REGULATORY COMPLIANCE WATCH

Be sure to monitor MFN clauses for compliance: *A client could sue for breach of contract. "It's pretty easy to calculate the damages" should that occur*

By Carl Ayers May 7 2020

There are some signs that use of most-favored-nation clauses isn't as popular as they once were. A recent **survey** found use of MFN clauses had fallen slightly over the year before.

Still, the clauses – which guarantee the investor the lowest fee charged by the adviser – appear in about half of all private fund side letters, reports **Daniel Bresler**, counsel with **Seward & Kissel** in New York. As you might expect, they tend to show up in contracts with newer managers because those with a long track record can better resist pressure by institutional investors to adopt such clauses.

Advisers tend to recoil from MFNs because they can present monitoring challenges (**RCW**, July 23, 2012).

MFNs can also provoke questions about fiduciary duty. "The **SEC** and **FINRA** both don't really like MFNs," maintains **Ben Anderson**, principal with **Anderson PLC** in Minneapolis. The SEC thinks MFNs create "a potential fiduciary duty problem." The thinking goes that you may not be showing the same loyalty of care to investors without an MFN provision.

While we couldn't find an enforcement case based on an MFN clause, legal risks remain. A client could sue for breach of contract. "It's pretty easy to calculate the damages" should that occur, notes Bresler.

Best practices tips

At the very least, "create a calendar" that forces you to periodically review contract clauses "so you don't inadvertently breach a side letter," adds Bresler.

Create a spreadsheet with the first column listing investors and the rows the terms, e.g., fees, presence of an MFN clause, etc., suggests Anderson.

Appoint someone to monitor the deals periodically. If it's the CCO, then the "CCO has to be at the table" with marketers, operations and business development when onboarding new clients to know the terms and to check and update the spreadsheet, Anderson adds.

Stephen Velie, CCO with **Thornburg Investment Management** ($40B in AUM) in Santa Fe, N.M., uses a spreadsheet. He'll even paste in the wording of each MFN clause.

"We would essentially be the umpire as to whether the MFN clause applies or not," he says. Compliance reviews all new contracts. Ops and sales are alerted if one features an MFN clause. Compliance would then report how the deal would "affect our current clients." Business staff ultimately will make the call on whether to proceed with the MFN clause.

"We'll try and match up the definitions" in a new contract "to make sure they're consistent and you compare apples to apples," Velie continues. In some cases, the firm may ask a new client to tweak a deal "so we don't implicate an MFN clause," he notes.

Disclosure plays a prominent role. "Certain institutional separate account clients have negotiated 'most favored nation' clauses in their investment advisory agreements," discloses **Rothschild Asset Management** ($8.2B in AUM) in New York. Its Form ADV brochure goes on to reveal that these "clauses may require R&Co to decrease the fees charged to the 'most favored nation' client whenever R&Co enters into an advisory agreement at a lower fee rate with another institutional separate account client."

Staying in the loop

Rothschild's compliance P&Ps state that any deviations from its fee terms, "as well as any 'most favored nation clauses' must be approved by the Chief Executive Officer, with notice to the Chief Compliance Officer."

Franklin Templeton Portfolio Advisors ($4B in AUM) in San Mateo, Calif, freely discloses that the "Advisers have sole discretion over whether or not to grant any MFN clause in all circumstances."

Some firms attempt to limit the provision. Before **Aberdeen Standard Investments** ($39B in AUM) in Philadelphia would trigger a clause the adviser would consider "the degree of similarity between clients, including the type of client, the scope of investment discretion, reporting and other servicing requirements, the amount of assets under management, the fee structure and the particular investment strategy (and therefore the relevant investment adviser) selected by each client."

"It should certainly be limited to the particular strategy," counsels Bresler. "That's the appropriate way to do it." But "try to be as consistent as possible" with terms to make implementation easier, he encourages.

The AUM threshold could be used "as a fundraising tool," notes Bresler. You could deny the triggering of an MFN to an investor because your policy dictates the clause applies only to a client with a certain level of AUM.

Watch out for red flags

There are additional clauses that can help to raise a red flag around fiduciary duty. Examples could include a redemption clause prompted by a portfolio manager who withdraws much of his capital. Another is a "key man" provision. This could give some investors preferential rights to sell out of a fund should the portfolio manager leave.

That's "a big red flag," says Bresler because some investors will get benefits unavailable to others. "You need to give that [right] to everybody," he states.

Thornburg discloses that the advisory firm doesn't "agree to 'most favored nation' clauses in all circumstances."

A provision you may wish to consider is to carve out of any MFN provision advisory employees and their family members, recommends Bresler. This would allow you to charge them lower fees.

A lawsuit to watch

A case that rests on appeal in the 2nd circuit argues a mutual fund violated its fiduciary duty to clients by *not* negotiating an MFN clause with an advisory firm. A federal judge last summer in *Hebda v. Davis* issued summary judgement on behalf of the defendant.

Attorneys for investor **Gary Hebda** claim **Davis Selected Advisers** ($23B in AUM) in Tucson, Ariz., took "excessive" IA fees in managing the mutual fund. Judge **Laura Swain** found the mutual fund board "followed a conscientious IAA approval process."

The "board should have a focus on keeping fees low for the benefit of investors," argues Hebda's attorney, **Andrew Robertson**, senior counsel with **Zwerling, Schachter & Zwerling** in New York. "As a fiduciary … it's absolutely in their [board's] interest to ensure that they're getting at least as a good a deal as other clients."

An attorney for Davis declined to comment to **RCW**.