JACKO LAW GROUP, PC

Legal Risk Management Tip
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MOST FAVORED NATIONS PROVISIONS: BENEFIT OR CURSE?

The concept of the "most favored nation" status commonly referred to as MFN, traces its origin to the General Agreement on Tariffs and Trade of 1948, as amended ("GATT"). All of the signatories to GATT agreed that in matters of international trade they shall accord the other contracting parties treatment no less favorable than that provided to other contracting parties. In practice, if one party improves the benefits it gives to one trading partner, it has to give the same "best" treatment to all parties so that they all remain "most favored."

Building on the concept of non-discriminatory treatment in the international trade setting, MFNs have emerged in the context of investment advisory agreements where clients with a certain degree of bargaining power can insist that the investment adviser give them the most favorable investment advisory fee among the investment adviser's clients. The client's bargaining power may emanate from sheer size, or from the fact that the investment adviser is relatively new to the business and eager to accept assets. Whichever the case, there are those investment advisers that will agree to MFNs without much thought or discussion simply because they never contemplate that someday the terms could apply to them.

An example of a MFN clause that a prospective client could propose for its advisory contract may appear as follows:

> "The investment advisory fees in this Agreement will be no less favorable than those granted to any other customer of the Investment Adviser. The Investment Adviser shall notify the Client promptly if it enters into an agreement with another customer that has a more favorable investment advisory fee and Client shall have the right to receive the more favorable investment advisory fees immediately."

While this provision could prove helpful to the client, such terms may be problematic for the investment adviser. As you can see, the language is very broad. There is no definition of who the customers are, whether they have to have the same investment strategy, or whether they have to have the same asset size. For this reason, investment advisers will need to evaluate the fairness of this provision in light of its fiduciary duty. It may not be fair for a client who is receiving discretionary investment advisory services to demand the same fee that is being charged to another client who is receiving model delivery. Moreover, it may not be fair for a client with a complex derivative strategy to demand the same fee that is being charged to another client with a large cap value strategy or for a client with $1million AUM to demand the same fee that is being charged to another client with $50million AUM. However, based on the language of the above MFN clause, in each of these scenarios, clients rightfully could assert a MFN demand leaving the investment adviser vulnerable.

For an investment adviser to assume the MFN will never apply to them is ill-advised. The risk is very real and usually manifests itself over time due to staff turnover, forgetfulness, or poor recordkeeping. For example:

- Assume in year one (1), eager investment adviser enters into an investment advisory agreement with a "founder" client with $20 million AUM at 1% advisory fees and an MFN provision;
- By year three (3), the investment adviser experiences extreme growth and enters into an investment advisory agreement with a much larger client and, having forgotten about the earlier MFN, charges a .50% investment advisory fee;
- During an internal audit in year 10, the investment adviser learns it has been in breach of the original MFN for 7 years.

Under the terms of the MFN, the investment adviser would be required to recalculate the advisory fee it charged the "founder" client to .50% on $20 million AUM (assuming the assets remain static) for the 7-year period it was in breach of the MFN. That recalculation equates to approximately $700,000 in fees that the investment adviser must now reimburse the founder client. This setback could materially impact the investment adviser.

Another common scenario is found with the above example in reverse. Where the investment advisory fee of the "founder" client is .50%, and the published investment advisory fee for the second client is 1.00% on $20 million AUM. During contract negotiations start, the second client expresses a willingness to pay 1.00% in exchange for and insistence on a MFN provision. Under the MFN, the investment adviser could only charge the second client the lowest rate charged to other clients, or .50% on $20 million AUM. Accordingly, the MFN would cause the investment adviser to forego $100,000 in annual advisory fees, which may not be a viable economic option.

MFNs are an important part of the investment advisory business, both for investment advisers and their clients. The MFN language can't be ignored - and it should not be assumed as a low-risk area. When discussing MFN treatment in the investment advisory agreement, investment advisers should focus on economic considerations, such as the scope of the MFN as well as the exceptions including a clause that would preserve preferential treatment for "founders." The investment adviser should consider the following when dealing with MFN clauses:

- It is a contractual-based obligation that must be contained in an investment advisory agreement.
- It should require a comparison between the treatments afforded to two (2) clients in like circumstances. It is therefore a relative standard that the investment adviser wants to be interpreted as narrowly as possible. For example, the investment adviser should seek to apply an MFN only to future clients, with like assets and with like investment strategies.
- In order to establish a violation of MFN treatment, a less favorable treatment must be found, based on the MFN language itself.
- In order to monitor MFNs, it is absolutely necessary that the investment adviser assign the responsibility of keeping a master list of MFNs and reviewing the list every time a

prospective client seeks to negotiate a discounted fee to determine if the discounted fee would trigger an MFN.

MFNs can be productive tools for investment advisers seeking to attract new assets and grow their business. At the same time, if not managed properly, they can be a deterrent to revenue growth and a ticking bomb that explodes to inflict great damage on the investment adviser. Accordingly, MFNs must be reviewed, drafted, negotiated, and stored with great care.
For more information on these and other considerations, please contact us at info@jackolg.com, or (619) 298-2880. Also, please visit our website at www.jackolg.com.

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