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## Collateralized Fund Obligations: The Technicolor Dreamcoat of Fund Finance—Part 1

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This article is the first installment of a two-part installment on Collateralized Fund Obligations (CFOs). This first installment describes the basics of a CFO structure, as well as the market and outlook for CFOs. The second installment, to be published in an upcoming issue of *The Investment Lawyer*, will include a more detailed discussion of a CFO transaction, including CFO portfolio types and considerations associated with executing a CFO.

Over the past several years as Collateralized Loan Obligations (CLOs) reached new and dizzying heights in issuance volume, CFOs have been quietly, and under the radar, gaining market acceptance and momentum among asset managers, owners, and investors. The CFO is a transformational technology for vehicles designed to finance limited partnership interests in private funds (LP interests) and other assets (together with LP interests, the Private Financial Assets). CFOs have their roots in the early 2000s and had hitherto been more of a niche product focused primarily on providing liquidity for limited partnership interests of private equity funds. However, a confluence of factors has piqued interest in the product. Chief among these are: (1) the growing (but still inefficient) secondaries market which can make sales of

LP interests unattractive; (2) the ability to collateralize CFOs with a variety of different financial assets (including credit opportunity funds, buy-out funds, infrastructure funds, real estate funds, private credit funds, co-investments, asset-based securitizations (ABS), CLO equity, and residuals in securitizations); and (3) the desire of certain classes of investors such as insurers, sovereign wealth funds and other regulated investors to gain exposure to Private Financial Assets in a structured and capital efficient rated format.

### **The Appeal of CFOs: Have Your Fund and Monetize It Too**

Financing Private Financial Assets such as LP interests via a CFO offers a long-term capital markets execution on terms that are more favorable with regard to interest rate and advance rate than shorter-term financings executed in the private, bilateral/club market, such as net asset value (NAV) facilities. Moreover, for a platform that holds Private Financial Assets, CFOs offer an attractive alternative to selling into the secondary market, thus allowing such platform to re-allocate or re-balance its holdings without giving up the upside associated with such holdings. For regulated investors subject to risk-based capital requirements (Regulated Investors), holding rated

notes issued by a CFO offers better capital treatment than holding Private Financial Assets individually and directly. This is primarily due to the fact that CFOs benefit from a broad base of Private Financial Assets, overcollateralization, liquidity support and other structural features which enable them to issue 65-75 percent of their capital structure in the form of investment grade rated debt. We expect that as structures and collateral pools evolve that the percentage of rated debt (relative to the equity portion) will increase.

### Basic Structure: If a NAV Facility and a CLO Had a Baby

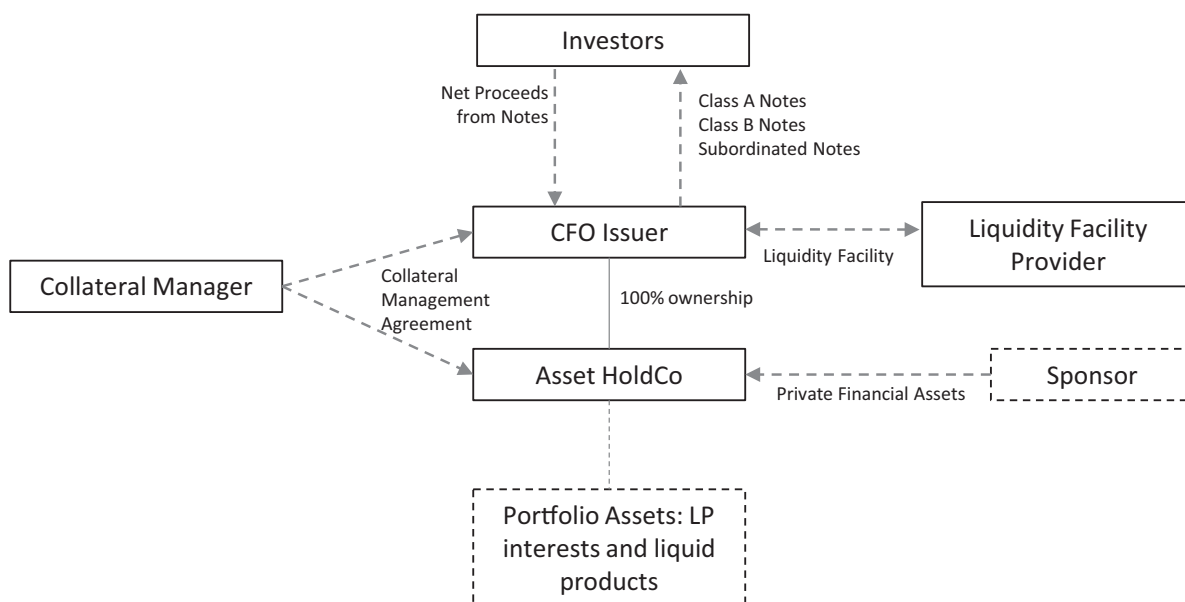
In a CFO, the issuer (CFO Issuer) is typically a bankruptcy-remote entity that acquires various Private Financial Assets, which it finances by issuing tranches of rated notes as well as an “equity” tranche, which can take the form of subordinated notes, limited liability company interests or limited partnership interests (Equity Tranche). Sometimes such Private Financial Assets are owned by a sponsor or alternatives platform and transferred into

the CFO as a means of gaining liquidity on such assets. In other instances, the CFO Issuer acquires such Private Financial Assets with the proceeds of the closing. Since the terms of most Private Financial Assets may prohibit them from being pledged to secure a financing without the consent of such Private Financial Asset’s general partner or investment manager, the Private Financial Assets can be held in a subsidiary of the CFO Issuer (Asset HoldCo). The assets of the Asset HoldCo are not subject to a pledge or a security interest, but equity interests of the Asset HoldCo are pledged to secure the repayment of the notes and other obligations of the CFO Issuer, and the Asset HoldCo may guarantee the obligations issued by the CLO Issuer. See Exhibit 1 for an illustrative CFO transaction.

One key structuring and modeling challenge of CFO transactions is the uncertainty regarding the timing and amount of distributions on the underlying assets. Unlike an ABS or CLO transaction, the Private Financial Assets that comprise the

Exhibit 1

### Illustrative CFO Transaction



underlying assets of a CFO typically do not have any stated principal amount that matures on a set date or an obligation to make interest payments regularly. Thus, sources of short-term liquidity, as well as structural features built into the transaction, are necessary to ensure that the CFO Issuer can make timely payment of interest, fees, and expenses, and that the Asset HoldCo can satisfy any capital calls from the underlying funds associated with its Private Financial Assets.

### Short-Term Liquidity

Unlike ABS or CLO transactions, in order to provide short-term liquidity for the CFO transaction, the Asset HoldCo may be required to hold some percentage of its assets in money market funds as well as lower-risk, liquid assets that can be redeemed within a relatively short period of time (but at least quarterly), such as diversified bond funds. In addition, the CFO Issuer will usually enter into a revolving liquidity facility with a third-party lender, as discussed further below. We note that the nature and amount of the liquidity facility can vary significantly, and we have seen transactions that feature customized approaches designed to provide the CFO Issuer with the requisite liquidity.

### Structural Features

While CFOs are very much bespoke transactions that can come in as many flavors as the underlying Private Financial Assets that are financed, they draw their structural inspiration from both NAV facilities and CLOs. While they pull from CLO technology in terms of the structure and tranching of the debt issued by the CFO Issuer, they also borrow loan-to-value or net-asset value mechanics from NAV facilities.

Some CFOs will have a set portfolio at close and no ability or only a limited ability to reinvest,<sup>1</sup> whereas others have an investment period of up to five years during which time proceeds of the offering can be deployed and reinvested. In some CFOs, the manager may also have the ability to cause the Asset

HoldCo to sell Private Financial Assets (typically subject to an overall percent limitation) and reinvest the proceeds from such sales into new Private Financial Assets. CFOs typically include an amortization period of up to another five years during which time the debt will be paid down according to an amortization schedule to the extent cash proceeds are available (or, if not available, catch-up payments would be made on subsequent payment dates); however, interest payments could step up in the event of a failure to pay down a certain amount of principal by a certain time frame or to pay off all principal by the end of the amortization schedule.

Although CFOs usually have a loan-to-value test, any breach would typically restrict or cut off distributions to the holders of the Equity Tranche, but would not necessarily result in an event of default. In addition, in many CFO structures, interest payments on senior notes are only required if the CFO has adequate cash flow; to the extent the CFO does not have sufficient cash to make interest payments, the interest payments would be deferred until the next payment date (unless such CFO provides that the liquidity facility may be drawn to make interest payments). CFOs also have a long maturity date relative to the underlying assets in order to ensure eventual repayment of principal, typically at least 15 years.

In some cases, the CFO Issuer may issue delayed draw notes to help ensure it can make capital calls on the funds in which it owns Private Financial Assets. In other cases, a cash reserve account may be established for such purpose. Cash reserves may also be set up to ensure the CFO Issuer has sufficient amounts for fees, expenses and interest for the next payment date. Finally, the sponsor or an affiliate may contractually agree to stand behind capital calls on the Private Financial Assets held by the CFO, but only to the extent this does not impair the bankruptcy remoteness of the CFO Issuer. Even absent a contractual obligation to make capital contributions required to satisfy capital calls on Private Financial Assets, many CFOs allow the holder of the Equity

Tranche to make capital contributions for various reasons, including to satisfy capital calls.

## CFOs versus Similar Products

### Rated Funds

CFO transactions are sometimes confused with the rated-note fund transaction (Rated Funds) since both allow Regulated Investors to invest in a fund or fund-like products via a rated debt instrument which provides for a better risk-based capital treatment than an equity investment. In a Rated Fund, a private fund may be established as a standalone vehicle or it may implement a feeder fund which issues both rated debt and equity. This allows for a Regulated Investor to invest in a private fund on a more capital-efficient basis by holding debt (and often the equity as well, but this is not required) as opposed to a more typical equity-only investment in a private fund.

Rated Funds are first and foremost private funds with (generally) a single pool of directly held assets (or indirectly via a master-feeder structure), whereas a CFO is more akin to a fund of funds. Additionally, a CFO is generally intended as a leveraging vehicle with a goal of providing a levered return. In contrast, Rated Funds, despite having inherent leverage created by the notes, are less often utilized for leveraging purposes, with funds seeking a levered return taking out separate asset backed leverage lines in order to enhance returns. Separately, Rated Funds are not a securitization, in large part because the notes issued in a Rated Fund are typically unsecured, whereas a CFO is supported by a security interest in the equity interests in the Asset HoldCo. However, the line between CFOs and Rated Funds has become increasingly blurred; for instance, some CFOs only invest in one fund (making it more like a Rated Fund), and Rated Funds are sometimes a “fund of funds” (making it more CFO-like). As CFOs and Rated Note Transactions continue to evolve, we will likely see more overlapping characteristics.

### NAV Facilities

Another close cousin of the CFO is the NAV facility. NAV facilities involve a bank or other financing source lending against the value of the assets in a primary fund or the value of the LP interests in a fund or group of funds. NAV facilities bear some structural resemblances. In both cases, the interests in the fund or group of funds is held by a holdco, which is in turn held by a special purpose entity borrower. However, NAV facilities usually involve fewer parties; they are often bilateral facilities with a single lender or a small syndicate of lenders, with no tranching and no separate “equity” piece that can be sold to a third-party investor. As such, there is generally less execution risk and lower transaction costs. However, the term of the debt issued under a CFO is much longer than under a NAV facility, the pricing is more favorable, and the ability to tranche a senior, mezzanine and equity piece allows the sponsor to bring in a wider swath of interested investors with different investment goals.

### NAIC Considerations for Insurance Investors

CFOs can offer an attractive risk-based capital charge for insurance companies who invest in the senior (and to an extent, the mezzanine) tranches issued by the CFO as compared to holding LP interests directly because LP interests are generally considered full equity and receive the highest capital charge. As of the date this article was written, the National Association of Insurance Commissioners (NAIC) has been conducting a process which includes updating the definition of “bond” for Schedule D purposes on a principles-based approach. Generally, it appears that the definition of bond will (assuming the relevant principles are met) incorporate debt tranches issued by CFOs. Separately, the NAIC is also considering residual tranches in structured products and whether such tranches should be considered a type of debt or “pure” equity (thereby increasing the capital charge that may be associated with certain residual tranches). Additionally, the NAIC has begun

considerations in relation to potential risk-based capital arbitrage by insurance companies investing in structured products and is focused on ensuring rated debt tranches are accurately reflective of the risks associated with the underlying investments in structured products. Such considerations may lead asset managers of CFOs to diversify the underlying funds and asset types held in order to ensure that risk of loss and liquidity concerns are better addressed in these types of portfolios than portfolios comprising solely of non-credit assets.

The NAIC's definition of bond is expected to become effective in January 2024 (although it has openly stated this may slip to January 2025), and the considerations surrounding arbitrage and residual tranches are not expected to have changes resulting to current practice until 2025 or later. While these considerations could adversely affect CFOs and other similar products, the process of determining the bond definition has demonstrated that the NAIC is mindful of the impact that regulatory changes would have on the market and is supportive of an evolving market, which includes greater involvement of alternative asset managers. As such, although there will be some changes to come, there is generally a feeling among market participants that such potential changes will not dampen the market for these vehicles in the near future.

## CFO Outlook: The 80s Called, They Want Their Yields Back

The outlook for CFOs appears promising. On the investor side, CFO notes tend to offer

higher interest rates than traditional securitizations, and CFO equity is typically forecasted to provide better returns than equity investments in other securitized products; in this sense, CFOs offer a key advantage in today's yield-hungry environment (rising interest rates notwithstanding).

The current market is challenging. Conviction is in short supply. Concerns over credit conditions abound, yet CFOs have a long history that predates the 2008-2009 financial crisis and have a solid track record during economic downturns, with no reported defaults on CFOs' rated notes even during the financial crisis. As such, we expect to see increased interest in CFO transactions as institutions go back to the future in an effort to navigate turbulent economic times.

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### NOTE

- <sup>1</sup> Note that, even in a "static" CFO which does not contemplate active reinvestment, market participants should nonetheless consider adding in the ability to recycle proceeds corresponding to the recycling that takes place at the underlying fund level.

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