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Are Hedge Clauses Valid?

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As previously published in the Investment Adviser Association's *IAA Today*, the article examines recent concerns about hedge clauses and contractual provisions that limit an adviser's liability to clients. These concerns stem from a 2019 Securities and Exchange Commission (SEC) release on advisers' fiduciary duties, which withdrew an older SEC no-action letter that was seen as a guide for including hedge clauses in advisory contracts. Worries intensified when the SEC proposed banning hedge clauses in private fund agreements, although this proposal was never adopted, and the courts invalidated the final rule for exceeding SEC authority. (See, the 2023 SEC release adopting the now invalid private funds rule, "2023 Release.") Recent SEC enforcement actions against certain hedge clauses have further heightened concerns.

Hedge clauses are now less likely to be valid, especially if they are general and the client is less sophisticated. While conducting due diligence on client sophistication and improving disclosure about hedge clauses might help them withstand challenges, success is not guaranteed.

An alternative approach to reducing an adviser's liability involves using other contractual provisions generally accepted by the SEC and courts. These include arbitration clauses, limits on damages, insurance requirements, service limitations, and conflict waivers. Such provisions can significantly lower an adviser's potential liability and are more likely to pass SEC and court scrutiny.

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CONTACTS

For more information, contact your Katten attorney or any of the following attorneys.

Richard D. Marshall
+1.212.940.8765
richard.marshall@katten.com