THIS LETTER IS WITHDRAWN. Please consult the following web page for more information: https://www.sec.gov/divisions/investment/im-modified-withdrawn-staff-statements.

Investment Advisers Act of 1940 – Sections 206(1) and (2)
Heitman Capital Management, LLC

February 12, 2007

Our Ref. No. 200463918
Heitman Capital Management, LLC, *et al.*
File No. 801-15473

RESPONSE OF THE OFFICE OF CHIEF COUNSEL
DIVISION OF INVESTMENT MANAGEMENT

Your letter dated February 2, 2007 requests our views under sections 206(1) and (2) of the Investment Advisers Act of 1940 (the "Advisers Act") concerning "hedge clauses," as described more fully below, that are used by Heitman Capital Management, LLC, Heitman Institutional Advisors, Heitman Endowment Advisors, L.P., Heitman Institutional Realty Advisors L.P., and Heitman Real Estate Securities LLC (each, a "Heitman Advisor") in investment advisory agreements with certain current and future sophisticated clients and clients that are represented by certain sophisticated financial intermediaries (the "Clients"). In particular, you request our assurance that we would not recommend that the Securities and Exchange Commission ("Commission") take any enforcement action under sections 206(1) and (2) of the Advisers Act against a Heitman Advisor, if it includes a hedge clause and related disclosure substantially in the form described below in its investment advisory agreements with such Clients.

BACKGROUND

You state the following: The Heitman Advisors provide investment advisory services predominantly to institutional investors. Each Heitman Advisor is registered with the Commission as an investment adviser under the Advisers Act. Each Heitman Advisor, historically, has included a "hedge clause" in investment advisory contracts entered into with Clients. The following is an example of the wording of the hedge clause presently included in the Heitman Advisors' form of such investment advisory contracts:

> *Client Indemnification:* Client shall indemnify and hold harmless Manager [a Heitman Advisor] and its affiliates and their respective directors, managers, officers, agents and employees, from and against any and all losses, claims, demands, actions, or liability of any nature, including but not limited to attorneys' fees, expenses and court costs, arising out of or in connection with this Agreement, except to the extent based upon, arising out of or in connection with Manager's grossly negligent, reckless, willfully improper or illegal conduct in its performance or failure to perform under this Agreement, actions outside the scope of Manager's authority or other material breach under this Agreement, by Manager, its directors, managers, officers, employees and agents.

The Heitman Advisors' form of such investment advisory contracts also includes a provision that states, in essence, that the Client may have legal rights against the Heitman Advisor regardless of the hedge clause ("non-waiver disclosure"). The non-

waiver disclosure immediately follows the "Client Indemnification" section. The following is an example of the wording of the non-waiver disclosure presently included in the Heitman Advisors' form of such investment advisory contracts:

> *Non-Waiver of Rights:* Notwithstanding the foregoing, nothing contained in this paragraph or elsewhere in this Agreement shall constitute a waiver by Client of any of its legal rights under applicable U.S. federal securities laws or any other laws whose applicability is not permitted to be contractually waived

You represent that the Clients, listed below, are 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:

I. Investment companies that are registered as such under the Investment Company Act of 1940 ("Company Act");
II. Institutional investors who are "qualified institutional buyers" as defined in rule 144A under the Securities Act of 1933;
III. Natural persons or companies who are "qualified clients" as defined in rule 205-3 under the Advisers Act;
IV. Any person or entity who is a "qualified purchaser" as defined in section 2(a)(51) of the Company Act ("Qualified Purchasers"); and
V. Any commingled fund entity ("CFE"), such as a multiple owner trust, partnership or limited liability company, that has a reasonable expectation (based upon indications of interests from investors) that it will meet the definition of Qualified Purchaser within 120 days of the date that the CFE acquires its first investment.

You state that the Heitman Advisors' other Clients include the following persons:

VI. Investors in wrap accounts ("Wrap Account Clients") that are sponsored by registered investment advisers under the Advisers Act ("Wrap Account Sponsors");
VII. Any CFE that is sponsored by an entity that is both unaffiliated with Heitman and a Qualified Purchaser (a "Qualified Sponsor"); and
VIII. Any entity all of the equity owners of which are entities or individuals of the types described in Categories I through VII above.

You represent that the Wrap Account Sponsors and the Qualified Sponsors are also 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.[1] You state that the Wrap Account Sponsors and the Qualified Sponsors act

[1] Telephone conversation among Kenneth C. Fang of the staff, and Jack W. Murphy and Christopher D. Christian of Dechert LLP, counsel to the Heitman Advisors, on February 12, 2007 ("February 12 Telephone Call").

as intermediaries (the "Intermediaries") between the appropriate Heitman Advisor and the Wrap Account Clients and the CFE (and its investors), respectively, and enter into investment advisory agreements with the appropriate Heitman Advisor on behalf of the Wrap Account Clients and the CFE, respectively.[2] You represent that the Intermediaries generally oversee the performance of the applicable Heitman Advisor under the relevant investment advisory contract. You represent further that an Intermediary could evaluate, and assist a Client in interpreting, the hedge clause and the non-waiver disclosure in the unlikely event that a Heitman Advisor's conduct gave rise to a cause of action under the investment advisory agreement.[3]

You seek our views on the use of a hedge clause and non-waiver disclosure, of the type described above, in the Heitman Advisors' investment advisory agreements with the Clients because the Heitman Advisors' use of the hedge clause may raise issues under sections 206(1) and (2) of the Advisers Act.

LEGAL ANALYSIS

Sections 206(1) and 206(2) of the Advisers Act make it unlawful for any investment adviser to employ any device, scheme, or artifice to defraud, or to engage in any transaction, practice, or course of business that operates as fraud or deceit on clients or prospective clients. Those antifraud provisions may be violated by the use of a hedge clause or other exculpatory provision in an investment advisory agreement which is likely to lead an investment advisory client to believe that he or she has waived non-waivable rights of action against the adviser that are provided by federal or state law.[4] We have previously taken the position that hedge clauses that purport to limit an investment adviser's liability to acts involving gross negligence or willful malfeasance are likely to mislead a client who is unsophisticated in the law into believing that he or she has waived

---

[2] You represent that the Wrap Account Sponsors and, in many instances, the Qualified Sponsors are fiduciaries with respect to the wrap account clients and CFEs, respectively, and as such must act in their best interests.

[3] *See* February 12 Telephone Call. You contend that investment advisory clients have very limited rights of action to proceed under federal law against an investment adviser for violations of the Advisers Act, citing Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11 (1979).

[4] *See*, *e.g.*, In the Matter of William Lee Parks, Investment Advisers Act Release No. 736 (Oct. 27, 1980) and In the Matter of Olympian Financial Services, Inc., Investment Advisers Act Release No. 659 (Jan. 16, 1979). *See also* Opinion of General Counsel Roger S. Forster Relating to the Use of Hedge Clauses by Brokers, Dealers, Investment Advisers and Others, Investment Advisers Act Release No. 58 (Apr. 10, 1951).

non-waivable rights,[5] even if the hedge clause explicitly provides that rights under federal or state law cannot be relinquished.[6]

You contend, however, that whether a hedge clause would mislead a client into believing that he or she has waived non-waivable rights in violation of section 206 of the Advisers Act depends on all of the surrounding facts and circumstances. You also request guidance concerning the application of sections 206(1) and 206(2) of the Advisers Act to the use of a hedge clause and non-waiver disclosure, of the type described above, in the Heitman Advisors' investment advisory contracts.

We believe that whether an investment adviser that uses hedge clauses in investment advisory agreements that purport to limit that adviser's liability to acts of gross negligence or willful malfeasance violates sections 206(1) and 206(2) of the Advisers Act would depend on all of the surrounding facts and circumstances. In making this determination, we would consider the form and content of the particular hedge clause (*e.g.*, its accuracy), any oral or written communications between the investment adviser and the client about the hedge clause, and the particular circumstances of the client.[7] For instance, when a hedge clause is in an investment advisory agreement with a client who is unsophisticated in the law, we would consider factors including, but not limited to, whether: (i) the hedge clause was written in plain English; (ii) the hedge clause was individually highlighted and explained during an in-person meeting with the client; and (iii) enhanced disclosure was provided to explain the instances in which such client may still have a right of action. In addition, we would consider the presence and sophistication of any intermediary assisting a client in his dealings with the investment adviser and the nature and extent of the intermediary's assistance to the client.

---

[5] *See* Auchinloss & Lawrence Incorporated, SEC Staff No-Action Letter (Feb. 8, 1974).

[6] *See* Omni Management Corporation, SEC Staff No-Action Letter (Dec. 13, 1975) and First National Bank of Akron, SEC Staff No-Action Letter (Feb. 27, 1976).

[7] We note that a hedge clause may be "misleading in its overall effect even though it might be argued that when narrowly and literally read, no single statement of material fact was false." *See* In the Matter of Spear & Staff, Inc., Investment Advisers Act Release No. 188 (March 25, 1965), *citing* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 185-195 (1963). Furthermore, we note that an investment adviser has an affirmative duty to explain a hedge clause if the investment adviser believes or has reason to believe that a particular client, in light of his or her unique circumstances, would be likely to be misled by it. *See* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 194 (1963) (defining an investment adviser's fiduciary duty as "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' [his or her] clients").

Consequently, we believe that the Heitman Advisors' use of a hedge clause and non-waiver disclosure, of the type described above, would not *per se* violate sections 206(1) and 206(2) of the Advisers Act. We take no position, however, regarding whether the use of any specific hedge clause and non-waiver disclosure by a Heitman Advisor would mislead any particular Client because of the fact-intensive nature of the inquiry that would be necessary to discern the relationship and communications between a Heitman Advisor and each Client (and any Intermediary), in light of the form and content of the hedge clause, and the Client's particular circumstances. As a matter of policy, we will not provide no-action or interpretive assurances under sections 206(1) or (2) of the Advisers Act regarding an investment adviser's use of any particular hedge clause with its clients.

Kenneth C. Fang
Senior Counsel

Dechert LLP

February 2, 2007

VIA COURIER

Douglas J. Scheidt, Esq.
Associate Director and Chief Counsel
Division of Investment Management
U.S. Securities and Exchange Commission
100 F Street, N.E., Mail Stop 05-04
Washington, D.C. 20002

Re: Heitman Capital Management, LLC
Heitman Institutional Advisors
Heitman Endowment Advisors, L.P.
Heitman Institutional Realty Advisors L.P.
Heitman Real Estate Securities LLC[1]

Dear Mr. Scheidt:

We are writing on behalf of our clients Heitman Capital Management, LLC ("HCM"), Heitman Institutional Advisors ("HIA"), Heitman Endowment Advisors, L.P. ("HEA"), Heitman Institutional Realty Advisors L.P. ("HIRA"), and Heitman Real Estate Securities LLC ("HRES") (collectively referred to as "Heitman"), with respect to the use of a so-called "hedge clause" by Heitman in its investment advisory contracts. We respectfully request that you confirm that the Division will not recommend that the Commission take any enforcement action under Sections 206(1) and (2) of the Investment Advisers Act of 1940 (the "Advisers Act") if Heitman includes an exculpatory "hedge clause" in its investment advisory contracts for use with current and future sophisticated clients, as described more fully below.

FACTUAL BACKGROUND

Heitman is a real estate investment management firm that makes investments in commercial real estate directly or in publicly traded real estate investment trust ("REIT") securities in the U.S. Heitman provides investment advisory services predominantly to institutional investors, including, but not limited to, state and municipal government entities, corporate pension funds, endowments, foundations, employee retirement systems, universities and certain high net worth individuals/family entities. Heitman also provides investment advisory services to private equity investment funds whose owners consist principally of institutional investors, and provides investment advisory services for certain wrap accounts

---

1 Each of Heitman Capital Management, LLC, Heitman Institutional Advisors, Heitman Endowment Advisors, L.P., Heitman Institutional Realty Advisors L.P. and Heitman Real Estate Securities LLC is registered with the Commission as an investment adviser under the Investment Advisers Act of 1940.

through a sub-advisory relationship with the broker-dealer sponsor of the wrap program.[2] Heitman also serves as a sub-adviser with respect to certain U.S. registered mutual funds.

Heitman enters into an investment advisory agreement with each client, which (for the most part) is individually negotiated. In fact, many of Heitman's large pension fund clients insist on using their own form of agreement that frequently contains a "gross negligence" standard of care. Historically, Heitman has included a "gross negligence" standard of care in investment advisory contracts entered into with private fund or separate account clients. The following is a sample of the language that is presently included in Heitman's form of such investment advisory contracts:

> *Client's Indemnification.* Client shall indemnify and hold harmless Manager [Heitman] and its affiliates and their respective directors, managers, officers, agents and employees, from and against any and all losses, claims, demands, actions, or liability of any nature, including but not limited to attorneys' fees, expenses and court costs, arising out of or in connection with this Agreement, except to the extent based upon, arising out of or in connection with Manager's *grossly negligent, reckless, willfully improper* or illegal conduct in its performance or failure to perform under this Agreement, actions outside the scope of Manager's authority or other material breach under this Agreement, by Manager, its directors, managers, officers, employees and agents. (emphasis added).

Heitman's form of such investment advisory contract includes a provision, which immediately follows the section "Client's Indemnification," that provides that the client is not precluded by the preceding clause from recourse against the Manager under federal securities laws or any other applicable laws. The following is a sample of this language:

> *Non-Waiver of Rights.* Notwithstanding the foregoing, nothing contained in this paragraph or elsewhere in this Agreement shall constitute a waiver by Client of any of its legal rights under applicable U.S. federal securities laws or any other laws whose applicability is not permitted to be contractually waived.[3]

Heitman was the subject of a routine inspection by the Commission's Midwest Regional Office, which requested in a comment letter that Heitman strike the "gross negligence"

---

[2] Heitman does not have a separate investment advisory contract or relationship with any of the individuals or entities participating in these wrap accounts.

[3] To the extent that language such as that set forth above is not currently included in investment advisory contracts for use with the categories of clients described herein, Heitman will provide direct notice of such terms to the clients and disclose such terms in Heitman's Form ADV - Part II to further dispel any possibility that a client may be misled into believing that it has waived any legal rights under federal or state law by reason of the proposed language.

standard from an investment advisory agreement with one of its pension fund clients. While the determination of whether a particular "gross negligence" provision is enforceable requires a fact-specific inquiry into the circumstances of the parties and the manner in which the parties entered into the contract in question, we are requesting that the Division staff confirm that the Division would not recommend that the Commission take any enforcement action under Section 206 of the Advisers Act if Heitman includes language such as that set forth above in its investment advisory contracts for use with current and future clients under the circumstances described below.[4]

APPLICABLE LAW

Generally, Section 206 of the Advisers Act, in part, makes it unlawful for any investment adviser to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client or to engage in any act, practice or course of business which is fraudulent, deceptive, or manipulative. In addition to these specific provisions, however, Section 206 of the Advisers Act also imposes on an investment adviser a fiduciary duty by operation of law.[5] As a fiduciary, an investment adviser has an affirmative duty to act solely in the best interests of its client and to make full and fair disclosure of all material facts. A breach of this fiduciary duty constitutes a violation of Section 206 of the Advisers Act.[6] Accordingly, while the Advisers Act does not impose a specific duty of care on investment advisers, advisers are required to act in the best interests of their clients.

Within this context, the Commission staff, in Advisers Act Release No. 58,[7] expressed the view through its general counsel that the use of a "hedge clause"[8] by an investment adviser could violate Section 206 of the Advisers Act, and is therefore potentially voidable under Section 215(a) of the Advisers Act,[9] if the clause is "likely to lead an investor to believe that he has in any way waived any right of action that he may have" against the investment adviser.[10]

A. Prior Division Guidance: Relevant No-Action Letters

Since Release No. 58 was general in nature, the Division staff has offered some further guidance on the use of a "hedge clause" in an investment advisory contract through the

---

[4] In requesting this relief, Heitman is not asking the Division staff for guidance with respect to whether the use of such language would or might be appropriate under other circumstances.

[5] *See* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963).

[6] *See In re Arleen W. Hughes*, Exchange Act Release No. 4048 (pub. avail., Feb. 18, 1948).

[7] SEC IA-Release No. 58 (Apr. 10, 1951) ("Release No. 58").

[8] A "hedge clause" is generally defined to mean a statement made to free oneself from responsibility.

[9] Section 215 of the Advisers Act states: "(a) Any condition, stipulation, or provision binding any person to waive compliance with any provision of this title or with any rule, regulation, or order thereunder shall be void."

[10] Release No. 58.

issuance of several no-action letters.

In *Jonathan-Forbes, Inc.*, the Division staff applied the position in Release No. 58 to the proposed use of an exculpatory clause in an investment advisory contract that attempts to limit the liability of the investment adviser.[11] Without providing further specific guidance, the Division staff stated that the clause proposed by Jonathan-Forbes, Inc., which contained a "gross negligence" standard with no waiver of rights provision, did not meet the standards "enunciated in [Release No. 58] and would therefore violate the anti-fraud provisions of the [Advisers Act]."[12]

In *Auchincloss & Lawrence*, the Division staff provided further guidance on the position taken in *Jonathan-Forbes* and Release No. 58 stating that any exculpatory clause that limited the liability of an investment adviser to "gross negligence" or "willful misconduct" is a "hedge clause," which is voidable under Section 215(a) of the Advisers Act on the grounds that "the express denial of liability ... may mislead a client into believing he has waived certain rights of action ...."[13] The Division staff in *Auchincloss* concluded, however, that it would not recommend enforcement action if Auchincloss revised the terms of its investment advisory contract to include language suggested by the Division staff, which included a negligence standard and a statement that the investor was not precluded from recourse against the investment adviser under the federal securities laws.[14]

In *Omni Management Corporation*,[15] the Division staff clarified its position in *Auchincloss*. While citing *Auchincloss* as precedent, Omni requested that the Division staff confirm that it would not recommend enforcement action if Omni used a gross negligence standard with a proviso that the investor had not waived any rights and was not prevented from recourse under the federal securities laws. The Division staff responded by stating:

> Notwithstanding the reference to 'violation of applicable law' and the proviso at the end of the new provision you propose, we believe the use of the adjective 'gross' to qualify 'negligence or malfeasance' may lead clients without expertise in the law to believe that ordinary negligence or malfeasance would not be sufficient to give rise to a right of action against Omni Management Corporation. Accordingly, we suggest that "gross" be deleted or, alternatively, no reference be made to negligence or

---

11 *Jonathan-Forbes, Inc.*, SEC No-Action Letter (pub. avail., Feb. 17, 1972).

12 *Id.*

13 *Auchincloss & Lawrence*, SEC No-Action Letter (pub. avail., Feb. 6, 1974).

14 *Id.*, stating: "Except for negligence or malfeasance, or violation of applicable law, neither you nor any of your officers, directors or employees shall be liable here under for any action performed or omitted to be performed or for any errors of judgment in managing the Account. The 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 waiver or limitation of any rights which the undersigned may have under any federal securities laws."

15 *Omni Management Corporation*, SEC No-Action Letter (pub. avail., Dec. 13, 1974).

> malfeasance. We also believe that the concluding proviso should mention state law as well as the federal securities laws.[16]

In *First National Bank of Akron*,[17] the Division staff reiterated its position on "hedge clauses" where the investment advisory contact purported to limit the liability of the investment adviser based upon "willful misconduct." The Division staff expressed the view that "if the hedge clause purports to limit liability to acts done in bad faith or to willful misconduct it is unlikely that a client who is unsophisticated in the law would realize that he may have a right of action under federal or state law even where his adviser has acted in good faith."[18] The Division staff also stated that the "same misleading effect may be present even if such a clause also explicitly provides that rights under federal or state law cannot be relinquished"[19] for those clients that are "unsophisticated in the law."

In *James Investment Research, Inc.*,[20] the Division staff provided further guidance on the permissibility of using a non-waiver of rights clause in an investment advisory contract. James Investment Research requested guidance from the Division staff on the use of an exculpatory clause in its investment advisory contract with a non-waiver of rights clause that stated, "Principal does not waive his rights under the Investment Advisers Act of 1940."[21] The Division staff recommended that James Investment Research add the words "or other federal securities laws or any non-waivable rights under applicable state law."[22] As such, *James Investment Research* seems to suggest that an exculpatory clause in an investment advisory contract may be permissible with an appropriate non-waiver of rights clause.

It should be noted that each of the aforementioned no-action letters relating to "hedge clauses" predated the decision of the U.S. Supreme Court in Transamerica Mortgage Advisors, Inc. v. Lewis, which held that advisory clients have only a limited private right of action against an investment adviser under Section 215 of the Advisers Act.[23] Monetary damages under this right of action are limited to fees paid. As a result, clients cannot successfully sue an adviser for damages based solely on a violation of the Advisers Act. Accordingly, an investor must enforce any contractual rights that it may have under state law.

---

[16] *Id.*

[17] *First National Bank of Akron*, SEC No-Action Letter (pub. avail., Feb. 27, 1976).

[18] *Id.*

[19] *Id.*

[20] *James Investment Research, Inc.*, Response of the Branch of Investment Adviser Regulation, Division of Investment Management, U.S. Securities and Exchange Commission (pub. avail., Apr. 10, 1977).

[21] *Id.*

[22] *Id.*

[23] *See* Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11 (1979); *see also* Frank Russell Co. v. Wellington Mgmt. Co., LLP, 154 F.3d 97 (3d Cir. 1998).

B. State Law

State courts have indicated that a determination of whether a particular "gross negligence" provision is enforceable requires a fact-specific inquiry into the circumstances of the parties and the manner in which the parties entered into the contract in question. The relevant legal authority suggests that a "gross negligence" provision is enforceable if the parties have relatively equal bargaining power and the provision is unambiguously stated in the contract.[24] In addition, under state statutory law, "gross negligence" provisions can be included in partnership and other agreements that frequently are "investment advisory" in nature.[25] The existence of these statutes is strong evidence that "gross negligence" provisions do not violate public policy.[26]

C. Commission Enforcement Actions

The Commission has enforced its position on hedge clauses on at least three occasions by

---

[24] *See, e.g.*, Blum v. Kauffman, 297 A.2d 48, 49 (Del. 1972) ("The contract must clearly and unequivocally spell out the intent to grant such immunity."); Garrison v. Combined Fitness Ctr., Ltd., 201 Ill.App.3d 581, 585 (Ill. App. Ct. 1990) ("[For] an exculpatory clause[] to be valid and enforceable, [it] should contain clear, explicit, and unequivocal language . . . ."); Chicago Steel Rule and Die Fabricators Co. v. ADT Security Systems, Inc., 327 Ill.App.3d 642, 645 (Ill. App. Ct. 2002) ("[S]uch a provision will be enforced if . . . there is nothing in the social relationship between the parties militating against enforcement . . . ."); Banco Espirito Santo de Investimento, S.A., v. Citibank, N.A., 2003 U.S. Dist. LEXIS 23062, at *34 (S.D.N.Y. Dec. 29, 2003) ("Where the language of the exculpatory agreement expresses in unequivocal terms the intention of the parties to relieve a defendant of liability for the defendant's negligence, the agreement will be enforced." (citation omitted)); ("New York law generally enforces contractual provisions absolving a party from its own negligence." (citation omitted)); Delmarva Power & Light Co. v. ABB Power T & D Co., Inc., 2002 Del. Super. LEXIS 311, at *21 (Del. Super. Ct. Apr. 30, 2002) ("In order for a contractual provision to relieve a party from the results of its own negligence it must expressly show this intent.").

[25] For example, the Delaware Code permits limitations on liability of fiduciaries of partnerships, providing that "[t]o the extent that, at law or in equity, a partner or other person has duties (including fiduciary duties) to a limited partnership or to another partner[,] . . . the partner's or other person's duties and liabilities may be expanded or *restricted* or eliminated by provisions in the partnership agreement . . . ." Del. C. § 17-1101(d) (emphasis added). Illinois statutory law similarly affords parties great latitude in entering into governance contracts of limited partnerships and limited liability companies. *See* 805 ILCS 210/403(b) (providing that "[e]xcept as provided in [the] Act, a general partner of a limited partnership has the liabilities of a partner in a partnership without limited partners"); 805 ILCS 180/15-5(7) (permitting an operating agreement of a limited liability company to enumerate the standards by which to measure members' performance of their obligations under the Act).

[26] *See* Chicago Steel Rule and Die Fabricators Co., 327 Ill.App.3d at 645-46 (Ill. App. Ct. 2002) ("The rationale supporting enforcement in Illinois of such provisions is the broad public policy permitting competent parties to contractually limit their respective liability and to allocate business risks in accordance with their business judgment." (citation omitted)).

instituting legal proceedings against Olympian Financial Services,[27] William Lee Parks[28] and Wall Street Money Management Group, Inc.[29] In each of these enforcement actions, the Commission enforced its position on hedge clauses as one of several violations of the Advisers Act.

In 1979, the Commission brought an enforcement action against Olympian Financial Services, Inc., a registered investment adviser, and E. Duane Bigsby, its president and sole shareholder. The Commission found that Olympian willfully violated, and Bigsby willfully aided and abetted violations of, Sections 204, 205 and 206 of the Advisers Act and Rules 204-1, 204-2 and 206(4)-1 thereunder. Specifically, the Commission found that the violations related to: (i) the receipt of excessive compensation; (ii) misleading and deceptive advertising; (iii) use of a "hedge clause" in advisory contracts; (iv) the absence of a non-assignment clause in advisory contracts; (v) failure to maintain required books and records; and (vi) failure to file required amendments to the investment adviser's registration.

In 1981, the Commission brought an enforcement action against William Lee Parks, a registered investment adviser, for willful violations of recordkeeping and filing provisions of Section 204 of the Advisers Act and Rules 204-1 and 204-2 thereunder, and for violations of the anti-fraud provisions of Section 206 of the Advisers Act for, among other things: (i) overcharging clients advisory fees; (ii) failure to refund to clients the unearned portion of advisory fees; and (iii) the use of a hedge clause in advisory contracts. The Commission also alleged material misstatements and omissions in connection with Parks' registration in violation of Section 207 of the Advisers Act.

In 1994, the Commission instituted legal proceedings against Wall Street Money Management Group, Inc., a registered investment adviser, and Peter Bruno, its sole shareholder. The Commission found that Wall Street willfully violated, and Bruno willfully aided and abetted violations of, Section 206 of the Advisers Act and Rule 206(4)-1 thereunder relating to the distribution of false and misleading advertisements. In addition, the Commission alleged that from at least January through May 1993, Wall Street utilized written investment advisory agreements which contained a paragraph that purported to limit Wall Street's liability to gross negligence or willful misconduct.[30]

In the two earlier cases, the release describing the action did not elaborate on the provisions of the "hedge clause" in question. In the 1994 action, the Commission described the clause in question as language that purported to limit the adviser's liability to gross negligence and

---

[27] *See, e.g.*, *In Re Olympian Financial Services, Inc.*, IA-Release No. 659 (pub. avail., Jan. 16, 1979).

[28] *See, e.g.*, *In Re William Lee Parks*, IA-Release No. 778 (pub. avail., Sept. 22, 1981).

[29] *See, e.g.*, *In Re Wall Street Money Management Group, Inc.*, IA-Release No. 1440 (pub. avail., Sept. 14, 1994).

[30] *See also In Re Brian J. Sheen*, IA-Release No. 1561 (pub. avail., April 30, 1996) (finding a violation of Section 206(2) of the Advisers Act for a clause in an investment advisory agreement that purported to eliminate liability for "any losses in the portfolio").

willful misconduct. The 1994 action did not mention any language in the contracts regarding non-waiver of rights or other qualifying language.

ANALYSIS

The Commission staff expressed the view in Release No. 58 that the use of a "hedge clause" by an investment adviser could violate Section 206 of the Advisers Act, and is therefore potentially voidable under Section 215(a) of the Advisers Act, if the clause is "likely to lead an investor to believe that he has in any way waived any right of action that he may have" against the investment adviser.[31] Ultimately, however, whether a liability or indemnification provision should be considered to mislead a client in violation of Section 206 of the Advisers Act depends on the surrounding facts and circumstances.[32] We believe that, given the surrounding facts and circumstances of the present case, Heitman's inclusion of a "gross negligence" standard of care in investment advisory contracts for the categories of investors described below does not violate Section 206 of the Advisers Act.

Omni Management Corporation and *First National Bank of Akron* are each distinguishable from the present facts. In each No-Action Letter, the Division staff expressed the concern that hedge clauses "may lead clients without expertise in the law"[33] or clients who are "unsophisticated in the law"[34] to mistakenly believe that, due to the terms "gross" or "willful" in an exculpatory contractual provision, the investor has waived his legal rights under applicable federal and state law. Heitman's clients are institutional clients, qualified purchasers or qualified clients who are not "unsophisticated in the law."[35] In addition, Heitman will seek to mitigate any risk that an investor might be misled into thinking that it may have waived certain of its legal rights by clearly stating in the investment advisory agreement that neither the "gross negligence" standard nor any other term in the investment advisory contract shall constitute a waiver by the client of any of its legal rights under applicable U.S. federal and state law.[36] This approach is consistent with the no-action positions taken in both *Auchincloss & Lawrence* and *James Investment Research*.

---

31 Release No. 58.

32 *See, e.g., Acorn Financial Services*, SEC No-Action Letter (pub. avail., July 25, 1984) (In evaluating a *per se* violation of Section 206 of the Adviser Act, the Commission staff stated "[w]hether or not any such action would violate Section 206 of the [Advisers] Act would depend on all of the facts and circumstances of the case . . . .").

33 *See Omni Management Corporation*, supra note 15 (emphasis added).

34 *See First National Bank of Akron*, supra note 17 (emphasis added).

35 We are not seeking relief for retail or other clients who maybe "unsophisticated in the law." As noted above, a determination of whether an investment advisory contract with a client may include a particular standard of care is a facts and circumstances determination that will depend on factors such as the sophistication of the client, the actual language of the contract, the manner in which the contract is entered into, whether the client is represented by counsel or by another advisor or intermediary, etc.

36 Under the Securities Exchange Act of 1934, we note that the Commission has implied (in the context of an arbitration clause) that a "hedge clause" may be acceptable in an agreement so long as such clause also clearly discloses that investors are not precluded from recourse under the law. *See Disclosure Regarding Recourse to the Federal Courts*

We also believe that a reviewing state court would find Heitman's "gross negligence" provision to be enforceable in light of, among other things: (i) the sophisticated nature of Heitman's clients; (ii) the unambiguous manner in which the "gross negligence" provision is stated; and (iii) the competitive nature of the investment advisory industry. This view is reinforced by the fact that Section 17(i) of the Investment Company Act of 1940, as amended (the "1940 Act"), explicitly contemplates the use of a "gross negligence" provision in investment advisory contracts with registered investment companies.[37]

Heitman proposes to be able to continue to include the "gross negligence" standard in its investment advisory or sub-advisory contracts with current or future clients that are willing to accept such standard provided that, at the time the contract is entered into (or, where applicable, at the time any amendment introducing a "gross negligence" standard is entered into), the client falls into one of the seven following categories:

i. Investment companies that are registered as such under the 1940 Act;[38]

ii. Investors in wrap account programs sponsored by investment advisers registered under the Advisers Act;

iii. Institutional investors meeting the Rule 144A definition of "qualified institutional buyer" ("QIB");[39]

Notwithstanding Arbitration Clauses in Broker-Dealer Customer Agreements, Exchange Act Release No. 34-19813 (May 26, 1983).

37 We are aware of no case in which the enforceability of a gross negligence provision in a contract with a registered investment company was invalidated.

38 As discussed above, Section 17(i) of the 1940 Act specifically contemplates use of a gross negligence standard in an advisory contract with a registered investment company. The 1940 Act does not require language regarding the non-waiver of rights to be included in such contracts, and Heitman may or may not include such language in its contracts with registered investment companies.

39 Generally, the term "qualified institutional buyer" means any of the following entities, acting for its own account or the accounts of other qualified institutional buyers, that in the aggregate owns and invests on a discretionary basis at least $100 million in securities of issuers that are not affiliated with the entity: (A) any insurance company as defined in Section 2(a)(13) of the Securities Act of 1933 ("1933 Act"); (B) any investment company registered under the 1940 Act or any business development company as defined in Section 2(a)(48) of the 1940 Act; (C) any small business investment company licensed by the U.S. Small Business Administration; (D) any employee benefit plan established and maintained by a state, its political subdivisions, or any agency or instrumentality of a state or its political subdivisions; (E) any employee benefit plan within the meaning of Title I of the Employee Retirement Income Security Act of 1974 ("ERISA"); (F) any trust fund whose trustee is a bank or trust company and whose participants are exclusively plans of the types identified in (D) or (E) above, except trust funds that include as participants individual retirement accounts or H.R. 10 plans; (G) any business development company as defined in the Advisers Act; (H) any organization described in Section 501(c) (3) of the Internal Revenue Code, corporation, partnership, or Massachusetts or similar business trust; and (I) any investment adviser registered under the Investment Advisers Act. *See* Rule 144A.

iv. Any person or entity meeting the definition of "qualified purchaser" in Section 2(a)(51) of the 1940 Act;[40]

v. Commingled fund entities, such as multiple owner trusts, partnerships and limited liability companies ("CFEs"), so long as:

a. the CFE meets the definition of "qualified purchaser" for purposes of Section 2(a)(51)(A)(iv) of the 1940 Act and Rule 2a51-3(a) (*i.e.*, the CFE owns and invests not less than $25 million in investments); or

b. the CFE has a reasonable expectation (based upon indications of interests from investors) that it will meet the requirements of category v.(a.) above within 120 days of the date the CFE acquires its first investment;[41] or

c. the CFE meets the definition of "qualified purchaser" for purposes of Section 2(a)(51) of the 1940 Act and Rule 2a51-3(b) (*i.e.*, each beneficial owner of the CFE's securities is a "qualified purchaser" under Section 2(a)(51) of the 1940 Act or a "knowledgeable employee" under Rule 3c-5 of the 1940 Act); or

d. the CFE is sponsored by an entity unaffiliated with Heitman that meets the definition of a "qualified purchaser" in Section 2(a)(51) of the 1940 Act ("Non-Affiliated Qualified Sponsor"); or

---

[40] Generally, the term "qualified purchaser" means: (i) any natural person (including any person who holds a joint, community property, or other similar shared ownership interest in an issuer that is excepted under Section 3(c)(7) with that person's qualified purchaser spouse) who owns not less than $5,000,000 in investments, as defined by the Commission; (ii) any company that owns not less than $5,000,000 in investments and that is owned directly or indirectly by or for two or more natural persons who are related as siblings or spouse (including former spouses); (iii) any trust that is not covered by clause (ii) and that was not formed for the specific purpose of acquiring the securities offered, as to which the trustee or other person authorized to make decisions with respect to the trust, and each settlor or other person who has contributed assets to the trust, is a person described in clause (i), (ii), or (iv); or (iv) any person, acting for its own account or the accounts of other qualified purchasers, who in the aggregate owns and invests on a discretionary basis, not less than $ 25,000,000 in investments.

[41] *Cf.*, Rule 203A-2(d) (the standard used for investment advisers expecting to be eligible for Commission registration within 120 days after the date the investment adviser's registration with the Commission becomes effective). In requesting this relief, Heitman is not asking for guidance with respect to CFEs that do not have a reasonable expectation of becoming a "qualified purchaser" for purposes of Section 2(a)(51)(A)(iv) of the 1940 Act within 120 days of the date the CFE acquires its first investment.

vi. Natural persons or companies who are "qualified clients" as defined in Rule 205-3 of the Advisers Act; or[42]

vii. Any entity all of the equity owners of which are entities or individuals of the types described in categories i. through vi. above.

Each client referred to in Items (i) through (vi) above is a sophisticated client that has the resources and experience to understand, and the bargaining power to negotiate and even in some cases to dictate, the terms of the investment advisory agreement. In addition, each wrap account participant and each CFE sponsored by a Non-Affiliated Qualified Sponsor referred to in Items (ii) and (v.d) is represented by a financial intermediary, which has a separate responsibility to negotiate with Heitman in the best interests of the client. In these cases, the intermediary is, in effect, the other party to the negotiation with Heitman.

We note that wrap account sponsors act as intermediaries between Heitman and the wrap account participants and that Non-Affiliated Qualified Sponsors act as intermediaries between Heitman and the CFE (and its investors). Wrap account sponsors and, in many cases the Non-Affiliated Qualified Sponsors, are responsible for acting as fiduciaries with respect to the underlying clients in the wrap account and CFE, respectively, and, as such, must act in the best interests of the underlying clients in the wrap account and the CFE. Wrap account sponsors and Non-Affiliated Qualified Sponsors have an ongoing relationship with Heitman such that they generally oversee the performance of Heitman under the investment advisory contracts. In the unlikely event that an underlying investor may believe it has reason to take action against Heitman under an investment advisory contract, the wrap account sponsor or the Non-Affiliated Qualified Sponsor, as applicable, could assist the underlying client in evaluating the hedge clause and non-waiver disclosure.

---

42 Generally, the term "qualified client" means: (A) a natural person who or a company that immediately after entering into the contract has at least $750,000 under the management of the investment adviser; (B) a natural person who or a company that the investment adviser entering into the contract (and any person acting on his behalf) reasonably believes, immediately prior to entering into the contract, either: (i) has a net worth (together, in the case of a natural person, with assets held jointly with a spouse) of more than $1,500,000 at the time the contract is entered into; or (ii) is a qualified purchaser as defined in section 2(a)(51)(A) of the Investment Company Act of 1940 at the time the contract is entered into. Qualified clients have been deemed by the Commission to be sophisticated enough to enter into advisory contracts that provide for performance based fees in spite of the statutory prohibition against such fees. *Cf.* Rule 205-3 (providing an exemption from the Advisers Act performance fee prohibition). Rule 205-3 reflects the Commission's recognition that there may be situations where a performance fee is appropriate and that more sophisticated or high net worth clients are in a position to protect themselves adequately against the potential abuses of performance fees. *See Exemption to Allow Registered Investment Advisers to Charge Fees Based Upon a Share of Capital Gains Upon or Capital Appreciation of a Client's Account,* IA-Release No. 996 (Nov. 14, 1985) [50 FR 48556 (Nov. 26, 1985)] ("The Commission has concluded that it is consistent with the protection of investors and the purposes of the [Advisers] Act to permit clients who are financially experienced and able to bear the risks associated with performance fees to have the opportunity to negotiate compensation arrangements which they and their advisers consider appropriate.")

Heitman will continue to include substantially the same "non-waiver of rights" clause that is in its current form of contract.

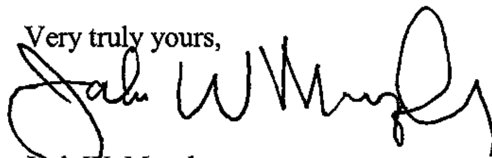
As noted above, the determination of whether a particular "gross negligence" provision is enforceable requires a fact-specific inquiry into the circumstances of the parties and the manner in which the parties entered into the contract in question.[43] However, the clients described in each of the aforementioned categories are sophisticated enough to understand the terms of any investment advisory agreement entered into with Heitman and to allocate business risks in accordance with their business judgment. These clients can be relied upon to use their sophistication and bargaining power to negotiate contractual provisions which they consider appropriate to protect their own interests.

CONCLUSION

We respectfully request that you confirm that Heitman's use of the language of the type described above in its investment advisory contracts would not be considered a "*per se*" violation of Section 206 of the Advisers Act and that the analysis of such language under Section 206 depends on the surrounding facts and circumstances. We also request that you confirm that the Division will not recommend that the Commission take any enforcement action under Section 206 of the Advisers Act if Heitman includes language of the type describe above in its investment advisory contracts for use with current and future sophisticated clients, as discussed above. Please do not hesitate to call me at 202.261.3303 or Christopher D. Christian of this office at 202.261.3321 with any questions that you may have.

Thank you for your consideration of this request.

Very truly yours,



Jack W. Murphy

cc: Stuart C. Katz

---

43 As noted above, by only requesting no-action relief with respect to specific categories of clients, Heitman is in no way implying that hedge clauses would not be enforceable with respect to other categories of clients. Rather, the status of each contract will continue to depend on the surrounding facts and circumstances.