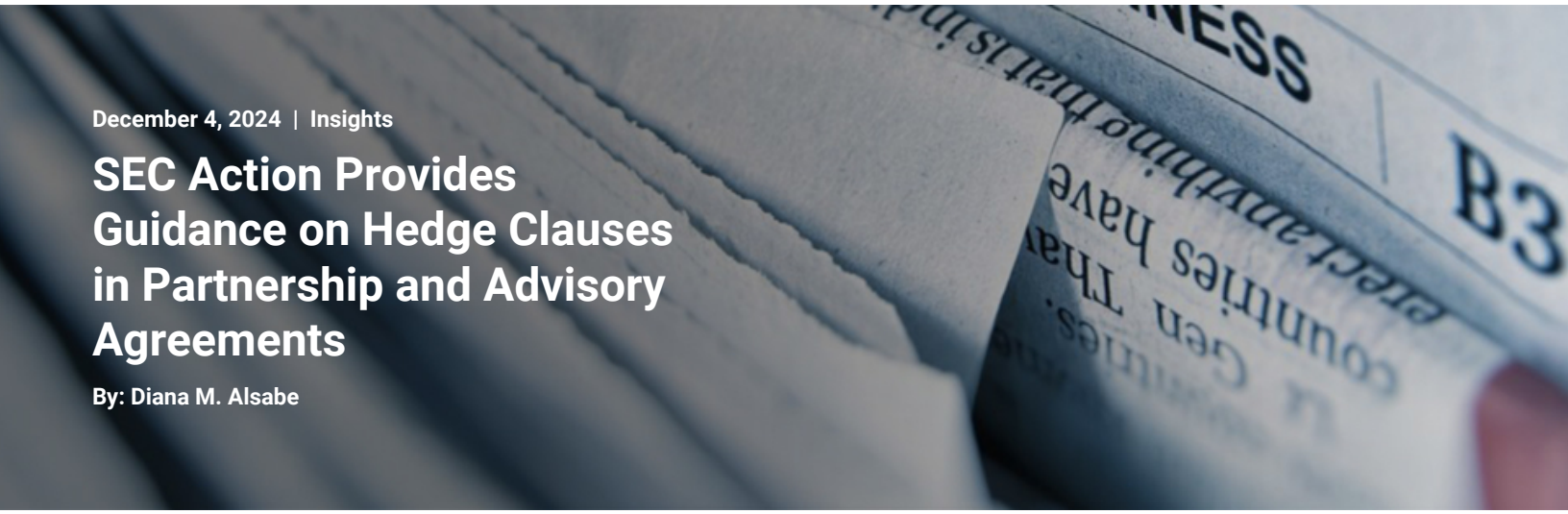

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SEC Action Provides Guidance on Hedge Clauses in Partnership and Advisory Agreements

By: Diana M. Alsabe

On September 3, 2024, the U.S. Securities and Exchange Commission (the "SEC") settled charges against ClearPath Capital Partners LLC ("ClearPath") for, among other things, the improper use of liability disclaimers, commonly referred to as "hedge clauses", in its private fund and investment advisory agreements.

In *In the Matter of ClearPath Capital Partners* (the "ClearPath Action"), the SEC found that ClearPath included hedge clause language in its private fund partnership and operating agreements. The SEC determined that such language could mislead clients into believing they had waived certain non-waivable legal rights against ClearPath.

The SEC evaluated these clauses under the federal fiduciary standard established by the Investment Advisers Act of 1940 (the "Advisers Act"). While the Advisers Act does not allow an adviser's federal fiduciary duty to be waived, its application may be shaped by the specifics of an agreement. Importantly, the Advisers Act prohibits advisory agreements from misrepresenting or misleading clients into believing they have waived legal claims that cannot be waived under federal or state law.

The ClearPath Action scrutinized hedge clause language in both advisory and private fund agreements. Advisory agreements included repeated disclaimers of liability for "action or inaction," except in cases of gross negligence, willful misconduct, or violations of applicable law. The SEC found this language inconsistent with an adviser's fiduciary duty, as it could dissuade retail clients from pursuing their non-waivable legal rights, thereby violating Section 206(2) of the Advisers Act.

Similarly, the SEC found that ClearPath's private fund agreements contained language that broadly sought to limit ClearPath's liability and waive its fiduciary duty. For instance, the private fund agreements contained language that sought to waive ClearPath's non-waivable fiduciary duty and disclaim ClearPath's liability for "mistakes of judgment" or for "action or inaction". Further, the private fund agreements expressly required investors to waive any and all current and future claims, and their right to assert such claims against ClearPath for breach of fiduciary duty. Such language was found to be in direct violation of



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Section 206(2) of the Advisers Act.

Although not the SEC's first action addressing hedge clauses, the ClearPath Action provides clearer guidance on what constitutes impermissible hedge clause language. Historically, the SEC has taken a facts-and-circumstances approach to determining whether specific hedge clauses are misleading, creating challenges for regulation in this area.

What Does This Mean for You?

For investment advisers to private funds, the ClearPath Action reinforces the SEC's stringent stance on liability disclaimers in advisory and private fund agreements. Advisers should carefully review their agreements to identify and address any potential hedge clause language that may conflict with their fiduciary duties. Additionally, advisers should carefully review their investment management agreements with clients to identify and address any potential hedge clause language that may conflict with their fiduciary duties. Clients with concerns about hedge clauses in their agreements should consult a Rich May attorney.

Disclaimer: This summary is provided for educational and informational purposes only and is not legal advice. Any specific questions about these topics should be directed to Diana Alsabe.

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