January 8, 1974) (Auchincloss & Lawrence Letter) (including a sample of acceptable hedge clause disclosure drafted by the SEC staff).

operating agreements of private funds managed by the RIA or its affiliates. The SEC noted that some of the parties to the RIA's private fund agreements were retail advisory clients of the RIA.[3]

One form of private fund agreement provided that the RIA and its affiliates would not be liable to any fund investor or the fund itself for honest mistakes of judgment, for action or inaction taken in good faith in respect of the fund, or for losses due to the foregoing. The RIA-related parties would also not be liable for losses due to the negligence, dishonesty or bad faith of any employee or other agent of the fund, provided that such employee or agent was supervised and selected, engaged or retained with reasonable care.

In addition, this form of private fund agreement expressly provided that its provisions modified or waived the fiduciary duties that might otherwise be owed by a fund general partner and other RIA-related parties and that the investors waived any claim of a breach of fiduciary duty to the extent that such duty is eliminated under the fund agreement. As with the retail advisory agreements, this form of private fund agreement had a savings clause in connection with liabilities that may not be waived, modified or limited under applicable law. A second form of private fund agreement similarly disclaimed liability absent fraud, deceit, gross negligence, willful misconduct or wrongful taking by the fund manager. The SEC order does not make clear whether this form of agreement had a savings clause.

Lessons Learned and Potential Roadmap

This settlement order is just the latest in a long line of statements by the SEC and its staff expressing their view that the appropriateness of the language in a hedge clause is a facts-and-circumstances determination.[4] An important consideration has generally been whether the provision is part of an agreement with an institutional investor or whether retail investors are also affected.[5] The SEC's attention to the presence of retail investors in the private funds at issue in this settlement order is one more reason why a private fund manager might reconsider accepting smaller investors or, in the alternative, consider revisiting its fund documentation in light of the facts and circumstances pertaining to each fund's investor base and other attributes.

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[3] The mere existence of retail investors in a fund is not determinative as the many advisers to retail funds registered with the SEC face no prohibition against limiting liability for the advisers' negligence. See Section 17(i) of the Investment Company Act of 1940 (prohibiting an adviser to a registered investment company from limiting liability to the fund or its shareholders for "willful misfeasance, bad faith or gross negligence" or "reckless disregard" of duties — each a more lenient standard than negligence). Thus, an investment adviser to a registered investment company may contractually limit its liability for ordinary negligence and shape the nature of its fiduciary duty with respect to the registered investment company and its shareholders.

[4] See, e.g., Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, Investment Advisers Act Rel. No. 6383 (August 23, 2023) (Adopting Release) (vacated, but stating SEC views on hedge clauses even absent rulemaking); and Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, Investment Advisers Act Rel. No. 5955 (February 9, 2022) (Proposing Release) (suggesting that certain standards remain up in the air, such as by asking for public comment on whether the SEC should "prohibit limiting liability for 'gross negligence,' or would prohibiting limitations of liability for ordinary negligence, as proposed, be more appropriate"). See also Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Investment Advisers Act Rel. No. 5248 (June 5, 2019) (2019 Interpretation) (among other things, withdrawing Heitman Capital Management, SEC Staff No-Action Letter (February 12, 2007) (Heitman Capital Letter)); Auchincloss & Lawrence Letter and the other guidance cited by the SEC staff in the now-withdrawn Heitman Capital Letter; and SEC Investment Advisers Act Rel. No. 58 (April 10, 1951) (opinion of then-general counsel of the SEC on hedge clauses).

[5] See, e.g., 2019 Interpretation, which indicated that the SEC believes there are "few (if any) circumstances" where a hedge clause in a retail agreement that purports to broadly relieve the adviser of liability would be consistent with Section 206(2).

Whether a firm advises small retail investors, major institutions, private funds or a mix of investor types, the firm may find it prudent to make use of the detailed excerpts from this settlement order, along with related SEC and staff guidance, to construct a roadmap to navigate this highly scrutinized topic.

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