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**Compliance Corner**
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# Are Hedge Clauses Valid?

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Concerns have arisen in recent years about hedge clauses, which are commonly used contractual provisions limiting an adviser's liability to its clients. These concerns have arisen because of statements in a 2019 SEC release on the fiduciary duties of advisers (the "2019 Release"), which withdrew an older SEC no-action letter that was widely interpreted as setting forth a roadmap for advisers to include hedge clauses in advisory contracts. These concerns increased when the SEC proposed to ban all hedge clauses in agreements with private funds, even though this proposal was never adopted and the final private funds rule that the SEC adopted was invalidated by the courts as exceeding SEC authority. (See, the 2023 SEC release adopting the now invalid private funds rule, "2023 Release.") Concerns further increased because of recent SEC enforcement actions alleging certain hedge clauses were invalid.

In general, commonly used hedge clauses are less likely to be valid the more general the hedge clause and the less sophisticated the client. While greater due diligence on the sophistication of the clients and better disclosure to clients about the hedge clauses may make it more likely hedge clauses will survive challenges, there is no guarantee these efforts will succeed.

An alternative approach that is more likely to reduce the adviser's liability to its clients involves use of other contractual provisions that have generally been accepted by the SEC and the courts. These include contractual provisions requiring disputes between the adviser and its clients to be resolved through arbitration in a specified venue, limitations on the types of damages clients can obtain for the adviser's actions, requirements that clients pay for certain insurance protecting the adviser from certain losses, limitations on the services the adviser will

provide to clients, and waivers of certain specified conflicts. Contractual provisions such as these can significantly reduce an adviser's potential liability and are more likely to survive scrutiny from the SEC and the courts.

## Definition of a Hedge Clause

A commonly used hedge clause is a contractual provision that limits an adviser's liability for certain actions. The following is an example of a commonly used hedge clause:

> "The Adviser shall not be liable for any losses incurred by the Client's account unless such losses were caused by the Adviser's gross negligence, willful misconduct, or breach of fiduciary duty, and not due to any ordinary errors in judgment or market fluctuations."

Closely akin to hedge clauses are indemnification provisions, which provide that the client or a third party, rather than the adviser, will be liable for certain actions by the adviser. The following is an example of an indemnification provision:

> "The Client undertakes to keep the Investment Manager and its agents and employees fully and effectively indemnified against all costs, losses, liabilities, and claims whatsoever incurred by the Investment Manager and its agents pursuant to or in connection with this Agreement or the provision of services to the Client unless due to the gross negligence, wilful default or fraud of the Investment Manager or its agents."

## Other Related Contractual Provisions

**Contractual Provisions Specifying the Services an Adviser Will Provide**

Surprisingly, the first statement by the SEC about the validity of hedge clauses suggests that an adviser cannot contractually limit the services it provides to clients. The specific clause at issue stated the following with respect to recommendations or information on particular securities: "the information furnished is obtained from sources believed to be reliable but . . . no assurance can be given as to its accuracy," with occasionally added language "to the effect that no liability is assumed with respect to such information."

There is now little question that contractual provisions limiting the types of services an adviser will provide to its clients are valid and enforceable. The SEC's 2019 Release confirms this

position: “The fiduciary duty follows the contours of the relationship between the adviser and its client, and the adviser and its client may shape that relationship by agreement, provided that there is full and fair disclosure and informed consent.”

Some law professors have argued for a much more sweeping interpretation of the ability of the adviser and the client to define by contract the elements of the fiduciary duty an adviser owes to a client, but this position has never been accepted by the SEC.

**Waivers of Conflicts of Interest**

Section 206(3) of the Advisers Act, unlike comparable provisions of ERISA and the Investment Company Act, expressly validates a serious conflict of interest – a principal trade between an adviser and its client – provided there is disclosure to the client and consent on a trade-by-trade basis. This suggests that virtually any specific conflict of interest can be waived by contract, which provides disclosure and client consent to the conflict.

An example of a broad waiver of multiple conflicts is the following:

> “The adviser’s conflicts of interest are set out in its Form ADV, Part 2A. These are the types of actual or potential conflicts of interest which affect or may affect the adviser’s services under this agreement and provides details of how these are sought to be managed.”

Citing the Restatement of Agency, the 2019 Release distinguishes between general and specific waivers of conflicts, noting that general waivers are generally ineffective but specific waivers are generally effective: “an agreement that contains general or broad language purporting to release an agent in advance from the agent’s general fiduciary obligation to the principal is not likely to be enforceable. This is because a broadly sweeping release of an agent’s fiduciary duty may not reflect an adequately informed judgment on the part of the principal; if effective, the release would expose the principal to the risk that the agent will exploit the agent’s position in ways not foreseeable by the principal at the time the principal agreed to the release. In contrast, when a principal consents to specific transactions or to specified types of conduct by the agent, the principal has a focused opportunity to assess risks that are more readily identifiable.”

**Limitations of Damages for an Adviser’s Actions**

Some contractual provisions limit the specific types of damages that a client can obtain because of an adviser’s actions. An example of such a provision is the following:

> "The adviser shall not be liable in any circumstances for any losses that constitute indirect, special or consequential loss, or loss of profits, opportunity, goodwill or reputation, or interest on any client losses in connection with or arising out of this agreement."

Such provisions are generally treated as valid and enforceable, in contrast with hedge clauses that limit all damages clients can obtain due to an adviser's actions.

**Requiring the Client to Obtain Liability Insurance for the Adviser**

If the client is required to pay for certain types of insurance, such an obligation could be viewed as limiting the adviser's liability to the client. Both the Investment Company Act and ERISA generally require the fund or plan, which is the adviser's client, to obtain and to pay for a fidelity bond, which is a form of insurance protecting the fund or plan from losses caused by certain types of misconduct by the officers and employees of the fund's or plan's adviser. No similar requirement is imposed by the Advisers Act, but an advisory contract could require the client to obtain a fidelity bond for the adviser. While these requirements do not relieve the adviser or its employees from liability for misconduct, by protecting the fund or plan from losses, these requirements effectively limit the adviser's financial exposure. General liability insurance can also protect the adviser and its employees from losses for conduct covered by the insurance. If the client agrees to pay for such insurance, the client is paying to limit the adviser's obligations in the event of losses.

Such provisions are generally viewed as valid, although insurance law may prohibit an insurance policy from paying a regulatory fine or paying for other types of losses incurred by the insured.

**Provisions Relating to Litigation Process: Venue, Jury Trial, Arbitration**

At one time, the SEC criticized arbitration and other contractual provisions that require disputes between the adviser and the client to be decided by arbitration, or in a particular court and without a jury trial, on the theory that such provisions were improper hedge clauses. More recently, however, and as noted in a 2023 report of the SEC staff, these types of provisions are widely included in advisory agreements and have not been challenged in recent years by the SEC. This is true even though such provisions can severely restrict the remedies a client can obtain against its adviser.

An example of an arbitration clause is the following:

> "All actions relating to: (a) this agreement and/or any amendments and addenda hereto, or the breach, invalidity or termination hereof; (b) any previous or subsequent agreement between the parties; and/or (c) any other relationship, transaction or dealing between the parties will be subject to and resolved by binding arbitration in Washington D.C. pursuant to the Arbitration Rules of the American Arbitration Association. Any award or order rendered by the arbitrator may be confirmed as a judgment or order in any state or federal court of competent jurisdiction."

The 2023 SEC staff report noted, however, that provisions such as this one may operate severely to limit the adviser's liability to a client and should be reviewed more critically by the SEC.

## Relevant Laws

### Advisers Act Section 215(a)

Section 215(a) of the Advisers Act restricts waivers, including those in hedge clauses, that purport to allow an adviser to avoid compliance with legal or regulatory requirements. It states: "Any condition, stipulation, or provision binding any person to waive compliance with any provision of this subchapter or with any rule, regulation, or order thereunder shall be void."

### ERISA

Section 410(a) of ERISA generally prohibits hedge clauses: "any provision in an agreement or instrument which purports to relieve a fiduciary from responsibility or liability for any responsibility, obligation, or duty under this part shall be void as against public policy." Section 410(b) of ERISA, however, permits insurance to cover liability of a fiduciary.

### Local Laws

Certain state and local laws may limit the inclusion of hedge clauses in advisory contracts. For example, the North American Securities Administrators Association (NASAA) generally states that an investment adviser cannot waive its fiduciary duty through a contractual provision like a hedge clause, which according to NASAA could be seen as misleading clients into believing that nonwaivable liability of the adviser has been waived.

### Governmental Entities

Some governmental entities are prohibited by regulations from agreeing to hedge clauses.

## Key Considerations in Evaluating a Hedge Clause

As illustrated above, hedge clauses can take many forms and be relevant in many contexts. Because of the variety and complexity of hedge clauses, the 2019 Release warns that "an adviser's federal fiduciary duty may not be waived, though its application may be shaped by agreement." The 2019 Release further points out that certain hedge clauses are never valid: "A contract provision purporting to waive the adviser's federal fiduciary duty generally, such as (i) a statement that the adviser will not act as a fiduciary, (ii) a blanket waiver of all conflicts of interest, or (iii) a waiver of any specific obligation under the Advisers Act, would be inconsistent with the Advisers Act, regardless of the sophistication of the client." However, the 2019 Release acknowledges that contractual provisions can limit the adviser's responsibilities to the client by defining the services the adviser will provide to the client.

In the 2023 Release, which adopted rules that have subsequently been invalidated by the courts, the SEC declined to adopt a proposed rule that would have broadly prohibited hedge clauses, which were defined as clauses that "seek reimbursement, indemnification, exculpation, or limitation of [the adviser's] liability by the private fund or its investors for a breach of fiduciary duty, willful misfeasance, bad faith, negligence, or recklessness in providing services to the private fund." When the SEC Commissioners were discussing the withdrawal of this proposed requirement from the final rule, the director of the Division of Investment Management stated that the 2023 Release was not intended to change the law as articulated in the 2019 Release.

### The Scope of the Clause

*Specific Versus General Waivers*

Although the 2019 Release notes that more specific waivers of liability may be valid, the 2019 Release does not define when a waiver is too general. Since a broad continuum exists between very specific and very general hedge clauses, it is often difficult to determine whether a hedge clause is sufficiently specific to withstand SEC scrutiny.

*Difficult Interpretive Issues*

The Difference Between Simple Negligence and Gross Negligence

Hedge clauses in use today often absolve the adviser from liability for simple negligence but retain the adviser's liability for gross negligence or reckless conduct. The difference between simple and gross negligence is often considered so subtle and elusive that Britain has abolished the distinction, and the Model Penal Code recommends a similar change in the United States. Gross negligence seems to be something more intentional than negligent conduct but less intentional than reckless conduct. A common definition of gross negligence is very great negligence, but not so great as to constitute recklessness.

Waiver of Certain Statutory or Regulatory Requirements

As noted above, a waiver of a statutory or regulatory requirement is invalid. It may be difficult to define, however, when a particular waiver actually waives a statutory or regulatory requirement. For example, a provision that states that an adviser has no obligation to make suitable investment recommendations to clients would probably be viewed as waiving a statutory requirement. However, a provision stating, depending on the circumstances and the overall services the adviser agrees to provide, that an adviser will conduct a suitability review of a client's investments once a year and no more frequently would probably be valid as defining the services the adviser will provide to the client.

**The Sophistication of the Client**

In the 2019 Release, the SEC stated that "[t]he question of whether a hedge clause violates the Advisers Act's antifraud provisions depends on all of the surrounding facts and circumstances, including the particular circumstances of the client (e.g., sophistication)." In the 2023 Release, the SEC stated that "full and fair disclosure for an institutional client (including the specificity, level of detail, and explanation of terminology) can differ, in some cases significantly, from full and fair disclosure for a retail client because institutional clients generally have a greater capacity and more resources than retail clients to analyze and understand complex conflicts and their ramifications." Recent SEC enforcement actions suggest that an adviser must adopt procedures to evaluate the sophistication of clients who are asked to consent to hedge clauses.

*Retail Versus Institutional Clients*

The 2019 Release incorporates an arbitrary distinction between a client who is a human being and a client who is a legal entity. So, for example, Warren Buffett is defined as a retail client because he is a human being, even though he is extremely sophisticated and has the resources to hire the best advisers to assist him. In contrast, a small LLP managed by a young and inexperienced investor is treated as an institution even though the decision-maker lacks both the sophistication to make complex investment decisions and the resources to retain advisers to assist him.

Once these simple distinctions are set aside, however, difficult interpretive questions immediately arise. It is often unclear whether a particular individual is sophisticated enough to evaluate a hedge clause, and it is also often unclear when a particular individual has sufficient resources to retain the experts he may need to help him. As noted above, in a recent enforcement action, the SEC stated that an adviser must adopt procedures to determine the sophistication of a client asked to consent to a hedge clause, but the enforcement action does not explain what procedures may be sufficient.

*Special Protected Clients*

As noted above, certain institutional clients, such as ERISA plans and governmental entities, may be prohibited from agreeing to a hedge clause. An adviser must identify these types of clients to avoid entering into an illegal contract. Sometimes, it may be difficult to determine whether the client is subject to a statutory limitation against a hedge clause.

**How Consent to the Hedge Clause Is Obtained**

The validity of the client's consent to a hedge clause is critical to the validity of the clause itself. Accordingly, certain practices for obtaining client consent to a hedge clause are generally disfavored.

*Negative Consent*

The 2019 Release seems to accept the effectiveness of negative consent by a client, even with respect to a waiver of conflicts of interest: "an adviser could provide a client full and fair disclosure of all material facts relating to the advisory relationship as well as full and fair disclosure of all conflicts of interest which might incline the adviser, consciously or unconsciously, to render advice that was not disinterested, through a combination of Form ADV

and other disclosure and the client could implicitly consent by entering into or continuing the investment advisory relationship with the adviser."

*Consent by Checking a Box*

Many online agreements now provide for consent by checking a box on a digital form. Although consent through such a procedure is widely used and accepted, there is a risk that a sensitive provision such as a hedge clause will not be valid if consent is obtained through this procedure.

**Disclosure Relating to Client Consent to the Hedge Clause**

In the 2023 Release, the SEC stated that disclosure relating to a hedge clause requires "specificity, level of detail, and explanation of terminology . . . . [T]he disclosure must be clear and detailed enough for the client to make an informed decision to consent to the conflict of interest or reject it." In the 2019 Release, the SEC emphasized that "[t]o the extent that a hedge clause creates a conflict of interest between an adviser and its client, the adviser must address the conflict as required by its duty of loyalty." In this context, the 2019 Release specifically noted that disclosing that a conflict "may" exist is inadequate when a conflict actually exists.

Although the 2019 Release withdrew an earlier no-action letter, guidance from that letter may be helpful in evaluating the disclosure that must be made in connection with asking a client to agree to a hedge clause:

> we would consider the form and content of the particular hedge clause (e.g., its accuracy), any oral or written communications between the investment adviser and the client about the hedge clause, and the particular circumstances of the client. For instance, when a hedge clause is in an investment advisory agreement with a client who is unsophisticated in the law, we would consider factors including, but not limited to, whether: (i) the hedge clause was written in plain English; (ii) the hedge clause was individually highlighted and explained during an in-person meeting with the client; and (iii) enhanced disclosure was provided to explain the instances in which such client may still have a right of action. In addition, we would consider the presence and sophistication of any intermediary assisting a client in his dealings with the investment adviser and the nature and extent of the intermediary's assistance to the client.

## A “Savings Clause” Probably Does Not Protect the Adviser from Liability for an Invalid Hedge Clause

A “savings clause” is a contractual provision stating that 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 laws. Recent SEC enforcement actions have found that such clauses do not protect the adviser from liability for including illegal hedge clauses in advisory agreements.

## An Improper Hedge Clause Can Be Illegal Even If Never Enforced

SEC enforcement actions suggest that an improper hedge clause is invalid even if never enforced, on the theory that an impermissible hedge clause may deceive the client into never pursuing a valid claim against an adviser.

## Hedge Clauses Are Probably Ineffective in Government Actions

Since hedge clauses are created by contract and the United States is almost never a party to an advisory contract, hedge clauses are probably not binding on the United States, since it did not agree to such clauses. In several settled enforcement cases, the SEC staff has not deferred to hedge clauses in determining what standard of care should apply to an adviser.

## Conclusion: A Possible Framework for Evaluating Hedge Clauses

A two-step analysis may help to separate legal from illegal hedge clauses. First, consider whether a reasonable client would consent to the hedge clause. This consideration requires an evaluation of the scope of the hedge clause, the sophistication of the client, and the disclosure explaining the hedge clause to the client. Applying this test in an extreme case, no reasonable client would knowingly agree to permit the adviser to steal the client’s money, or always to subordinate the client’s interests to the interests of the adviser. Second, consider whether the hedge clause effectively permits the adviser to cease acting as a fiduciary to the client.

The commonly used hedge clauses described at the beginning of this article are the most difficult to defend. When an adviser seeks to include such provisions in client agreements, the following steps are recommended, but do not guarantee that a very broad hedge clause will withstand SEC or judicial scrutiny:

1. Adopt and follow procedures to assess the sophistication of the client asked to consent to the hedge clause. Document these assessments. Do not simply guess.
2. Follow the guidance set forth above relating to disclosure:
    a. Write the hedge clause in plain English.
    b. Highlight the hedge clause to the client.
    c. Provide disclosure to the client explaining the hedge clause and its consequences.
    d. Include a "savings clause" immediately after the hedge clause.
    e. Encourage the client to consult an expert before consenting to the hedge clause.
    f. Do not rely on the client checking a box on a computer form for consent.

Advisers may also consider contractual provisions other than a commonly used hedge clause to reduce potential liability. These include:

1. limitations on the services the adviser will provide;
2. disclosure and client consent to specific conflicts;
3. limitations on the adviser's damages for breaches;
4. arbitration and venue selection agreements; and
5. requiring the client to obtain and to pay for certain insurance protecting the adviser.

These provisions are more likely to be enforced than a commonly used hedge clause and can be highly effective in reducing the adviser's liability. However, even these provisions may be challenged if the SEC or the courts take a more restrictive view of such provisions.

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