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Not Off the Hook: The SEC Addresses its Position on Exculpation And Indemnification For Private Fund Advisers

The Capital Commitment on **April 16, 2024**

In its final Private Fund Adviser Rules adopted last year, the SEC dropped one of the more controversial proposed rules—the proposal to prohibit contractual exculpation or indemnification provisions that would shield or indemnify the adviser in matters involving the adviser's negligence or breach of fiduciary duty. On its face, this was a concession to the fund management industry. However, the Rule's Adopting Release asserted that the SEC believed the provision was not needed because the antifraud provisions of the Advisers Act already prohibited certain provisions that would be covered by the proposal. Because the SEC's interpretation was based on current law (there is no grandfathering or "implementation date" in the future), we predict that contractual indemnification or exculpation provisions will remain firmly in the SEC's sights for 2024. SEC exams and enforcement proceedings are likely to focus on these provisions, and they may be implicated in GP/LP disputes as well.

The SEC's initial proposed Private Fund Adviser Rules recommended prohibiting a common protection for private fund advisors – the ability to rely on exculpatory and indemnification provisions from the fund for certain conduct (typically covering simple negligence) in providing services to the private fund. We wrote about the wide-ranging impact of that potential amendment in April 2023.

In what might appear to be a major concession to the concerns expressed around this proposed amendment, the SEC dropped the prohibition on exculpation/indemnification for simple negligence from the new rules published in August 2023 (along with certain other proposed changes).

However, the Adopting Release highlighted that the omission of this change was not due to a change of heart from the SEC. Instead, it took the view that these changes were largely unnecessary, explaining that the antifraud provisions of the Advisers Act already prohibit certain relevant conduct. For example, citing settled enforcement actions and staff views, the Release stated that contractual provisions which generally waive an adviser's Federal fiduciary duty under the Advisers Act (which may involve conduct that is intentional, reckless, or merely negligent) would already be prohibited, in the context of retail investors and if there is no "savings clause" providing that the adviser is not waiving its Federal fiduciary duty. The release did not directly address the SEC's prior statements, in its Interpretation Regarding Standard of Conduct for Investment Advisers, that whether a hedge clause in an agreement with an institutional client would be problematic would depend on the facts and circumstances.

Furthermore, the Adopting Release asserted that "*an adviser may not seek reimbursement, indemnification, or exculpation for breaching its Federal fiduciary duty because that would operate effectively as a waiver, which would be invalid under the Act*".

While the Adopting Release did not explicitly address whether the advancement of investigation or litigation expenses prior to the finding of a breach would be permitted, the decision to drop the indemnification restrictions should be read in conjunction with the Investigation Expenses portion of the rule. This section provides that, as of the compliance date for the provision, seeking reimbursement of expenses relating to a governmental or regulatory investigation involving the adviser would only be permitted: (1) with consent from the investors in the fund and (2) if the matter does not lead to a court or governmental sanction for a violation of the Advisers Act.

The SEC did temper its message, however, by noting that institutional investors are less in need of extensive and detailed disclosures than is the case with "retail" investors, stating 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." Citing a recent enforcement action involving a hedge clause, the Release also noted that most, if not all, of the adviser's clients were retail investors, and earlier this year the SEC settled an enforcement action based in part on an alleged improper "hedge clause" provided to retail clients. The SEC may be more likely to focus its efforts on private funds with predominantly "retail" investors (*i.e.,* 3(c)(1) funds, which do not limit their investors to "qualified purchasers"), and less likely to focus its efforts on private funds with predominantly institutional or otherwise sophisticated investors (*i.e.,* 3(c)(7) funds).

Contrary to the formal new rules which have an extended implementation period, the impact of this clarifying commentary describing the SEC's interpretation of the existing rules is that private fund advisers need to apply this approach as of today.

As a result, private fund advisers and investors will need to review and, perhaps, revise their existing contractual indemnification and exculpation arrangements, particularly with respect to 3(c)(1) funds. As we explained in April 2023, insurers may still be called upon to fill the gap.

Read more of our Top Ten Regulatory and Litigation Risks for Private Funds in 2024.

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