Collateralized Fund Obligations (CFOs): The Technicolor Dreamcoat of Fund Finance

Authored by Mary Bear, Jon Burke, Christopher P. Duerden, John M. Timperio, Lindsay Trapp, Elliott M. Kieffer, David E. Miller and Eric Zeng

September 2022

Dechert
LLP

Collateralized Fund Obligations (CFOs): The Technicolor Dreamcoat of Fund Finance

September 2022 / Authored by: Mary Bear, Jon Burke, Christopher P. Duerden, John M. Timperio, Lindsay Trapp, Elliott Kieffer, David Miller and Eric Zeng

Overview

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 have piqued interest in the product. Chief among these are (i) the growing (but still inefficient) secondaries market which can make sales of LP interests unattractive, (ii) 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 (iii) 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.

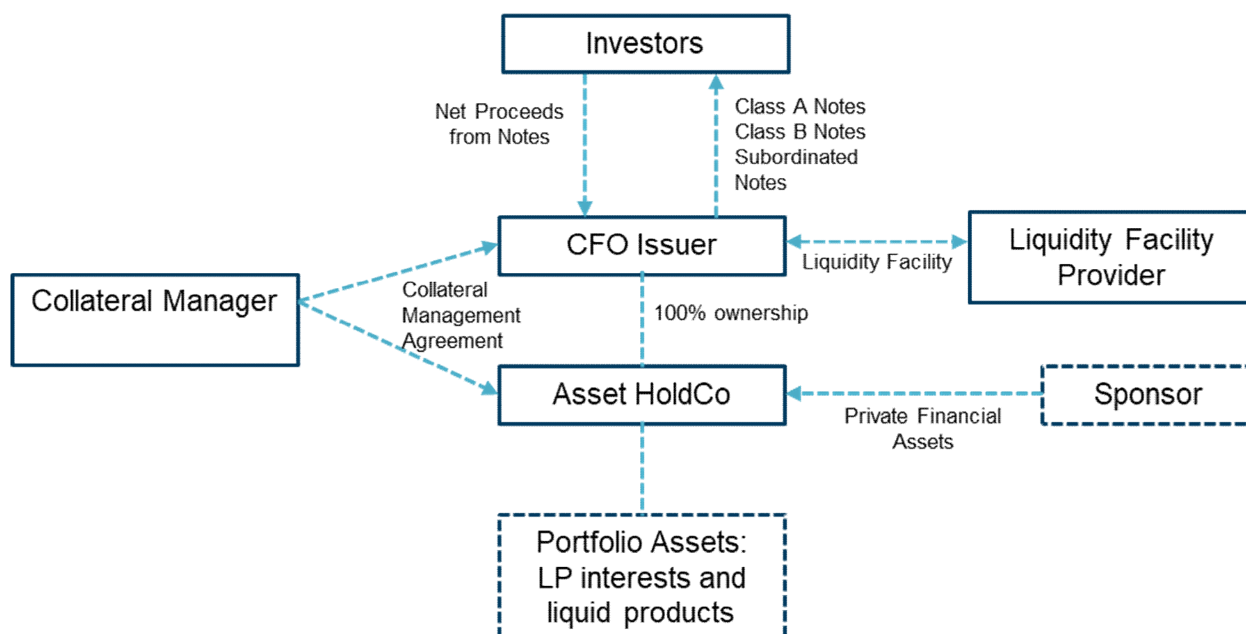
The Appeal of CFOs: Have your fund and monetize it too

Financing Private Financial Assets such as LP interests via a CFO offers a long-term capital markets execution on terms which 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% 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 (the "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 below 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 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,[1] 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.

Types of Portfolios

The portfolios of a CFO differ significantly in the type and diversity of assets:

- Identified Pool vs Blind Pool: CFOs come in two flavors: (1) those with an identified pool of assets transferred by a sponsor or alternatives platform and (2) those that are “blind pool” fundraising vehicles. Blind pools offer a great deal of flexibility for the manager, as the CFO can add new funds after closing and are used generally for fundraising purposes. On the other hand, identified pools offer less flexibility in terms of underlying assets but are often easier for rating agencies and investors to evaluate, and are generally used as a method of monetizing a specific pool of assets. In some cases, a CFO is a hybrid of the two, including some identified assets at closing but also the ability to continue to buy new assets after closing.

- Third-party vs affiliated funds: While some CFO transactions only contain Private Financial Assets in funds managed by the CFO’s manager and/or its affiliates, others have significant portions (up to 100%) of the portfolio comprised of Private Financial Assets managed by third parties.

[1] 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.

- Number of funds: Some CFO transactions have only one fund or a handful (e.g., three to six) of different funds in which they invest, while others invest in upwards of 100 funds.

- Vintages: Some CFOs include staggered vintages of Private Financial Assets in which certain “older” Private Financial Assets that are closer to their final distribution date are combined with other “newer” Private Financial Assets that are several years away from their final distribution. This can help ensure adequate cash flow during the life of the CFO, with older vintages distributing cash in early years and newer vintages distributing cash during later years.

- Fully drawn versus ongoing commitments: In some CFOs, the LP interests are fully drawn or almost fully drawn, while in others there remain significant outstanding capital commitments. Those with outstanding capital commitments generally require the Issuer (or an affiliate) to demonstrate ongoing liquidity to fund such capital commitments via liquid products, a liquidity facility, delayed draw notes or otherwise. To the extent the CFO issues delayed draw notes or relies on any kind of unfunded commitment from its investors, the ability of such holders to fund will be a consideration that needs to be addressed, including by way of minimum ratings requirements applicable to the holders of the delayed draw notes and any transferees.

- Types of assets: While most Private Financial Assets consist of LP interests in private equity funds, venture capital funds, credit funds, hedge funds, real estate funds, energy funds and infrastructure funds, CFO transactions can also include interests in CLO equity and CLO equity funds, equity in ABS securitizations, direct co-investment in portfolio companies, broadly syndicated loan assets and others. While some portfolios are concentrated, a method to ensure cash is available for distribution includes adding a mixed portfolio of LP interests in funds with credit or other income-bearing strategies combined with more equity or real-estate concentrated portfolios. Furthermore, while most Private Financial Assets are comprised of minority investments in underlying funds, some Private Financial Assets may be the sole interest in a “fund-of-one”. CFOs can accommodate many different products and asset classes, so long as appropriate liquidity can be demonstrated and stress tests can be satisfied.

To date, there has been no one “standard” for a CFO asset portfolio. As such, the CFO structure offers flexibility to a sponsor or asset owner for fundraising and/or monetizing with respect to assets that do not fit neatly into any of the more traditional channels.

Closing a CFO: Timing and execution

CFOs, unlike CLOs, do not feature any traditional warehousing of assets. Rather than a manager selecting assets, financing them in a warehouse and then undertaking a take-out securitization, CFOs are initially conceived with a sponsor meeting with the rating agency and investment bank and identifying a portfolio or a model for a portfolio. Subject to confidentiality restrictions discussed in more detail below, investors and other parties to the CFO will often diligence the underlying assets (i.e., the underlying funds) held by the CFO as if they were directly investing in such assets; thus, there is significant time spent up-front agreeing upon a portfolio and a structure before going to market. To the extent the manager or sponsor is not expecting to retain the Equity Tranche in the CFO transaction, it is also imperative to have an investor lined up to either purchase or retain the equity of the CFO before launching, as the CFO itself will likely never materialize without securing the equity piece. Although timing varies from deal to deal, sponsors should expect the entire process to take anywhere from three months to nine months.

In addition to a more extensive due diligence and structuring process, sponsors and their counsel must also simultaneously undertake “onboarding” of the CFO’s assets. In CFOs which involve an established pool of assets, the sponsor of a CFO will usually “seed” the CFO with existing Private Financial Assets it holds, receiving cash or equity in the CFO (i.e., the Equity Tranche) or some combination of the two in exchange for such Private Financial Assets. However, transferring Private Financial Assets to the Asset HoldCo of a CFO presents unique challenges and considerations that are not present in CLOs or ABS transactions, including securities law, anti-money laundering and KYC considerations, tax ramifications for the underlying fund and confidentiality. Given the interdisciplinary nature of a CFO transaction and the complexities involved, it can require multiple separate work streams covering the negotiations and documentation around the financing and the collateral transfer.

Some of the key considerations for general partners of transferring funds and CFO sponsors as transferring limited partners include:

GP-Side Considerations:

- Timing: Many private funds have set LP interest transfer windows, which could be quarterly, every six months or yearly. The transaction parties need to track and manage the timing of each transfer in order to avoid substantial delays. Some general partners of private funds (“GPs”) have placed the underlying LP interests in escrow until the CFO Issuer’s relevant closing to help address timing offsets.

- CFO Issuer and CFO Issuer Investor Representations: The CFO Issuer will need to make the required securities law representations (e.g. “qualified purchaser” status) in order to hold the various underlying LP interests. Transaction parties need to consider when these representations need to be made, as the vehicle will not generally be sufficiently capitalized until the transfers take effect. Similar timing considerations arise with respect to the AML/KYC representations that the CFO Issuer and the investors of the CFO Issuer will need to make, particularly relating to ownership, as CFOs are often “orphan” vehicles and the equity tranche owner will not technically hold the equity tranche until after the takeout. In addition, transaction parties need to ensure that the CFO Issuer investors make the appropriate representations up their ownership chain.

- Default: Subscription lines are typically used to cover capital calls made by underlying funds. Where there is no subscription line, GPs often require transferring limited partners (“LPs”) to represent that they will cover defaults of transferee LPs.

- Subscription Lines: Many funds have a subscription line in which the original owner of the LP interest was part of the borrowing base. The GP should discuss with the credit provider early in the process to determine if the transfer would affect the borrowing base.

- Tax Issues: GPs should consult tax counsel for the fund in order to analyze the implications of any change in the investor’s domicile (e.g. if the CFO Issuer itself (or the Asset HoldCo) is a Cayman entity and the prior investor was U.S. based).

- Side Letters: GPs need to consider whether side letters with respect to the LP interests are transferred in full or whether terms will be loosened, as well as the timing considerations involved with the re-negotiation of any terms.

LP-Side Considerations:

- GP Consent; Confidentiality and Non-disclosure Agreements
  - A transfer of a limited partner's interest in each fund will require consent from each GP. GPs can withhold consent to the transfer of interests in a variety of ways pursuant to the respective fund's governing documents. Significant lead time and interfacing with the GPs will be required to achieve consent to the transfers.
  - Pursuant to the fund's confidentiality provisions in its limited partnership agreement ("LPA"), each GP will likely require a non-disclosure agreement before providing any of the materials necessary for the transfer of the interest. Significant lead time will be needed to negotiate these agreements with the GP.
- The sum of interests to be transferred and timing of the CFO securitization
  - Each GP likely has a secondary/transfer program where the GP is only willing to provide specific effective dates that can be quarter-based, bi-annual or even annual. The timing and representations made as part of the takeout need to be in line with the effective dates offered by the GP. If the timing benchmarks required by the GP are not met, the transfer risks being moved to the subsequent effective date.
- Materials required for the transfers
  - Although generally similar in terms of material provisions, each fund has its own fund governing documents consisting of a subscription agreement, an LPA, a private placement memorandum ("PPM") and, if initially negotiated, an associated side letter. Each fund's transfer agreements and subscription materials for the transfer of interest are borne out of these materials. The materials therefore present with their own nuances and distinctions such as with respect to fund's tax and AML/KYC requirements.
  - For both tax and AML/KYC, the domicile of the transferee and the fund will present nuances and challenges for the transferee to consider. For example, depending upon the size/sophistication of the GP of a given fund, the GP will handle AML/KYC internally or outsource to a third party fund administrator. Generally, third party fund administrators will present with more stringent AML/KYC requirements
- Interfacing with opposing counsel
  - Depending upon the sum of interests and the variety of GPs, a variety of opposing counsel will need to be engaged representing general timing and transaction complexities.
- Costs
  - Depending upon whether the GP engages their own counsel to effect the transfer, each transfer of interest will likely incur legal costs to be borne by the transferring parties. These costs can be relatively significant (in addition to the costs associated with the CFO itself) depending on how many interests are being transferred.

Disclosure vs Confidentiality

Given that a CFO includes underlying funds which themselves are subject to a panoply of risks, preparing a CFO's offering documents involves a delicate balancing act between maximizing disclosure and preserving confidentiality. While including the names of each underlying fund and attaching the "risk factors" section from each private placement memorandums for each such fund would provide investors with the most fulsome set of information, the Private Financial Assets are often subject to confidentiality restrictions that prohibit sharing the PPM or even the name of the fund and the manager. Moreover, some CFOs do not have all of the funds determined at the outset (or, in the case of completely "blind" pools, would have none). Depending on the provisions of the LPA, consent may be necessary to provide basic information about the CFO's investments, such as the names of the funds in which the CFO invests. Private funds may also be sensitive to sharing the fact that a CFO is one of its limited partners. Obtaining consent to include the PPM's risk factor section in a CFO's offering documents can be even more difficult, as such material is often considered highly proprietary. However, to the extent the CFO consists mainly or entirely of funds affiliated with the sponsor, this may be a viable alternative.

In scenarios where the CFO Issuer cannot disclose the funds or attach PPM risk factors associated with each fund, an alternative would be to summarize the primary risk factors associated with each asset class that the CFO is investing in without disclosing specific funds. Many CFO sponsors may opt for a hybrid of the two approaches; for instance, a CFO's offering materials may attach the PPM's risk factors for three or four of the largest funds (measured as a percentage of the CFO's aggregate investments), but include only a generic summary of risk factors for the remaining funds included in the CFO's portfolio. Additionally, in some cases, the CFO offering materials may include anonymized data for the Private Financial Assets.

Sponsors considering utilizing new fund interests in a CFO should consider negotiating provisions similar to a fund of funds or third party feeder fund in relation to confidentiality matters when investing.

Cash Distribution Mechanics

As a general matter, due to the unique liquidity considerations of a CFO transaction, interest and principal payments to the noteholders are more variable than in CLO or ABS transactions (given that notes may PIK if insufficient funds are available for any given payment date), and distributions to the Equity Tranche are more restricted. Furthermore, a reserve account may be funded for the purpose of supporting the liquidity needs of a CFO prior to being available for distribution.

In a CFO, the priority of payments typically provides for the following:

1. administrative expenses
2. management fees[2]
3. fees, expenses and interest for the liquidity facility
4. mandatory repayment (if any) of principal outstanding on the liquidity facility

[2] Management fees may not always be charged, particularly if the manager or an affiliate holds the Equity Tranche

5. interest on the notes (in order of priority), subject to deferral if insufficient cash is available at this step

6. optional repayment of principal outstanding on the liquidity facility

7. during the amortization period (or while certain trigger events are continuing, such as a loan-to-value trigger), scheduled amortization on the notes (in order of priority), subject to deferral if insufficient cash is available at this step

8. administrative expense catch-up

9. payments on the Equity Tranche, subject to restrictions on timing (which is usually not allowed until at least three years after closing date) and amount (which is usually limited relative to the loan-to-value ratio, liquid asset balance and a percentage of initial principal balance on the Equity Tranche) to the extent such payments are made prior to the payment in full of the senior notes, as well as reserve for senior fees, expenses and interest for the next payment date

Additionally, to the extent the CFO has the ability to reinvest proceeds from Private Financial Assets into additional Private Financial Assets or the obligation to fund further capital calls, cash may be diverted for such purposes in the waterfall prior to any distributions to the Equity Tranche.

Liquidity Facilities

The CFO Issuer usually enters into a revolving liquidity facility that it can draw upon to fund capital commitments of underlying funds and pay interest on notes and other fees and expenses of the CFO transaction. The liquidity lender, typically an insurance company or bank, will charge an upfront fee and an ongoing commitment fee for the non-used portion. Although it is generally not expected that these liquidity facilities will ever have to be fully utilized, having access to a liquidity facility minimizes the likelihood the CFO Issuer will be unable to pay ongoing obligations and protects the transaction from the punitive consequences of failing to fund capital commitments on underlying funds. As such, ensuring there is adequate liquidity to support the transaction, including through the use of liquidity facilities, is necessary to obtain the desired ratings on the CFO's notes.

Although the terms of liquidity facilities vary, they generally have a term of three to five years (often aligning with the reinvestment period of the CFO), subject to extension at the discretion of the liquidity lenders and upon payment of an extension fee. Liquidity facilities usually terminate upon redemption, unless the CFO Issuer is able to negotiate a feature in which the facility does not terminate if the CFO is subject to a refinancing. The commitment size is generally 10-15% of total CFO issuance. In addition, given that the liquidity facility is often required to achieve the desired ratings, rating agencies will require such facilities to include counterparty ratings requirements for the liquidity lenders, along with mechanics for replacing downgraded liquidity lenders.

Rating Agency Considerations

Although different rating agencies employ different methodologies, the following are some of the key factors that most rating agencies take into consideration when evaluating CFOs:

- Manager track record: Rating agencies focus specifically on how funds managed by the general partner ("GP") or manager have performed historically, including their internal rate of return. This analysis looks separately at how such manager or GP has fared among different vintages of funds, as well as different fund

strategies/asset classes. Alignment of interest is also key: whether and how much of the GP's own money is employed in such funds is usually a positive indication of aligned interests.

- Liquidity: Rating agencies take into account the CFO Issuer's ongoing obligations and its ability to satisfy these obligations through its expected sources of liquidity (liquid assets, liquidity facility, delayed draw notes, cash reserve mechanics, etc.)
- Loan-to-value / overcollateralization: Although there is no standard "haircut" that can be applied to any specific Private Financial Assets or portfolio of Private Financial Assets, the rating agencies will examine the principal balance of the notes and liquidity facility relative to the NAV of the underlying Private Financial Assets, liquid products and other CFO assets.
- Diversification: Rating agencies will evaluate the diversity of funds in terms of strategy (private equity, credit fund, real estate, etc.), geography (U.S. vs non-U.S., developed markets vs undeveloped markets, etc.), number of funds and vintage. Rating agencies may also take a look-through approach (looking through to the assets held by the underlying funds) to determine concentration limits. Additional asset types and mixing of underlying fund strategies can also assist with cash flow diversification.

U.S. Risk Retention Analysis

U.S. risk retention rules generally require the sponsor to retain at least 5% of the securitized assets in a securitization involving the issuance of asset-backed securities. However, an "asset-backed security" is defined as a fixed-income or other security collateralized by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset. Since repayment of the CFO notes primarily depends on LP interests, and most LP interests are not "self-liquidating" (i.e., interests in private funds do not convert to cash within a finite period of time), most sponsors take the position that the U.S. risk retention rules do not apply to CFO transactions. However, given that the structure of the CFO transaction and the notes issued utilize some of the technology and legal documentation that are commonly seen in traditional securitization transactions, and given the lack of guidance on CFOs from any rule-making authority, there remains some uncertainty on this subject. Furthermore, to the extent CFOs include Private Financial Assets other than LP interests (for instance, ABS or CMBS notes, broadly-syndicated loans or other debt-like investments), this would further complicate the analysis.

CFOs vs 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 of this OnPoint, 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 into structured products and are 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 they have 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 amongst 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). Furthermore, CFOs offer flexibility and room for creativity for sponsors, as they lie somewhere on the spectrum between more standardized products like CLOs, on the one end, and more bespoke creatures of the private funds world, on the other end. As such, we expect this to be an area of continued creativity and variety—with structures as variegated as the assets underlying the transactions—and demand driven by sophisticated, regulated investors.

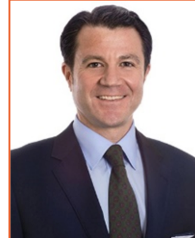
The current market is challenging. Conviction is in short supply. Concerns over credit conditions abound, yet CFOs have a long history that pre-dates the 2008-2009 financial crisis and have a solid track record during economic downturns, with no reported defaults on CFOs' rated notes even during the 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.

This update was authored by:

Mary Bear
Consulting Attorney
Charlotte
+1 704 339 3162
mary.bear@dechert.com

Jon Burke
Partner
New York
+1 212 641 5694
jon.burke@dechert.com

Christopher P. Duerden
Partner
Charlotte
+1 704 339 3113
christopher.duerden@dechert.com



John M. Timperio
Partner
Charlotte
+1 704 339 3180
john.timperio@dechert.com

Lindsay Trapp
Partner
Charlotte: +1 212 698 3810
Dublin: +353 1 436 8588
New York: +1 212 698 3500
lindsay.trapp@dechert.com

Elliott M. Kieffer
Associate
New York
+1 646 731 6168
elliott.kieffer@dechert.com

David E. Miller
Associate
Boston
+1 617 728 7115
david.miller@dechert.com

Eric Zeng
Associate
Charlotte
+1 704 339 3119
eric.zeng@dechert.com

© 2022 Dechert LLP. All rights reserved. This publication should not be considered as legal opinions on specific facts or as a substitute for legal counsel. It is provided by Dechert LLP as a general informational service and may be considered attorney advertising in some jurisdictions. Prior results do not guarantee a similar outcome. We can be reached at the following postal addresses: in the U.S.: 1095 Avenue of the Americas, New York, NY 10036-6797 (+1 212 698 3500); in Hong Kong: 31/F Jardine House, One Connaught Place, Central, Hong Kong (+852 3518 4700); and in the UK: 160 Queen Victoria Street, London EC4V 4QQ (+44 20 7184 7000).

Dechert internationally is a combination of separate limited liability partnerships and other entities registered in different jurisdictions. Dechert has more than 900 qualified lawyers and 700 staff members in its offices in Belgium, China, France, Germany, Hong Kong, Ireland, Luxembourg, Russia, Singapore, the United Arab Emirates, the UK and the U.S. Further details of these partnerships and entities can be found at dechert.com on our Legal Notices page.