



## **“First Among Equals” and how to deal with most favoured nation clauses in investment management agreements?**

**Date: 28 May 2024**

**Prepared by: Andrew Goldstein**

**Key terms: IMAs, MFN clauses, investment management, distribution**

When seeking to appeal to large institutional clients, fund managers and their distribution agents are ever under pressure to deliver services to those clients under a “Most Favoured Nation” clause, often simply referred to as an “MFN”. In this article, we explain, what is an MFN, what to be careful of in agreeing to MFNs and lastly good practice around management of MFNs.

### **What is an MFN?**

An MFN is a term in an agreement under which the service provider (in this article, the investment manager) agrees that with regard to a particular client (the “Favoured Nation Client” or “FNC”), that the client will be given preferential treatment along with or over and above other clients.

In investment management agreements (“IMAs”), this involves the Favoured Nation Client being in the enviable position that no other client will get a better deal than they do. This can take several forms, but most commonly this applies to fees, so that the FNC will either pay the lowest possible fee, or that if the investment manager wishes to offer better terms to another client, then those better terms need also be offered to the FNC.

### **Challenges when dealing with MFNs**

While it all sounds theoretically straightforward, a number of issues arise with MFNs. In our experience, these are the most common:

- MFNs are offered too widely and the obligations between FNCs conflict with each other;
- The terms of the MFN clauses are unclear, and arguments arise from the ambiguity.

We examine these two areas in more detail.

### **Managing Many MFNs**

*Legal advice is provided by Goldstein Legal Services Pty Ltd (“Goldstein Legal”). Goldstein Legal is incorporated in New South Wales, Australia, ABN 38 662 000 786. Goldstein Legal is regulated by the Law Society of New South Wales (“Law Society”), under practice ID no. 39992 as an incorporated legal practice, and has liability limited by a scheme approved under Professional Standards Legislation.*

While it is possible to manage a number of different MFNs, in practise this is not always well-managed. Most investment managers do not run well-compiled material contract registers, so line to line comparisons between competing MFNs is often a “from scratch” exercise, conducted on the run in the course of negotiating a new IMA with a well-resourced institutional investor insisting they “always” get an MFN in their preferred form. Institutional investors do often have their own version of an MFN, and they may not be drafted in like terms to other institutions.

It is highly advisable for investment managers to keep an up-to-date register of their key IMAs and have existing MFNs easy to find. Distribution agents need to be aware of these and factor them into their negotiations.

### **Key components in the MFN**

The key components in common investment management-style MFNs involve:

1. The applicable fees payable by the FNC;
2. That the preferential treatment applies to either the same or materially the same investment strategy in which the FNC invests;
3. That the client has the same or common characteristics to the FNC.

Below we tease out some key considerations arising out of these aspects.

#### *Fees*

As a point of guidance, MFN clauses should generally only apply where the clients involved are being charged on a similar basis. For example, in our view it is not appropriate to evaluate for MFN purposes a client who pays performance fees only, with a client who pays ongoing management fees only. They are being charged in a very different manner, with very different risk and reward characteristics, so we recommend that MFNs clearly identify that they apply only where the clients are being charged fees in like manner.

#### *Investment Strategy*

When preparing or negotiating an MFN, it is important to be very clear on whether the MFN is to apply only to the exact strategy being deployed, or whether it is to be broader than that, and may apply (for example) to an entire asset class or sector of an asset class, or to a particular style or methodology being deployed.

As an adviser to investment managers generally, we ask Is the investment manager getting enough of a benefit to justify the MFN?

It is also important to reflect on future changes to investment strategy and whether these have any impact on the way the MFN clause has been struck.

Generally speaking the investment manager wants the MFN to apply very specifically to a particular FNC, and to a very particular strategy.

### *Client characteristics*

The Australian investment management distribution ecosystem typically distinguishes between wholesale and retail clients (see the *Corporations Act* (Cth) s.761G), and within wholesale clients, between “platform” or “wealth” clients, and institutional clients like large public offer superannuation funds, large corporate and government investors.

In drafting an MFN, precision is needed if the intention is to limit the application of the MFN to clients within the same class or classification. Is the MFN to apply broadly to any type of client, or only to public offer super fund investors?

Further, MFNs are typically intended to apply where the clients involved are of similar size. Most commonly, we see MFNs apply where two or more clients are investing a similar amount of money in the strategy, but we have seen attempts to capture clients who are operating in the same or similar parts of the industry. In those instances, additional care may also be needed to consider any aspects related to competition law.

### **Summary**

Investment managers are typically driven by large wholesale clients applying pressure to accept MFN terms.

It is highly advisable for investment managers to keep an up-to-date register of their key IMAs and have existing MFNs easy to find. Distribution agents need to be aware of these and factor them into the early stages of the negotiation process.

Before agreeing to an MFN, ensure that the scope of the MFN is appropriate and well thought through. It should apply only to a narrow scope of clients, sensibly limited to similar fee arrangements, to “like” clients, and only to the same investment strategy.

An overarching consideration is that there must be good value, or at least appropriate risk and reward, for the investment manager to agree to the MFN, and not simply sway under the market power of the investor.

\*\*\*\*