CADWALADER

Brief Primer on CFOs and Rated Feeder Funds

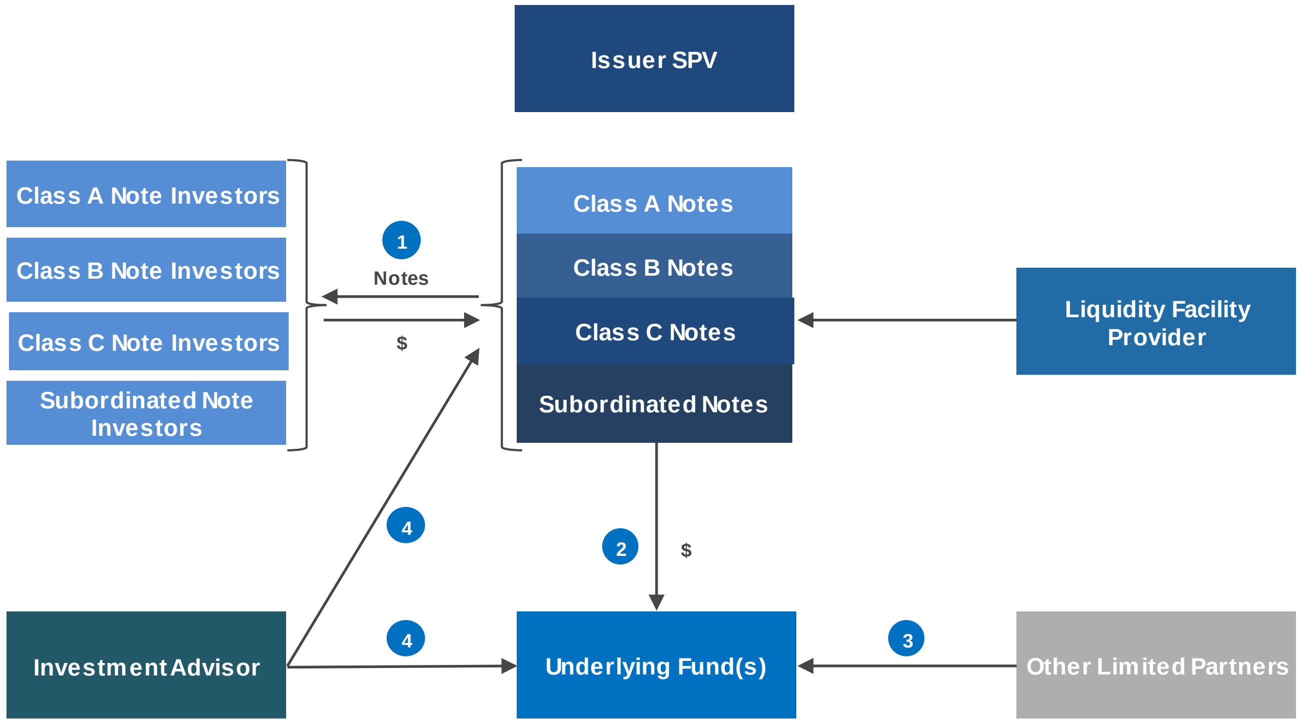
Overview: CFOs and Rated Feeder Funds

Through our extensive experience representing underwriters and sponsors in connection with CFOs and Rated Feeders, we've identified a number of key issues and considerations that should be addressed when contemplating a CFO or Rated Feeder structure.

This presentation discusses a number of these high-level issues and considerations. It is important to note that a number of these considerations will overlap and must be considered holistically when determining what structure works best to achieve a particular sponsor's objectives.

Defining CFOs and Rated Feeder Funds	▪ A **collateralized fund obligation** ("CFO") is a structured transaction backed by a pool of limited partnership (or other) interests in investment funds. Typically, a special purpose entity purchases the pool of underlying fund investments, which are then used as collateral to back rated notes and/or loans ("debt") and unrated notes and/or loans ("equity"). ▪ A CFO is similar to a **rated feeder fund** ("Rated Feeder"), which is a traditional feeder fund that issues both rated debt and equity. In each case, the equity provides the subordination required to support the ratings of the debt. The ratings incentivize a broader set of investors (including insurance companies) to participate indirectly in the investment strategy of the investment funds.
Structure	▪ Typically includes at least two to three debt tranches and an equity tranche that provides the subordination required to support the senior debt tranche ratings. The equity tranche may be in the form of subordinated notes or more traditional equity, such as LP interests.
Appeal for Investors	▪ In recent years, CFOs and Rated Feeders have grown in popularity as fund sponsors look to generate increased returns for investors and more traditional fixed income investors such as insurance companies seek exposure to non-traditional asset classes such as private equity and secondaries funds.

Typical Transaction Structure



1. Issuer issues notes to the respective investors.
2. Issuer provides an LP commitment to the Underlying Fund(s).
   - Drawn proceeds from the issuance of the Notes, net of closing costs and funding the Reserve Account deposit, are invested with the Underlying Fund(s).
3. The Underlying Fund(s) receive LP commitments from other Limited Partners.
4. The Investment Advisor acts as manager for the Underlying Fund(s). The investment advisor or one of its affiliates acts as manager for the Issuer.

Structural and Tax Considerations

☑ **Form of Issuer.** Sponsors will need to consider the domicile and entity type (e.g., foreign corporation, Delaware limited liability company, Delaware limited partnership, etc.) for the issuer of the CFO/Rated Feeder. This determination will in large part be driven by the tax discussions touched on below, as well as any specific investor needs.

☑ **Type of Offering.** Sponsors will need to consider the offering type and whether to engage a placement agent/underwriter. Offerings of notes can be done via 4(a)(2), 144A and/or Reg S and some tranches may also be issued in loan form based on investor need. Notes may be issued in global, certificated and/or uncertificated form – this determination will be driven primarily by the funding mechanics of the debt and equity (see “Cash Management” below).

☑ **Tax Considerations.** An initial consideration of any structuring discussion is whether the underlying investment fund(s) will generate effectively connected income (“ECI”) for U.S. tax purposes. This will be a key driver in determining the form of the issuer as well as whether non-U.S. investors will be able to invest directly in the debt and equity.

Jurisdictional and Marketing Considerations

☑ **U.S. vs. non-U.S.** Sponsors should be aware that restrictions on acquisition by non-U.S. investors of both the debt and equity tranches issued by the issuer may be needed. In particular, it should be assumed that delayed draw debt tranches could be treated as equity for tax and therefore subject to limitations on transfer (e.g., limited to U.S. investors, subject to higher minimum denominations, etc.) to ensure no adverse tax consequences to the issuer. For example, transactions involving ECI should be limited to U.S. investors or employ a blocker structure to facilitate indirect investment by non-U.S. investors (see "Structural and Tax Considerations—Tax Considerations" above).

Careful consideration will need to be taken in respect of (1) the composition of the underlying fund portfolio(s) and (2) the jurisdiction of the transaction parties involved as to the extent there is sufficient nexus with either the UK or the EU, as the transaction may constitute a securitization for the purposes of the UK/EU Securitisation Regulation (risk retention).

☑ **Investor Eligibility.** Sponsors will need to ensure that the issuer (and each investor in the debt and equity) is able to satisfy any eligibility requirements of the underlying investment fund(s) on a pass-thru basis.

Cash Management Issues and Considerations

Unlike traditional structured products, the issuer of a CFO/Rated Feeder will have a largely unfunded obligation to the underlying investment fund(s) that will be funded over time, which would result in a funding mismatch if the debt and equity are fully funded at closing of the transaction. To address this, the sponsor could employ several tactics (or any combination of the following – for example, a combination of fully drawn and unfunded tranches).

☑ **Delayed Draw Debt.** Structuring the debt and/or equity with a delayed draw mechanic would allow the sponsor to coordinate the draws from investors in the CFO/Rated Feeder with the obligation of the issuer to make capital contributions to the underlying investment fund(s), thereby minimizing cash drag during the period which the issuer has a large unfunded commitment to the underlying investment fund(s). However, investors will often require payment of an undrawn fee and a minimum draw requirement that scales up over time to ensure that they are earning an adequate return on committed capital.

Another consideration with respect to delayed draw debt is the appropriate mechanism for setting interest rates. If the interest rate applicable to a tranche of delayed draw debt is not floating or fixed at closing and instead is determined at the time of each draw, the sponsor should consider having the issuer enter into (and the issuer may in fact be required to enter into) hedging arrangements to mitigate any future interest rate risks.

☑ **Liquid Assets.** In structures that provide for one or more tranches to be fully funded at closing, the sponsor should consider how best to minimize cash drag until the issuer is required to make capital contributions to the underlying investment fund(s). In this regard, some transactions have included an ability to invest (either directly or indirectly) in income generating liquid assets (such as syndicated loans, bonds, CLOs and other liquid asset-backed securities) during this interim period.

Cash Management Issues and Considerations (Cont'd)

☑ **Recycling/Redraw/Clawback/Tax Distribution.** The governing documents of underlying investment fund(s) typically permit the fund(s) to (i) recycle cash distributions made to the investors, (ii) redraw such distributions, and (iii) require the investors to return distributions to fund clawback obligations to the fund(s). In addition, the underlying investment fund(s) are typically permitted to rebalance capital contributions in connection with subsequent closings of the fund(s) by returning capital contributions to the investors and distributing additional payments made by new investors in the fund in connection with subsequent closings. The underlying investment fund(s) also may be permitted to make tax distributions to the investors. While each of these features is relatively common in the investment fund space, receipt of cash and/or return of cash by an issuer of a CFO/Rated Feeder poses unique challenges. The rating requirements of the debt generally restrict the issuer from redrawing principal payments made on the debt. The transaction documents for the CFO/Rated Feeder typically provide an exception in connection with additional closings (see "Additional Closings" below) and permit the issuer to (i) the create reserve accounts and (ii) hold back proceeds from distribution through the waterfall in anticipation of future capital calls and other obligations of the issuer with respect to the fund(s).

The restrictions that apply to the debt generally do not apply to the equity and, as a result, the sponsor should consider including provisions in the transaction documents that permit the issuer to draw amounts from the equity to satisfy clawback and other obligations of the issuer to the fund(s).

Tax distributions by the issuer to the holders of the equity of the issuer are a novel concept at this time and warrant additional considerations before adoption.

☑ **Reserve Account.** Because the funds underlying CFOs and Rated Feeders often will not make regular distributions until the latter part of the fund's life cycle, CFOs and Rated Feeders will typically have a reserve mechanism to trap cash in the waterfall to ensure that the issuer will have sufficient liquidity to make payments of interest, fees and expenses on subsequent payment dates. See also "Liquidity Facility" below.

Additional Closings

☑ **Additional CFO/Rated Feeder Closings.** Transaction documents for CFOs/Rated Feeders generally include mechanics for additional closings, allowing the sponsor to upsize the transaction after the initial close. In this regard, sponsors should be mindful of the need to include mechanics providing for (1) rebalancing of drawn amounts (in the case of delayed draw tranches), (2) additional payments to existing holders of the same tranche as compensation for originally funding the portion to be drawn from new investors, similar to the additional payment mechanics in the underlying investment fund(s), and (3) payment of a premium equal to the amount of any additional payment the issuer would be required to make as a limited partner in the underlying investment fund(s) in respect of its upsized commitment therein.

☑ **Additional Fund Closings.** Underlying investment funds may also hold additional closings from time to time in which the issuer does not participate. In such circumstances, the issuer, as a limited partner in the fund, may be subject to rebalancing and as a result receive a return of a portion of its capital contributions and an additional premium thereon. Sponsors will need to determine how to allocate these payments among the various tranches and ensure that the returned capital contributions are retained or available to be recalled to the extent they may be recalled by the underlying investment fund.

Additional Issues and Considerations

☑ **Liquidity Facility.** As most underlying funds will not produce consistent cash flow, CFOs (but not generally Rated Feeders) typically will have a related liquidity facility that functions similar to a revolving working capital facility and can be used by the issuer to make interest payments, pay expenses and fund capital calls from the underlying investment fund(s). See also "Reserve Account" above.

☑ **Defaulting Holders.** In transactions that include delayed draw tranches, sponsors should include appropriate remedies with respect to holders that fail to fund their portion of any draw. Ideally, the issuer would be able to simply pass through any remedies that would normally be imposed by the underlying investment fund(s). However, the issuer will be limited in the scope of remedies that can be imposed with respect to any defaulting holder of rated debt. In such circumstances, the remedies available to the issuer will mimic more closely those that are typically applied in respect of defaulting lenders in a syndicated loan facility. With respect to defaulting holders of the equity tranche, the issuer will have greater latitude to impose penalties more closely mirroring those at the underlying investment fund level.

☑ **Voting Mechanics.** Sponsors will need to determine how voting rights with respect to the limited partnership interests held are allocated by the issuer. The equity tranche, as the effective "limited partners" of the underlying investment fund(s) would be the natural choice to exercise any voting rights on behalf of the issuer. However, sponsors will need to be mindful of any such voting rights with respect to which any debt investors may want input, as well as control of any voting rights following an event of default.

☑ **Subscription Facilities.** If a sponsor is seeking to include the commitments of investors in the CFO/Rated Feeder in the borrowing base of any subscription facilities at the underlying investment fund(s), language corresponding to the subscription facility acknowledgements contained within the underlying investment fund documents should be included in the transaction documents. It should be noted, however, that questions regarding the enforceability of the commitments in a bankruptcy, particularly with respect to the debt, may limit the ability to receive credit for these commitments in any subscription facility.

Additional Issues and Considerations (Cont'd)

☑ **Coordination with Underlying Investment Fund Documents.** Similar to how sponsors prospectively include language required by subscription line providers, sponsors should consider including in fund documentation provisions meant to address the unique structural considerations specific to CFOs and Rated Feeders noted above. This will ensure seamless integration of the CFO/Rated Feeder with the underlying investment fund(s) and avoid potential pitfalls if an underlying investment fund has held an initial closing prior to closing of the CFO/Rated Feeder (particularly in the application of defaulting holder remedies at the issuer level). Sponsors should also consider appropriate carveouts in any MFN clauses such that any provisions specific to the structure of the CFO/Rated Feeder are not scoped in to any MFN.

Sponsors should also consider how a removal of the general partner at an underlying fund or the dissolution of an underlying fund impacts the issuer.