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Collateralized Fund Obligations: The Technicolor Dreamcoat of Fund Finance—Part 2: A Deeper Dive

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This article is the second installment of a two-part series by the authors. The first installment, which describes the basics of a CFO structure, as well as the market and outlook for CFOs, appeared in the January 2023 issue of *The Investment Lawyer*.

In recent months, collateralized fund obligation (CFO) transactions have gathered momentum as an attractive way for investors that hold limited partnership (LP) interests in private closed-end funds (LP interests) to monetize these LP interests, as well as other assets (together with LP interests, the Private Financial Assets). A key component of the appeal of CFOs is their flexibility and room for creativity for sponsors, as CFOs lie somewhere on the spectrum between more standardized products such as collateralized loan obligations (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.

Types of Portfolios

As discussed in Part 1, a CFO consists of an issuer (CFO Issuer) which issues 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). The assets of the CFO are placed in a subsidiary of the CFO Issuer (Asset HoldCo) which holds a portfolio of Private Financial Assets. These portfolios can vary significantly from one CFO to the next in terms of 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 generally are 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 percent) of the portfolio comprised of Private Financial Assets managed by third parties.

- *Number of funds*: Some CFO transactions have only one fund or a handful (for example, 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 CFO 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 (that is, 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 on 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 also must 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 (that is, 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 asset-backed securitization (ABS) transactions, including securities law, anti-money laundering (AML), and know your customer (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.

Below are some of the key considerations for general partners of transferring funds and CFO sponsors as transferring limited partners.

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 (for example, "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 generally will not 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 (for example, if the CFO Issuer itself (or the Asset HoldCo) is a Cayman entity and the prior investor was US 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.

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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 the 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 on 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 on whether the GP engages its 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 that 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 memoranda 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 private placement memorandum (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 in which 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[1]
3. Fees, expenses and interest for the liquidity facility
4. Mandatory repayment (if any) of principal outstanding on the liquidity facility
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 on to fund capital commitments of underlying funds and pay interest on notes and other fees and expenses of the CFO

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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 generally is 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 percent 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 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 net asset value (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 (United States vs non-United States, 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.

US Risk Retention Analysis

US risk retention rules generally require the sponsor to retain at least 5 percent 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" (that is, interests in private funds do not convert to cash within a finite period of time), most sponsors take the position that the US 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: Crossing the Finish Line

Successful execution of a CFO depends on a variety of disciplinary teams and multiple work streams. As such, sponsors who embark on a CFO transaction should seek out underwriters and advisers with experience structuring CFO portfolios and working with rating agencies, as well as legal counsel which has broad familiarity with the regulatory implications of CFOs (both for sponsors and typical CFO investors), a deep background in securitization and fund finance, and experience advising on and coordinating transfers of private fund interests.

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NOTE

1 Management fees may not always be charged, particularly if the manager or an affiliate holds the Equity Tranche.

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