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Hedge Clauses in Advisory Contracts

On February 12, 2007, the SEC's staff issued a no-action letter providing guidance in response to a request from Heitman Capital Management, LLC and certain of its affiliates, each of which is a registered investment adviser under the Investment Advisers Act of 1940 (the "Advisers Act"). Heitman requested the SEC staff's views under Sections 206(1) and (2) of the Advisers Act concerning the use of "hedge clauses" and related disclosure in investment advisory agreements.

A typical "hedge clause" in an investment advisory contract or hedge fund limited partnership/limited liability company agreement is structured as an exculpation of the adviser from liability and/or as indemnification of the adviser by the advisory client unless the adviser has been grossly negligent or has engaged in reckless or willful misconduct, illegal acts or acts outside the scope of its authority. Often, hedge clauses are followed by "non-waiver disclosure" that explains that the client may have certain legal rights, generally arising under federal and state securities laws, notwithstanding the hedge clause that have not been waived.

The question presented by Heitman is whether the use of a hedge clause in combination with non-waiver disclosure violates Sections 206(1) and (2) of the Advisers Act. Sections 206(1) and (2) make it unlawful for any adviser to employ any device, scheme, or artifice to defraud, or to engage in any transaction, practice, or course of business that operates as fraud or deceit on, clients or prospective clients. The concern is that these antifraud provisions may be violated by the use of a hedge clause if such a clause is likely to lead a client to believe that it has waived non-waivable rights of action against the adviser that are provided by federal or state law.

The SEC staff had previously taken the position that "hedge clauses that purport to limit an adviser's liability to acts involving gross negligence or willful malfeasance are likely to mislead a client who is unsophisticated in the law into believing that he or she has waived non-waivable rights, even if the hedge clause explicitly provides that rights under federal or state law cannot be relinquished." However, the staff has never clearly articulated the scope of the rights of an advisory client under the federal securities laws that may not be contractually waived or limited. Indeed, many investment advisers take the position that there are a wide range of activities and issues that fall outside of this scope and for which responsibility may be properly limited pursuant to a contractual hedge clause. In addition, an investment adviser and its client may agree to certain corrective actions that may be beneficial to the investment adviser so long as the client is fully informed, sophisticated, and agrees contractually in writing.

Heitman argued that a bright-line prohibition was improper and that the question of whether a hedge clause would mislead a client depends on the surrounding facts and circumstances. The SEC staff agreed with Heitman's argument and indicated that, in making the relevant determination, the staff "would consider the form and content of the particular hedge clause (*e.g.*, its accuracy), any oral or written communications between the adviser and the client about the hedge clause, and the particular circumstances of the client." The staff indicated that it would also consider the sophistication of the client, and presence and sophistication of any intermediary assisting a client in its dealings with the adviser and the nature and extent of the intermediary's assistance to the client in determining the

permissibility of a hedge clause. For unsophisticated clients, the staff would consider numerous factors including, but not limited to, whether: (i) the hedge clause was written in plain English; (ii) the adviser highlighted and explained the hedge clause during an in-person meeting with the client; and (iii) the adviser provided enhanced disclosure to explain the instances in which such client may still have a right of action against the adviser.

The staff noted that a hedge clause may be misleading in its overall effect even if, when narrowly and literally read, no single statement of material fact is false. Furthermore, the staff stressed an adviser has an affirmative duty to explain a hedge clause to its client if the adviser believes or has reason to believe that the client, in light of its unique circumstances, would be likely to be misled by the clause.

In sum, the staff indicated that the use of a hedge clause, accompanied by non-waiver disclosure of the type described above, would not *per se* violate Sections 206(1) and (2) of the Advisers Act. As a matter of policy, the staff noted it will not provide no-action or interpretive assurances under Sections 206(1) or (2) regarding an adviser's use of any particular hedge clause.

Advisers may wish to review the standard of care and indemnification language in their advisory agreements and hedge fund operating documents, and consider the level of sophistication of each of their clients and the depth of the disclosure provided to them orally and in the applicable disclosure documents regarding the applicable standard of care. To the extent the client is subject to ERISA, advisers should consider expanding the "non-waiver clause" to clarify that the client is not waiving any applicable rights under ERISA to the extent that the adviser would otherwise be exculpated/ indemnified for a breach of fiduciary duty.