Exculpatory Hedge Clauses in Investment Advisory Contracts: Developments since *Heitman Capital*

By Francis J. Facciolo and Leland S. Solon

The Investment Company Act of 1940 (ICA) and the Investment Advisers Act of 1940 (IAA) prevent an investment adviser from contractually limiting liability to its advisees through three main routes: statutory anti-waiver prohibitions,[1] the IAA's anti-fraud provisions, and limitations on indemnification by registered investment companies of their investment advisers.[2] This article focuses on one of these three areas, the IAA's anti-fraud provisions, and specifically, the SEC's expansive interpretations of those anti-fraud provisions to cover exculpatory "hedge clauses" – caveats or cautionary statements – by investment advisers purporting to limit their liability to their advisees.

Hedge clauses remain very common in the investment adviser industry. In the first half of 2013, hedge clauses that triggered a finding of a contractual deficiency were commonly found in state and Canadian provincial examinations of investment advisers.[3]

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This article describes how the SEC's position on hedge clauses has evolved in light of the IAA's anti-fraud provisions, culminating in the 2007 no-action letter of *Heitman Capital Management, LLC,*[4] which granted new and unexpected leeway to advisers. In *Heitman Capital*, the SEC stated that it would no longer provide no-action guidance on hedge clauses; therefore, the only avenue for further development of the law in this area is in the courts or SEC enforcement actions.

Although hedge clauses have been raised by plaintiffs in a number of cases, there has only been one case with a published opinion that addresses the effect hedge clauses have on a contract between an investment adviser and its advisee. The Ninth Circuit, in the recent case of *Hsu v. UBS Financial Services, Inc.*,[5] has allowed an investment adviser to legally disclaim its liability – or create the perception in the mind of the advisee that the adviser has disclaimed its liability – for the actions of an investment manager to whom the investment

adviser refers an advisee. This is a surprising outcome because recommending an investment manager can constitute investment advice under the IAA,[6] and the disclaimer of liability for the recommended manager's actions is arguably inconsistent with the recommending adviser's broad fiduciary duties.[7]

The SEC has relied upon two IAA provisions in developing its position on hedge clauses. The first is Section 206, the anti-fraud provisions, and the second is Section 215, the provision voiding certain illegal advisory contracts. Sections 206(1) and 206(2) make it unlawful for an investment adviser "to employ any device, scheme, or artifice to defraud any client or prospective client," and/or to "engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client," respectively.[8]

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Section 215(a) provides that "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."[9]

The SEC's first statement on hedge clauses came in a 1951 Opinion of the General Counsel.[10] The hedge clauses addressed in the general counsel's opinion related to literature used by both broker-dealer and investment advisers containing recommendations or information on particular securities. Such publications contained statements to the effect "that the information furnished is obtained from sources believed to be reliable but that 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." Concerned that a hedge clause would "create in the mind of the investor a belief that he has given up legal rights and is foreclosed from a remedy which he might otherwise have either at common law or under the" federal securities laws, the general counsel opined that a hedge clause or similar provision violates Section 206's anti-fraud provisions (and other SEC statutes) if it "is likely to lead an investor to believe that he has in any way waived any right of action he may have."[11]

Over time, the hedge clause language was generalized by broker-dealers and investment advisers to contracts with advisees beyond the literature context. The added language disclaiming liability mentioned in the general counsel's opinion is what the SEC has focused on in a series of no-action letters and enforcement actions.

Until 2007, the SEC through a series of no-action letters and enforcement actions took a very restrictive position on what a permissible hedge clause was. Essentially, in the no-action letters described in this article, the SEC reasoned that the antifraud provisions of the IAA contained in Sections 206(1) and 206(2) were violated any time a hedge clause attempted to limit investment adviser liability for negligence or malfeasance by using such adjectives as "gross" or "willful" to qualify what type of investment adviser negligence or malfeasance might trigger liability to an advisee. In 2007, the SEC issued a no-action letter to Heitman Capital Management, LLC, which marked

a turn in the SEC's position and declared, for the first time, that such qualifications are not *per se* violations of Sections 206(1) and 206(2). Rather, the *Heitman Capital* no-action letter announced that whether a particular hedge clause is "mislead[ing] [as to] any particular Client" can only be answered by a "fact-intensive…inquiry" that focuses on a particular advisee's "particular circumstances," the "relationship and communications between" the investment adviser and the advisee, and "the form and content of the hedge clause."[12]

It was not until the 1970s that the SEC first began to give some content to the 1951 opinion of its general counsel. In various no-actions letters, the SEC separately rejected attempts to disclaim investment adviser liability for "ordinary negligence,"[13] to limit such liability to "*gross* negligence or *willful* malfeasance,"[14] and to limit such liability to "acts done in bad faith."[15] The SEC has pointed out that the use of adjectives to qualify liability for negligence or malfeasance may violate Section 206 because there may be situations where applicable law requires a greater degree of care by a fiduciary, and that, accordingly, the agreement should at the least state that the advisor was not disclaiming liability for "violation[s] of applicable law."[16] One way used by an investment adviser to clarify such waivers has been to include a statement to the effect that an advisee has not waived his rights under the federal securities law or state law. The SEC has made clear that reference merely to the federal securities laws is not adequate.[17]

Even such a non-waiver statement was not necessarily adequate in the SEC's view, however. As the SEC understood fiduciary law, an advisee "may have a right of action under federal and state law even where his adviser has acted in good faith."[18] The SEC pointed out in one no-action letter that the combination of a non-waiver statement with a disclaimer of an investment adviser's liability for gross or willful conduct might lead an "unsophisticated" advisee to believe it had no legal rights for any actions undertaken by an investment adviser.[19]

The SEC has never addressed the issue of whether exculpatory clauses other than those discussed to this point might be permissible. But the State of Connecticut has done so when it stated in a release that exculpatory provisions relieving an investment adviser of its "liability for losses caused by conditions and events beyond its control such as war, strikes, natural disasters, new government restrictions, market fluctuations, communications disruptions, etc.… are acceptable since they do not attempt to limit or misstate the adviser's fiduciary obligations to its clients."[20] This conclusion is consistent with the reasoning behind the SEC's no-action letters.

In addition to the above-cited no-action letters, the SEC has instituted three enforcement actions that penalized advisors for using hedge clauses, among other violations, although none of these actions provide much additional guidance on what makes a hedge clause problematic. In the two earliest actions from 1979 and 1981, the SEC did not describe the content of the hedge clause or why it was objectionable.[21] In 1994, the SEC brought an enforcement action alleging, among other violations, that the adviser's agreements contained a paragraph purporting to limit the adviser's liability to "gross negligence or willful misconduct," although the SEC still provided no explanation of why the hedge clause was problematic.[22]

There also is a well-developed body of state administrative law adopting the SEC's approach to limitations on hedge clauses and applying it to state registered investment advisers.[23] In part, this is a function of the fact that many state securities laws governing investment advisers are modeled on the IAA[24] and in part a function of the fact that the anti-fraud provisions of Section 206 of the IAA are not limited to investment advisers registered with the SEC.

The "hedge clause" doctrine and the 1951 general counsel's opinion have been cited by the SEC in other areas of investment adviser regulation where, in the SEC's view, an advisee might be misled into believing that he or she had no rights arising from the fiduciary duties owed by an investment adviser to its advisees. For example, in a 1984 no-action letter *Robert D. Brown Investment Counsel, Inc.*,[25] the SEC stated that a provision in a year-to-year advisory contract providing that the advisee could only elect to terminate the contract once a year (on the contract's anniversary) was fraudulent and deceptive under the IAA. The fiduciary relationship between investment adviser and

advisee was built on confidence, the SEC explained, and, if that confidence was lost, a provision in the contract requiring the further rendering of services, even if they were not satisfactory, raised "serious questions" under the IAA's anti-fraud provisions. The SEC stated that a provision denying a client's right to terminate the contract was invalid because "the contract might lead the client to believe that he is not entitled to terminate the contract when fiduciary principles indicate that he has that right."[26]

Based on the SEC's actions, and especially the no-action letters, one could have read the agency's position on hedge clauses to be very restrictive in setting limits on the contractual rights of an investment adviser and its advisee to negotiate disclaimers of liability. But this is not what the SEC's current position is on hedge clauses, as it made clear in a seminal 2007 no-action letter, *Heitman Capital Management, LLC*.[27] Heitman Capital sought guidance on a hedge clause in which an advisee indemnified Heitman Capital and other investment advisers affiliated with Heitman Capital, except for "*grossly* negligent, reckless, *willfully* improper or illegal conduct in its performance;" actions "outside the scope of [the] Manager's authority;" or "other material breach under" the advisory contract. In addition to this hedge clause, the agreement also contained a "non-waiver of rights" provision: "Notwithstanding the foregoing," nothing in the agreement was to constitute a waiver of any of the client's "legal rights under applicable [US] federal securities law or any other laws whose applicability is not permitted to be contractually waived."

In its letter to the SEC, Heitman Capial asserted that its clients were primarily institutional investors such as large pension funds that were "sophisticated persons that have the resources and experience to understand the investment advisory agreements with the applicable Heitman Advisor, and the bargaining power to negotiate, and in some cases even dictate, the terms of the investment advisory agreements." In addition, some Heitman Capital investment advisers provided advice to wrap account and certain commingled fund entities that were represented by financial intermediaries with allegedly similar levels of sophistication and bargaining power. Heitman Capital also contended that most of these financial intermediaries had a separate responsibility to negotiate with Heitman Capital in the best interests of their underlying clients and assist their clients in evaluating the advisory agreement, including the hedge clause and non-waiver disclosure.

The SEC's Division of Investment Management's response noted Heitman Capital's representations, and reiterated the general principle that whether an advisor's hedge clause purporting to limit adviser liability to acts of gross negligence or willful malfeasance violates Section 206 depends on all of the "surrounding facts and circumstances." In this analysis, the SEC wrote that it would consider (1) "the form and content" of the particular hedge clause, "e.g., its accuracy," (2) communications between the adviser and the client about the hedge clause, and (3) the particular circumstances of the client. Where a client was "unsophisticated" in the law, the SEC asserted, relevant factors would include whether the hedge clause was "written in plain English," "individually highlighted and explained during an in-person meeting," and whether "enhanced disclosure" was provided to explain when a client may still have a right of action.[28]

In light of these general principles and Heitman Capital's factual representations, the SEC's response indicated that Heitman Capital's use of a hedge clause and non-waiver disclosure "would not *per se* violate sections 206(1) and 206(2) of the [IAA]."[29] The no-action letter emphasized, however, that the SEC was taking no position and could give no assurance on whether this Heitman Capital advisory agreement was misleading (and therefore illegal) as applied to any particular client "because of the fact-intensive nature of the inquiry."[30]

In its no-action request, Heitman Capital relied on an interpretation of state law, including that of New York, to the effect that agreements relieving a party of liability for its negligence will be enforced. Although the SEC made no mention of this interpretation in its response, this type of reasoning is implicit in the SEC's statement that a hedge clause and non-waiver disclosure of the type used by the

Heitman Capital investment advisers are not *per se* violations of the IAA. In other words, in the SEC's view, such limitations of liability are apparently permitted if the normal standards for modifying fiduciary duties, full disclosure and informed consent by the beneficiary,[31] are met.

As the SEC indicated in *Heitman Capital* that it would not be issuing further no-action or interpretive assurances under Sections 206(1) or 206(2) of the IAA regarding an adviser's use of any particular hedge clause, the only places in which further developments can occur are SEC enforcement actions or court cases brought either by the SEC or advisees themselves. Since *Heitman Capital*, there have been no SEC enforcement actions on the subject. One published case briefly mentions a hedge clause issue but was decided on other grounds,[32] and there are a handful of cases in which the issue has been raised in the pleadings but that have not resulted in any sort of decisions or orders in which the issue has been discussed.[33] There has been, however, one published case substantively treating hedge clauses: *Hsu v. UBS Financial Services, Inc.*[34]

In *Hsu*, the Ninth Circuit ultimately affirmed the district court determination that the plaintiff failed to state a claim under IAA when he contended that UBS had used an illegal hedge clause in its contracts with him and other clients.[35] The *Hsu* decisions reflect a failure by the plaintiff to clearly connect UBS' fiduciary obligations as an investment adviser, which it became by recommending a list of investment managers to its advisees, to its disclaimer of liability for the actions of these investment managers it recommends.

The plaintiff in *Hsu* was an individual investor advisee who was seeking class certification for similarly situated advisees. He had entered into a contract to participate in UBS' "wrap" fee program, which consisted of investment advisory, execution, clearing and custodial services for a single fee. Under the arrangement, the plaintiff was provided the opportunity to select an investment manager for his wrap fee arrangement, and given a list of potential investment managers for this purpose by UBS. Interestingly, while the wrap fee provisions and list that UBS provided to the plaintiff purported to be only a recommended list of permissible advisers – that is, the advisee was free to select an investment manager other than from the UBS list – the plaintiff attached to his complaint what allegedly were UBS' internal guidelines indicating that the advisee must select someone from the UBS pre-approved list.[36] The plaintiff selected Horizon Asset Management Services, LLC (Horizon) as its investment manager from the list that UBS provided. The basis for the plaintiff's complaint was UBS' apparent disclaimer of liability for the third-party investment manager Horizon's actions.

The plaintiff sought rescission of the wrap fee contracts and "restitution [from UBS] for sums paid to defendant by all class members." To show that UBS unlawfully limited its liability, plaintiff's main argument was based on a comparison of the language describing the wrap fee program and UBS' obligations to advisees in different provisions of the subject contract and a brochure describing the program. On the one hand, plaintiff noted, the wrap fee account disclosure stated that UBS was plaintiff's "investment advisor" with a "fiduciary relationship" to plaintiff, and subject to the legal standards of the IAA. On the other hand, plaintiff pointed out, the contract contained a hedge clause with respect to the third-party investment manager: UBS, the contract stated, "may or may not have researched" the investment manager plaintiff selected.[37] In addition, the contract stated that UBS "shall not be liable for and Client agrees to hold UBS Financial Services Inc. harmless against all losses to Client for any error of judgment, mistake of law, negligence, willful misfeasance, or bad faith on the part of the Investment Manager or any other matter within the Investment Manager's control such as … compliance with applicable law."

The district court granted UBS' motion to dismiss for failure to state a claim, agreeing with UBS that it did not disclaim any duties owed to the plaintiff and that it had not required the plaintiff to waive any rights under the IAA.[38] Essentially, the district court observed, the plaintiff's argument was that, while the UBS statement that it was a fiduciary and the hedge clause disclaiming liability for conduct by Horizon, Hsu's investment manager, may have been clear when read in

isolation, those two provisions were contradictory and misleading when read together. But the hedge clause was not "incongruous" with the other terms of the contract, the district court held, and, therefore, was not deceptive. The district court explained: "The contract never disclaimed liability for UBS's own role as investment advisor [sic]. Rather, it disclaimed liability for any misconduct on behalf of Horizon, HSU's separate investment manager."[39]

In ruling that UBS was permitted to disclaim liability for Horizon's misconduct under these circumstances, the district court's ruling was seemingly vulnerable to appeal. Recommendations regarding whether to select a particular investment adviser can qualify one as an investment adviser under the IAA. If a fiduciary recommends a particular investment adviser who should not have been recommended, then there could be a violation of the recommender's fiduciary duties, and specifically the recommending fiduciary's duty of care. As an agent, the fiduciary "has a duty to the principal to act with the care, competence, and diligence normally exercised by agents in similar circumstances," and, in evaluating whether that standard has been met, "[s]pecial skills or knowledge possessed by [the] agent" are to be taken into account.[40] On the one hand, while fiduciaries are generally not deemed "insurers" of a particular result or the acts of others,[41] the duty of care can impose liability for the acts of others, provided the injurious act of the third-party was foreseeable and the imposition of liability is fair under the circumstances.[42] In the investment advisory context, it can be argued that the damaging actions of another adviser that the principal adviser recommends is foreseeable, because the principal adviser's professional responsibilities necessarily relate to the advisory services the third-party is to provide to the client, and the disclaimer of liability by an investment adviser for the actions of another investment manager whom the adviser recommends seems potentially inconsistent with the investment adviser's fiduciary obligations. Additionally, applying the *Heitman Capital* principles to *Hsu*, if UBS had a fiduciary duty of care with respect to its selection of recommended investment managers, then it seems likely that an advisee could be confused by the various exculpatory statements into thinking that he or she had no cause of action against UBS for its choosing to include specified investment managers in its recommended list.

At the motion to dismiss stage, the plaintiff did not expressly argue, and the district court did not render a ruling, on whether UBS owed a fiduciary duty to the plaintiff in connection with the list of investment managers UBS provided. Rather, the district court held that there was "no contradiction" between the statements that UBS owed a fiduciary duty to the plaintiff and the exculpatory provisions.[43] Implicit in the district court's conclusion that there is no contradiction between the provisions is that UBS and the plaintiff had the contractual power to limit UBS' fiduciary duties to the plaintiff, something which UBS had done, as it appears that it took almost no responsibility for its list of recommended investment managers.

On appeal to the Ninth Circuit, the plaintiff in contrast did clearly argue that "the recommendation of an investment manager to a client generally qualifies as an advisory service and is subject to" the IAA.[44] UBS countered that Hsu "erroneously assumes" that UBS engages in investment advisory services "merely by providing a list of Investment Managers" to clients, and that, "irrespective of whether UBS' mere provision of a list of Investment Managers constituted an advisory service," UBS' disclaimer of liability for Horizon's conduct did not contradict the other contract provisions of UBS fiduciary duties.[45]

It was UBS' argument that ultimately prevailed, as the Ninth Circuit affirmed the dismissal of the complaint. In a brief four paragraph decision, not selected for publication, the court ruled that the plaintiff failed to satisfy Rule 9's pleading requirement of setting forth what is false or misleading about a statement, and why it is misleading, and, therefore, failed to put UBS on fair notice of the claim. According to the Ninth Circuit, while the plaintiff asserted that UBS deceived clients by leading them to believe that they waived certain "unwaivable fiduciary duties" through the hedge clauses, the plaintiff never "identifies or explains what those 'unwaivable fiduciary duties are'… HSU's claim fails because the

clauses that he points to do not waive compliance with any provision of the IAA."[46] Judging by the Ninth Circuit's decision, it appears that, despite there being references by the plaintiff to UBS' owing a fiduciary duty to plaintiff based on its list of recommended investment managers in both plaintiff's opening and reply briefs to the Ninth Circuit, the point was lost on the panel.

The Ninth Circuit also refused to consider plaintiff's argument that, in practice, UBS allegedly required clients to use an investment manager from the UBS pre-approved list, calling this an argument raised for the first time on appeal.[47] This is puzzling, however, because the plaintiff had cited an internal UBS document that ostensibly required that the investment manager be on UBS' pre-approved list, both in his complaint and his opposition to UBS' motion to dismiss. While it can be argued from the pleadings and opposition to motion to dismiss that UBS' policy requiring the plaintiff to select an adviser from the list was not a central focal point of the plaintiff's contention that UBS violated the anti-fraud provision (that was the language of the hedge clauses themselves), the Ninth Circuit's refusal to consider the argument works a particularly harsh result, given that the plaintiff referenced the point below, and its close relation to the hedge clauses and fiduciary duty issues raised in the complaint.

On paper, the *Hsu* plaintiff's case seemed solid under the principles elucidated in *Heitman Capital*: the plaintiff was not an institutional investor, and there were no facts suggesting that he was a sophisticated person, had any bargaining power to negotiate with UBS over the hedge clause, or that the hedge clause was ever explained to him by UBS or any intermediary. But the *Hsu* opinions reflect the practical difficulty that plaintiffs may have in stating claims under the IAA for deceptive practices based on hedge clauses. In the section of its decision summarizing the parties' respective arguments, the district court noted, in a manner suggesting skepticism, that the plaintiff was seeking rescission of "'*all*' of UBS' contracts for this particular 'wrap' fee program" (emphasis in original). Although the district court never gave a ground for its skepticism, perhaps it grew out of several facts, including some of which UBS pointed out in its motion to dismiss or on appeal: plaintiff utilized Horizon as his investment manager for approximately two-and-one half years in the program, never exercising his apparent right to switch his investment manager at any time;[48] and plaintiff never alleged that he was "ever actually misled" by the hedge clause or anything else into believing that he was actually unable to sue UBS for Horizon's conduct.[49]

Heitman Capital clarified that disclaimers for a variety of conduct such as mere negligence are potentially permissible if the advisee is sufficiently sophisticated and possesses bargaining power or is represented by a financial intermediary with these qualities. Without regard to whom the advisee or the financial intermediary is, *Hsu* allowed a hedge clause disclaiming an adviser's liability for the acts of an investment manager that the investment adviser recommends, even though that recommendation in itself constitutes investment advice.

Further developments in this area will have to await further litigation or SEC enforcement actions. But, as the courts have proven to be inhospitable venues for complaints about hedge clauses, we may be waiting for quite some time.

Notes

1. IAA § 215(a), 15 U.S.C.A. § 80b-15(a); ICA § 47(a), 15 U.S.C.A. § 80a-47(a) (2006).

2. *See* ICA § 17(h)-(i), 15 U.S.C.A § 80a-17(h)-(i).

3. North American Securities Administrators Ass'n, 2013 Coordinated Investment Adviser Exams, available at *http://www.nasaa.org/wp-content/uploads/2013/10/IA-Sweep-2013-Final.pdf* (last visited Dec. 27, 2013). One thousand one hundred thirty investment advisers were examined (primarily between January 1, 2013, and June 30, 2013), revealing 6,482 deficiencies. Of the 6,482 total deficiencies, 791 were "Contract Deficiencies," 9% of which (approximately 71) involved hedge clauses. From the figures it is impossible to tell whether 71 investment advisers used improper hedge clauses or whether there were multiple agreements involving the same investment advisers with improper hedge clauses.

4. Heitman Capital Mgmt., LLC, SEC No-Action Letter, 2007 WL 789073 (Feb. 12, 2007).

5. 2011 WL 3443942 (N.D. Cal. Aug. 5, 2011), *aff'd*, 2013 WL 492443 (9th Cir. Feb. 11, 2013), *cert denied*, 134 S.Ct. 266 (Mem.) (Oct. 2013).

6. *See* SEC v. Bolla, 401 F. Supp. 2d 43 (D.D.C. 2005) *aff'd in relevant part,* SEC v. Washington Investment Network, 475 F.3d 392, 400 (D.C. Cir. 2007) (company's business of advising clients about different investment managers fell within IAA's definition of investment

adviser). *See also*, *e.g., Applicability of the Investment Advisers Act to Financial Planners, Pension Consultants, and Other Persons Who Provide Investment Advisory Services as a Component of Other Financial Services*, Release No. IA - 1092, 1987 WL 112702 at 3 ("A person providing advice to a client as to the selection or retention of an investment manager or managers also, under certain circumstances, would be deemed to be 'advising' others within the meaning of Section 202(a)(11)."); Capital Asset Program, SEC No-Action Letter, 1974 WL 10950 ("Since the placing of assets under the management of an investment adviser would normally involve investing in securities, advising a client to select or dismiss an investment adviser would inherently involve advising such a client as to the advisability of investing in securities in general"); William Bye Co., SEC No-Action Letter, 1973 WL 6670 at 2 (SEC's view that company "preparing a periodic quantitative evaluative analysis of the rates of return for investment managers it studies, would be 'advising others … as to the value of securities' and issuing 'analyses or reports concerning securities' within the meaning of Section 202(a)(11) of the Act."). *But see, e.g.,* Sebastian Associates, Ltd., SEC No-Action Letter, 1975 WL 10853 at 2 (recommending no action based on representations that company acting as agent for entertainer and athlete clients in connection with advertising and promotional opportunities, even though as a part of the business company would assist clients in retaining "outside specialists," including estate planning attorneys and "reputable investment advisers or financial consultants"); Hudson Valley Planning, Inc., SEC No-Action Letter, 1978 WL 12359 ("consultant" to employee benefit plan clients not required to register as investment adviser, where consultant primarily drafted and analyzed data-drive questionnaires of a client's investment advisers, and only incidentally provided, upon a client's request, generalized information as to investment advisers capable of fulfilling the client's needs, and without recommending a specific adviser or general advice about investments).

7. *See* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 194 (1963).

8. 15 U.S.C.A. § 80b-6(1)-(2).

9. 15 U.S.C.A. § 80b-15(a).

10. *Opinion of the General Counsel Relating to the Use of "Hedge Clauses" by Brokers, Dealers, Investment Advisers, and Others,* Investment Advisers Act Release No. IA-58 (Apr. 10, 1951).

11. The general counsel was concerned with hedge clauses under the Securities Act of 1933 and the Securities Exchange Act of 1934 as well as the IAA. But, as indicated in the main text, this article examines hedge clauses only in the context of the IAA.

12. Heitman Capital Mgmt., LLC, *supra* n.4, at *3-4.

13. Jonathan-Forbes Inc., SEC No-Action Letter, 1972 WL 7681 (Mar. 20, 1972).

14. Auchincloss & Lawrence Inc., SEC No-Action Letter, 1974 WL 10979 (Feb. 8, 1974) (emphasis added). *See also* Omni Mgmt. Corp., SEC No-Action Letter, 1975 WL 12007 (Dec. 13, 1975) (impermissible to use "gross" to qualify negligence or malfeasance).

15. First Nat'l Bank of Akron, SEC No-Action Letter, 1976 WL 12229 (Feb. 27, 1976).

16. Auchincloss, *supra* n.14. *See also*, First Nat'l Bank of Akron*, supra* n.15 (even a clause that explicitly provides that rights under federal or state law cannot be relinquished may still be misleading; if the hedge clause purports to limit liability to bad faith or wilful misconduct, a client who is unsophisticated in the law may not realize that he may still have a right of action under federal or state law even where adviser acts in good faith).

17. James Inv. Research, Inc., SEC No-Action Letter, 1977 WL 12791 (Apr.10, 1977); Omni Mgmt., *supra* n.14. As with all disclosure, the SEC is also concerned that a hedge clause not be misleading because it could be read in several different ways by an advisee. *See* O.T.C. Fact Sheets, SEC No-Action Letter, 1972 WL 9136 (July 4, 1972) (statement in publication providing information about certain companies that the information "'is believed reliable, but due to possible typesetting errors its accuracy and completeness cannot be guaranteed' is misleading in as much as it implies that typesetting errors are the only possible cause of inaccuracy or incompleteness"); James Inv., *supra* n.17. (SEC suggested moving the statement that an advisee did not waive any of its legal rights so that it was clear that this non-waiver also applies to a statement that the investment adviser was not liable for any act by an agent).

18. First Nat'l Bank of Akron, *supra* n.15; *accord* Auchincloss, *supra* n.14. In its response to the *Auchincloss* no-action request, the SEC suggested not only deleting the adjectives "gross" and "willful" from the hedge clause, but also adding the statement that "[t]he federal securities laws impose liabilities under certain circumstances on persons who act in good faith, and therefore nothing herein shall in any way constitute a wavier or limitation of any rights which the undersigned may have under any federal securities laws." *Id.* Although it is puzzling why this suggested addition did not include a reference to applicable state law, the SEC's concern about ensuring that there is no misunderstanding of the waiver by an advisee is clear. Shortly after the *Auchinloss* no-action letter, Auchincloss & Lawrence wrote to the SEC indicating that, rather than incorporate the revisions that the SEC no-action letter suggested, it was deleting and not replacing the subject exculpatory language from all of its existing and future proposed advisory contracts. *See* Auchincloss, SEC No-Action Letter, 1974 WL 6828 (April 5, 1974).

19. First Nat'l Bank of Akron, *supra* n.15.

20. Connecticut Dep't of Banking, Securities and Business Investments Division, Investment Advisers Cautioned on Use of Hedge Clauses (May 1991), available at *http://www.ct.gov/dob/cwp/view.asp?a=2252&q=299222*.

21. *See e.g., In re Olympian Financial Services, Inc.*, IA-Release No 659, 1979 WL 173510 (Jan. 16, 1979); *In re William Lee Parks*, IA-Release No. 778, 1980 WL 20762 (Sept. 22, 1981).

22. *In re: Wall Street Money Management Group, Inc.*, IA-Release No. 1464, 1995 WL 36238 (Jan. 30, 1995).

23. *See e.g.,* Alaska Dep't of Commerce, The Division's State Investment Advisor Exam Function, available at *http://www.dced.state.ak.us/bsc/compliance.htm*; Connecticut Dep't of Banking, Securities and Business Investments Division, Investment Advisers Cautioned on Use of Hedge Clauses (May 1991), available at *http://www.ct.gov/dob/cwp/view.asp?a=2252&q=299222*; In the Matter of: Wall Street Money Management Group, Inc., (Ill. Sec. Dept.) 1996 WL 390495 (Feb. 21,1996); Jay Fishman, "Maine's Take on Investment Adviser Hedge Clauses and Assets Under Management" (Jan. 3, 2008), available at *http://jimhamiltonblog.blogspot.com/2008/01/maines-take-on-investment-adviser-hedge.html* (discussing Maine's position on hedge clauses); Dishonest or Unethical Practices by Investment Advisers, Investment Adviser Representatives and Federal Covered Advisers., SC Code of Reg. 13-502, discussed at South Carolina Securities Division, Investment Adviser Examination Program Overview, available at *http://2hsvz0l74ah31vgcm16peuy12tz.wpengine.netdna-cdn.com/wp-content/uploads/2011/03/examoverview.pdf* (last visited Dec. 25, 2013); In the Matter of Henry C. Brock, Utah Dep't of Commerce, Division of Securities, Stipulation and Consent Order, Docket No. SD 03-0007 (Apr. 17, 2006), available at *http://www.securities.utah.gov/dockets/03000732.pdf* (last visited Dec. 25, 2013); Unethical business practices, Investment advisers and federal covered advisers, Wash. Admin. Code 460-24A-220(19) (current as amended Dec. 4, 2013).

24. Connecticut Dep't of Banking, Investment Advisers Cautioned on Use of Hedge Clauses (May 1991) ("Inasmuch as there appears to be no relevant Connecticut case law, it is appropriate to look to federal authorities since the anti-fraud provisions in Section 206 of the Investment Advisers Act…and Section 36b-5(a) of the CUSA [the Connecticut Uniform Securities Act] are largely identical.").

25. SEC No-Action Letter, 1984 WL 48400 (July 19, 1984).

26. *Id.* A similar sort of approach had been taken by the SEC to mandatory arbitration clauses in contracts between investment advisers and advisees. In a 1986 no-action letter, the SEC indicated that such clauses might violate Section 206 of the IAA because they might "lead clients to believe that they are barred from exercising their rights under the Act." McEldowney Financial Services, SEC No-Action Letter, 1986 WL 67330 (Oct. 17, 1986). But the SEC itself has acknowledged that this position might no longer be good law: "Those positions, however, largely predated Supreme Court decisions upholding pre-dispute arbitration clauses under the federal securities laws, and a subsequent federal district court opinion citing those decisions upheld the validity of a pre-dispute arbitration clause in an advisory client agreement." SEC, Study on Investment Advisers and Broker-Dealers 43-44 (Jan. 2011). The SEC was referring to Bakas v. Ameriprise Financial Services, Inc., 651 F. Supp. 2d 997, 1000-1001 (D. Minn. 2009).

27. Heitman Capital Mgmt., LLC, *supra* n.4.

28. *Id.* at *3.

29. *Id.* at *4.

30. *Id.*

31. *See* Birnbaum v. Birnbaum, 73 N.Y.2d 461, 539 N.E.2d 574, 541 N.Y.S.2d 746 (1989).

32. Kleinman V. Oak Associates, Ltd., 2007 WL 2071968 (N.D. Ohio 2007).

33. *See e.g.,* Bruck v. Morgan Stanley Smith Barney, LLC, 2013 WL 2299529 (D.Mass May 23, 2013) (granting motion to compel arbitration of claims that defendants created "'an unlawful and fraudulent scheme to avoid the fiduciary duties imposed upon them'" by the IAA, allegedly in connection with account improperly designated "non-fiduciary" by defendants); Bruck, Trial Pleading, 2012 WL 5424954 (D. Mass. 2013) (Count XII). *See also, e.g.,* Gramercy Advisors, LLC v. Jones, 2007 WL 2729021 (S.D.N.Y. 2007); Gramercy, Reply Memorandum in Further Support of Motion to Defer Motion for Partial Summary Judgment, Case No. 07-CV-2809 (S.D.N.Y. 2007). *See also,* Wootten, v. Fisher Investments, Inc., Plaintiff's Amended Motion to Preliminarily Enjoin Arbitration Proceedings, Case No. 4:10-cv-00598 SNLJ (E.D. Mo. 2010), 2010 WL 4062991.

34. WL 3443942 (N.D. Cal. Aug. 5, 2011), *aff'd*, 2013 WL 492443 (9th Cir. Feb. 11, 2013), *cert denied*, 134 S.Ct. 266 (Mem.) (Oct. 2013).

35. Hsu, *supra* n.5, 2013 WL 492443 at *1.

36. First Amended Complaint, HSU, Case No. 3:11-cv-02076-WHA (N.D. Cal. 2011), Exhibit D, p.2 ("Investment Advisor and investment strategy must be on either the MAC Researched Advisor List or the Reviewed Advisor List.").

37. First Amended Class Action Complaint, AC 2011 WL 1593366 (N.D.Cal.) (Trial Pleading), Exhibit A, p. 1., ¶2.

38. 2011 WL 3443942 at *1, *7.

39. 2011 WL 3443942 at *7.

40. Restatement (Third) of Agency §8.08 (2006). *See also* Capital Gains Research Bureau, *supra* n.7 (noting fiduciaries have "an affirmative duty of 'utmost good faith, and full and fair disclosure of all material facts,' as well as an affirmative obligation 'to employ reasonable care to avoid misleading'" (citations omitted).

41. Francis v. United Jersey Bank, 87 N.J. 15, 432 A.2d 814 (N.J., 1981) ("Generally directors are accorded broad immunity and are not insurers of corporate activities").

42. S*ee, e.g.,* Call v. Czaplicki, 2010 WL 3724275 (D.N.J.) (declining to rule that an insurance agent has a duty of reasonable investigation of an attorney whom insurance agent refers to a client because, in contrast to insurance agent's duty to procure adequate insurance, the insurance agent does not have qualifications to understand whether a particular attorney is competent), *reconsideration granted in part and denied in part*, Call v. Czaplicki, 2011 WL 2532712 (D.N.J. 2011).

43. 2011 WL 3443942 at *7

44. Appellant's Reply Brief, Hsu v. UBS Financial Services, Inc., No. 11-17131 (9th Cir. 2013), at 6. *See also* Appellant's Opening Brief, Hsu v. UBS Financial Services, Inc. No. 11-17131 (9th Cir. 2013), at 6.

45. Appellee's Brief, Hsu v. UBS Financial Services, Inc. No. 11-17131 (9th Cir. 2013) at 18.

46. 2013 WL 492443 at *1.

47. 2013 WL 492443 at *1.

48. Defendant UBS Financial Services, Inc.'s Notice of Motion and Motion to Dismiss, Case No. 3:11-cv-02076-WHA (N.D. Cal. 2011), 2011 WL 7562119 at 9.

49. *Id*. at 16.

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