SEC Enforcement Case Summary
Adviser Charged with Custody Rule and Liability Disclaimer Violations

On September 3, 2024, the SEC charged private fund manager ClearPath Capital Partners, LLC with failing to comply with the Custody Rule 206(4)-2 under the Investment Advisers Act of 1940 (the Advisers Act), and for including impermissible liability disclaimers or "hedge clauses" in its advisory and private fund agreements. ClearPath served as an investment adviser to retail investors and adviser and general partner for three private funds. As such, ClearPath was deemed to have custody of fund assets pursuant to the Custody Rule.

The Custody Rule includes specific requirements to protect client assets over which an adviser has custody, providing an alternative to private funds for complying with several of those specific requirements when those funds are subject to an annual audit by a qualified independent public accounting with qualifying audited financial statements distributed to all limited partners within 120 days of the fund's fiscal year end (FYE) (aka "audit provision").

ClearPath relied on the audit provision under the Custody Rule. However, the SEC found that the firm failed to timely deliver audited financials to fund investors in seven instances from 2018 through 2022. The firm's violations included: 1) failure to demonstrate that it had delivered the audited financial statements it received; 2) financial statements that were delivered late (ranging from 333 to 1064 days after FYE); and 3) failure to perform a final liquidating audit for a fund that was liquidated.

With regard to the hedge clause violation, the Advisers Act establishes a federal fiduciary duty for investment advisers that may not be waived. The SEC has long held that advisory agreements may not misrepresent, or contain misleading statements regarding, the scope of an adviser's unwaivable fiduciary duty that could lead a client to believe incorrectly that the client has waived a non-waivable cause of action against the adviser provided by state or federal law. This is true even if there is a disclaimer (sometimes known as a "savings clause" or "non-waiver" disclosure) stating that compliance with the state or federal securities laws is not waivable. In June 2019, the SEC published an interpretive release stating that "there are few (if any) circumstances in which a hedge clause in an agreement with a retail client would be consistent with antifraud provisions, where the hedge clause purports to relieve the adviser from liability for conduct as to which the client has a non-waivable cause of action against the adviser provided by state or federal law. Such a hedge clause generally is likely to mislead those retail clients into not exercising their legal rights, in violation of the antifraud provisions, even where the agreement otherwise specifies that the client may continue to retain its non-waivable rights."

ClearPath was faulted for including hedge clauses in advisory agreements with retail clients representing that ClearPath is not liable to its clients for "any action or inaction," with exceptions for "gross negligence" or "willful malfeasance" and violations of "applicable law." The SEC noted that language, when read in its entirety, was inconsistent with an adviser's fiduciary duty because it may mislead ClearPath's retail clients into not exercising their non-waivable legal rights. Accordingly, the SEC alleged that these hedge clauses violated Section 206(2) of the Advisers Act.

Moreover, the SEC faulted ClearPath for including improper hedge clauses in partnership and operating agreements for private funds in which retail advisory clients were investors. Following is the specific language to which the SEC objected.

> "None of the Indemnified Parties shall be liable to any Limited Partner or the Partnership for honest mistakes of judgment, or for action or inaction, taken in good faith in respect of the Partnership, or for losses due to such mistakes, action, or inaction, or to the negligence, dishonesty, or bad faith of any employee, broker, or other agent of the Partnership, provided that such employee, broker, or agent was supervised and selected, engaged, or retained with reasonable care. . . Notwithstanding any of the foregoing to the contrary, the provisions of this paragraph 15.3 and the immediately following paragraph 15.4(a) shall not be construed so as to relieve (or attempt to relieve) any person (except in the case of members of the Advisory Committee and their Constituent Limited Partners, who need only have acted in good faith in order to receive the benefit of exculpation under this paragraph 15.3) of any liability by reason of "gross negligence" or intentional wrongdoing (including fraud or other intentional criminal conduct) or to the extent (but only to the extent) that such liability may not be waived, modified, or limited under applicable law, but shall be construed so as to effectuate the provisions of such paragraphs to the fullest extent permitted by law. The Partners acknowledge and agree that certain provisions of this Agreement expressly or implicitly waive, reduce, redefine or otherwise modify fiduciary duties of the General Partner and the other Indemnified Parties (as defined below) arising under applicable law. It is the express intention of the Limited Partners that such waiver, reduction, redefinition or other modification be fully enforceable and binding upon the Partners. Accordingly, each Limited Partner hereby irrevocably: (i) waives any and all current and future claims (and right to assert such claims) against the General Partner and the other Indemnified Parties for any breach of fiduciary duty that would otherwise arise under applicable law but would be inconsistent with the terms of this Agreement; and (ii) agrees to fully reimburse the General Partner and any other applicable Indemnified Party for any and all losses, expenses,

> costs or other damages resulting from any waived claim brought by, through, or on behalf of such Limited Partner."
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> "A Manager shall not be liable to the Company, a series, or to any Member for any loss or damage sustained by the Company, such series or Member, unless the loss or damage shall have been the result of fraud, deceit, gross negligence, willful misconduct or a wrongful taking by the Manager."

The SEC charged ClearPath with violations of fiduciary duty under Section 206(2) and anti-fraud provisions of Section 2064(4) as well as violations of the Custody Rule 206(4)-2 and Compliance Rule 206(4)-7 for failing to implement policies and procedures to prevent such violations. The firm agreed to pay a civil penalty of $65,000 to settle the SEC's charges.

This case is instructive in highlighting specific hedge clause language that SEC staff have objected to. We recommend that firms work with outside counsel to review their investment advisory agreements and fund governing documents for potentially problematic hedge clauses, similar to those noted in this case.

See Summary - https://www.sec.gov/newsroom/press-releases/2024-113