



Fund Finance 2025

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Contributing Editor:

Wes Misson

Cadwalader, Wickersham & Taft LLP



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TABLE OF CONTENTS

Introduction

Wes Misson

Cadwalader, Wickersham & Taft LLP

Industry Viewpoints

1 **Morganization: origins and evolution of private equity and fund finance**

Dr. Mick Young

JPMorganChase

11 **The end of Fund Finance?**

Mike Mascia

EverBank, N.A.

Expert Analysis Chapters

16 **NAV and hybrid fund finance facilities**

Leon Stephenson

Reed Smith

29 **Collateral damage: what not to overlook in subscription line and management fee line facility diligence**

Anthony Pirraglia, Peter Beardsley & Richard Facundo

Loeb & Loeb LLP

41 **Derivatives at fund level**

Jonathan Gilmour, Joseph Wren, Nicholas Baines & Nick Morgan

Travers Smith LLP

51 **Oh, what a sweet life it is with subscription facilities!**

Kathryn Cecil, Jons Lehmann & Jan Sysel

Fried, Frank, Harris, Shriver & Jacobson LLP

60 **Fund finance in the secondaries context – liquidity breeds financing needs**

Katie McMenamin, Mimi C. Cheng & Edward Ford

Simpson Thacher & Bartlett LLP

68 **NAV facilities – the investor’s perspective**

Patricia Lynch, Patricia Teixeira & Justin Gaudenzi

Ropes & Gray LLP

75 **Enforcement: analysis of lender remedies under U.S. law in subscription-secured credit facilities**

Ellen G. McGinnis, Richard D. Anigian & Emily Fuller

Haynes and Boone, LLP

- 94** **Use of preferred equity in private equity net asset value facilities**
Meyer C. Dworkin, David J. Kennedy & Kwesi Larbi-Siaw
Davis Polk & Wardwell LLP
- 101** **Financing evergreen funds: the growth of individual investors in the private equity secondaries market**
Brian Foster, George Pelling, Michael Newell & John Donnelly
Cadwalader, Wickersham & Taft LLP
- 105** **Umbrella facilities: pros and cons for a sponsor**
Richard Fletcher & Yagmur Yarar
Macfarlanes LLP
- 115** **Side letters: pitfalls and perils for a financing**
Thomas Smith, Margaret O'Neill & John W. Rife III
Debevoise & Plimpton LLP
- 125** **Fund finance lending in Cayman, Luxembourg and Ireland: a practical checklist**
James Heinicke, David Nelson, Jad Nader & Laura Holtham
Ogier
- 138** **Assessing lender risk in fund finance markets**
Robin Smith, Alistair Russell, Nick Ghazi & Holly Brown
Carey Olsen
- 152** **Fund finance meets securitisation**
Richard Day, Blake Jones & Julia Tsybina
Clifford Chance LLP
- 160** **Fund finance facilities: a cradle to grave timeline**
Bronwen Jones, Kevin-Paul Deveau & Brendan Gallen
Reed Smith
- 169** **Rated subscription lines: welcoming a new era of fund finance**
Danny Peel, Charles Bischoff, Laura Smith & Adam Burk
Travers Smith LLP
- 179** **Bespoke ABF and ABS liquidity structures of Cayman Islands funds**
Dr. Agnes Molnar & Richard Mansi
Travers Thorp Alberga
- 189** **NAV and holdco back-levering financings – practicalities of collateral enforcement by asset class**
Sherri Snelson & Juliesa Edwards
White & Case LLP
- 199** **Collateralised fund obligations**
Christopher P. Duerden, Caroline M. Lee, Anthony Lombardi & Lindsay Trapp
Dechert LLP

- 211** **Innovative rated note structures spur insurance investments in private equity**
Pierre Maugüé, Ramya Tiller & Christine Gilleland
Debevoise & Plimpton LLP
- 220** **Financing secondary fund acquisitions**
Ron D. Franklin, Jinyoung Joo & Allison F. Saltstein
Proskauer
- 228** **Any preference? Preferred equity as part of the financing toolkit**
Ravi Chopra, Robert Emerson & Ed Saunders
Goodwin
- 237** **Fund manager M&A: finance considerations and trends**
Matthew Bivona, Corinne Musa & Trevor Vega
Akin
- 244** **Understanding true leverage at the fund level: a European market and sector approach**
Michel Jimenez Lunz & Antoine Fortier Grethen
SJL Jimenez Lunz
- 252** **Institutional investors: the final frontier of net asset value-based finance**
Charlotte Lewis-Williams, Ryan Moreno, Soumitro Mukerji & Mei Mei Wong
DLA Piper
- 257** **The fund finance market in Asia**
James Webb Travers Thorp Alberga
Ian Roebuck Baker McKenzie
Benjamin Masson Natixis Corporate & Investment Banking
- 267** **Securing success: key considerations for account security in fund finance transactions**
Benjamin Berman, Jeremiah Wagner, Donald Cooley & Dan Marcus
Latham & Watkins
- 274** **Private credit trends impacting fund finance**
Sarah Kessler, Daniel Durschlag, Mark Proctor & Allison Tam
Willkie Farr & Gallagher LLP
- 282** **Financing for continuation funds: a practical guide to market trends, opportunities and issue spotting**
Fiona Cumming & Parisa Clovis
A&O Shearman

Jurisdiction Chapters

- 289 Australia**
Tom Highnam, Rita Pang, Jialu Xu & Nick Swart
Allens
- 300 Bermuda**
Matthew Ebbs-Brewer & Arielle DeSilva
Appleby
- 308 British Virgin Islands**
Andrew Jowett & Johanna Murphy
Appleby
- 317 Canada**
Michael Henriques, John J. Oberdorf III, Kenneth D. Kraft & Tim T. Bezeredi
Dentons Canada LLP
- 324 Cayman Islands**
Simon Raftopoulos & Georgina Pullinger
Appleby
- 333 England & Wales**
Michael Hubbard, Samantha Hutchinson, Nathan Parker & Sukhvir Basran
King & Spalding International LLP
- 340 France**
Philippe Max & Meryll Aloro
Dentons
- 347 Guernsey**
Jeremy Berchem & Leona Maharaj
Appleby
- 356 Hong Kong**
James Ford, Patrick Wong & Natalie Ashford
A&O Shearman
- 368 Ireland**
Kevin Lynch, Ian Dillon, David O'Shea & Ben Rayner
Arthur Cox LLP
- 384 Italy**
Alessandro Fosco Fagotto, Edoardo Galeotti, Valerio Lemma & Giorgio Peli
Dentons
- 393 Jersey**
James Gaudin, Paul Worsnop, Simon Felton & Daniel Healy
Appleby

398 Luxembourg

Vassiliyan Zanev, Marc Meyers & Maude Royer

Loyens & Loeff Luxembourg SARL

409 Mauritius

Malcolm Moller

Appleby

416 Netherlands

Gianluca Kreuze, Michaël Maters & Ruben den Hollander

Loyens & Loeff N.V.

425 Scotland

Andrew Christie, Dawn Reoch & Ruaridh Cole

Burness Paull LLP

432 Singapore

Jean Woo, Danny Tan, Tao Koon Chiam & Hanyin Huang

Ashurst LLP

440 Spain

Jabier Badiola Bergara & Adelaida Torres Rovi

Dentons

448 USA

Jan Sysel, Duncan McKay & Yvonne Ho

Fried, Frank, Harris, Shriver & Jacobson LLP

Innovative rated note structures spur insurance investments in private equity

Pierre Maugüé

Ramya Tiller

Christine Gilleland

Debevoise & Plimpton LLP

As insurance companies look for opportunities to invest in a diversified portfolio of funds, and funds look for ways to access additional capital, there is increasing demand for innovative rated note structures. Such investments are typically structured in one of two ways: (i) through a rated note feeder fund for investment in a single fund; or (ii) through a special purpose vehicle structure for investment in a portfolio of funds, creating a fund of funds structure. For investment in a single fund, the master fund typically creates a feeder fund that issues rated debt and equity through which the insurance company can participate as a debt-only investor or as a debt and equity investor, depending on the structure of the deal. For investment in a portfolio of funds, the special purpose vehicle is typically structured to include one or several tranches of rated debt supported by limited partnership (LP) interests in the underlying funds that comprise the investment portfolio and a tranche of equity commitments (structured as straight equity or subordinated notes), which, as the first-loss tranche, is important for the ratings analysis. Although insurance regulators have proposed changes to the investment classification and/or regulatory capital requirements for the equity tranches and notes issued by these structures, we expect interest in these structures to continue even as market conditions tighten.

This chapter reviews how these investments are typically structured, some important parameters that need to be determined in their structuring, the current regulatory environment, and recent trends.

Key characteristics

- *Basic Single Fund Structure:* Structured notes obligations invested in a single master fund usually take the form of a feeder fund that issues one or more tranches of debt and equity. Typically, the investor purchases debt and equity, with the substantially larger commitment taking the form of debt (for example, 80% debt and 20% equity). This structure relies on the ability to map steady cash flows from the master fund for the ratings analysis and we therefore usually see this structure used to invest in debt funds. If the sponsor needs the ability to adapt terms for the rated debt that would not be available in a feeder fund structure, the sponsor may choose to create a parallel fund structure instead, although such a structure may add complexity.
- *Basic Fund of Funds Structure:* Structured notes obligations invested in a portfolio of funds generally involve two entities: an issuer, which is a special purpose vehicle that issues debt and equity; and

an asset holdco, which is a special purpose vehicle that is a direct subsidiary of the issuer and is the entity that holds the investment portfolio. The issuer then pledges its ownership interest in the asset holdco for the benefit of the noteholders. Some transactions do not use a separate asset holdco, in which case the issuer directly pledges the underlying portfolio of fund interests.

- *Debt-like Characteristics:* Insurance companies rely on the debt characterisation of the structured notes obligations for more attractive risk-based capital (RBC) treatment, which, for U.S. insurance companies, depends on whether the investment is categorised as a bond under statutory accounting and RBC rules that benefit from more attractive RBC charges compared to equity investments. To support the accounting and RBC analysis, the return on the debt is generally structured as regular interest payments and repayment of principal, subject to a priority of payments waterfall. The equity in the issuer gets the benefit of the upside once the scheduled debt payments have been made pursuant to the priority of payments.
- *Priority of Payments Waterfall:* Structured notes issued in these structures typically have long maturity (for example, 10–15 years), although the notes are generally expected to be repaid much faster. Because of this, a structured notes obligation that relies on market performance and is supported by alternative investments that are inherently illiquid assets requires some protection from economic downturns. Common terms used to provide that protection include:
 - Payment of interest is generally required only to the extent that cash is available; otherwise, the interest is deferred until cash is next available in the priority of payments.
 - The amortisation schedule is usually a target amortisation schedule that requires amortisation payments only to the extent that cash is available in the priority of payments (with cumulative catch-up payments in subsequent periods). The amortisation schedule is often supplemented by a cash sweep if certain loan-to-value tests are not satisfied.
 - Full repayment of the debt can be targeted within a relatively short period of time (e.g., four to five years) based on modelled cash flows, but final legal maturity will often be set at 10–15 years to provide flexibility, in particular in case of an economic downturn.
 - Distributions are made to equity only once interest and target amortisation have been paid in accordance with the target schedule. Distributions to equity are also generally subject to *pro forma* satisfaction of a loan-to-value ratio and, sometimes, a liquidity ratio.
- *Funding Capital Calls:* There are certain structural holes that the investors need to be prepared to either address in the documentation or, more commonly, accept as deal risk:
 - The debt and equity committed to the issuer is generally (but not always) equal to the LP commitments made to the underlying funds. If the underlying funds can call capital to pay fees and expenses in addition to the LP capital commitment, in the absence of adequate reserve or sufficient distributions to supplement existing reserves, there is a possibility that there will not be sufficient cash available to fund a capital call to pay fees or expenses.
 - Many funds permit recycling of commitments. However, if the issuer has received a cash distribution from the underlying funds, and that cash is run through the waterfall, it is no longer available for recycling. While it is not uncommon to allow distributions to equity to be recalled, the cash may have been paid to the rated notes under the waterfall and it would be unusual to allow payments to rated notes to be recycled (and such recycling could impact whether the rated notes could obtain debt treatment under U.S. insurance company statutory accounting rules). The portfolio needs to provide sufficient cash into the structure to be able to cover these additional calls on capital.

In these cases, the issuer would become a defaulting limited partner if the investment portfolio does not generate sufficient cash to service these capital calls, thereby impairing the debtholders' collateral. It is therefore important to control when and how much cash leaves the structure.

- *Investment Grade Rating:* Insurance companies rely on the investment grade or quasi-investment grade rating of the debt for their RBC analysis. For U.S. insurance companies, RBC asset charges are assigned based on the investment's National Association of Insurance Commissioners (NAIC) designation. For debt investments that are designated as "filing exempt", the RBC asset charges are currently determined based on the credit ratings assigned to the investment by nationally recognised statistical rating organisations. If a debt investment is not "filing exempt", the RBC asset charge is determined based on the NAIC designation applied by the NAIC's Securities Valuation Office (SVO) after filing of the investment documentation and related materials to assess the credit risk of the investment and determine the appropriate RBC asset charge. At this time, the NAIC is considering proposals to grant the SVO discretion to challenge the "filing exempt" status of an investment if the SVO were to determine that the assigned credit rating does not provide a reasonable assessment of risk for regulatory purposes (which, under the NAIC's proposal, would be the case if the assigned credit rating differs by three or more notches from the SVO's assessed designation). This proposal could result in uncertain regulatory capital treatment for insurance company debt investments.
 - If the debt is downgraded to the extent that the rated notes are funded on a delayed draw basis, the debtholders might request an Event of Default or a draw stop on unfunded commitments until the investment grade rating is restored.

Critical single fund structuring parameters

When structuring these rated note feeder fund investments, issuers must determine certain key parameters. We list four of them here, and discuss each in turn:

- whether the structure will be through a feeder fund or a parallel fund;
- whether the holder of the debt and equity commitments will be the same;
- whether the master fund will seek to pursue a subscription line facility; and
- what type of fund would support a rated note feeder.

Feeder fund or parallel fund

Sponsors typically choose to structure a rated note through a feeder fund to accommodate insurance companies interested in participating in a fund. Creating a feeder fund allows the sponsor to simplify the overall fund structure and keep the terms of the debt investment structure the same as the equity investment structure but for the specific debt characteristics required to make the rated notes debt. The feeder fund structure, however, does not allow the sponsor to make adjustments to the investment structure that may be necessary to achieve or maintain a particular rating or to address particular insurance company issues. To the extent that the feeder fund structure does not allow enough flexibility to make the necessary adjustments (for example, the fund is levered, which impacts the rating), the sponsor could create a standalone parallel fund. While this may add complexity to creation and maintenance for the sponsor, a parallel fund structure allows the sponsor to more closely manage the parallel fund to maintain the necessary rating and to adjust the terms as may be required by the insurance company.

Debt, equity or both

Typically, a rated note feeder fund is structured so that the issuer issues debt and equity interests to each investor. Subject to the ratings constraints, the interests are heavily weighted towards debt commitments in recognition of the insurance companies' preference for debt investments. When the holders of the debt and equity investment own a vertical slice of the structure, it streamlines documentation and assures that the insurance companies' investment more closely aligns with the pure equity investors. For example, the equity component allows for recycling and clawbacks. However, certain insurance companies are subject to specific internal policies, or regulatory requirements, that make any equity investment a significantly

more cumbersome undertaking. For example, Korean insurance companies face a lengthy regulatory approval process for any equity investment. In such cases, the sponsor is sometimes required to structure the rated note feeder fund as a strictly debt investment for the insurance company investors. In the U.S., the NAIC adopted, on June 13, 2023, a new 45% RBC asset charge applicable to the first-loss tranche, or residual tranche, of asset-backed securities (including feeder fund structures), to take effect for 2024 year-end insurance company financial reporting. This new asset charge will make holding the equity or first-loss tranche incrementally less capital efficient for a U.S. insurance company investor, and insurance companies may instead wish to have an unregulated affiliate invest in the first-loss tranche, instead of having it held directly on the insurance company's balance sheet. A significant complication this presents is trying to replicate equity concepts, such as recycling and clawbacks, in a purely debt structure. Another concern a sponsor may have is that if the issuer files for bankruptcy, the debt commitments are no longer enforceable against the investor, whereas equity investors would still have to fund a capital call. To address this concern, the sponsor may structure the debt commitment as convertible to an equity commitment upon bankruptcy of the issuer.

Subscription line facilities

If a master fund intends to utilise a subscription line facility, early discussions should be had with the subscription line lenders regarding treatment of the rated note feeder fund in their borrowing base calculations. Subscription line lenders are often concerned about the quality of a debt commitment as collateral because, as noted above, in the event that the issuer enters bankruptcy, creditors are not required to fund their debt commitments. This is as opposed to the equity holders, who are required to fund capital calls even in the event that the issuer enters bankruptcy. Sponsors have tried to address this concern in various ways, including by (i) creating a mechanic that converts the debt commitments into equity commitments in the event of bankruptcy, (ii) creating the commitments as debt/equity commitments from day one pursuant to which the debt/equity commitments are shared and the issuer can choose whether to draw on the commitments as debt or as equity, or (iii) creating the feeder fund as a bankruptcy remote vehicle to dramatically decrease the likelihood that the feeder fund will enter bankruptcy. None of these methods have been truly tested in the courts, so it is unclear which method is most effective to address the subscription lenders' concern.

Ratings and cash flows

Another consideration for a sponsor is what type of fund could support a rated note feeder suitable for insurance companies to invest in. In order to achieve the necessary rating, the issuer will need to show the ratings agency sufficient regular cash flow to support the issued debt. Similarly, in order for U.S. insurance company investors to obtain appropriate bond treatment for the rated notes under newly adopted U.S. statutory accounting rules that go into effect on January 1, 2025, the insurance company investor will need to provide sufficient analysis that the characteristics of the underlying investments of the rated feeder lend themselves to the production of predictable cash flows to support the debt. If the investment is in a single private equity fund, there is no pool of cash flows to rely upon, as many private equity funds do not expect distributions until five to seven years after inception. Such delayed cash flows will likely not be acceptable to a ratings agency and could result in an investment's classification as equity resulting in less favourable RBC charges under the insurance company's accounting and RBC analysis. We therefore typically see rated note feeder funds invested in debt funds, as debt investments typically produce cash flows immediately and those cash flows are regular and predictable.

Critical fund of funds structuring parameters

When structuring these fund of funds investments, issuers must determine certain key parameters. We list three of them here, and discuss each in turn:

- whether the investment portfolio will be set as of the closing date;
- whether the commitments to the issuer will be funded in full on the closing date; and
- whether the issuer will be consolidated with its parent's balance sheet and whether that parent has other obligations that subject the parent and its subsidiaries to covenants with which the structured notes obligations might conflict.

Setting the investment portfolio

The issuer needs to determine whether the asset holdco will have set the investment portfolio as of the closing date, or whether the asset holdco will build or adjust the portfolio after the closing date based on agreed investment guidelines. If the investment portfolio may change after the closing date, it is important to ensure that the investment portfolio will be sufficiently diversified to support an appropriate rating. In addition, the issuer needs to be prohibited from committing more than the aggregate principal amount of debt and equity that has been committed to the issuer. Alternatively, noteholders will have to be comfortable that expected distributions on the underlying funds will be sufficient to fund capital calls for which no matching source of funding is identified at closing.

Funded or unfunded commitments

Another important parameter is whether the debt and equity commitments will be fully drawn on the closing date, or whether there will be a delayed drawing schedule. Having some or all of the commitments unfunded as of the closing date presents additional considerations. There needs to be a comfort level regarding the credit worthiness of the relevant debtholders and equity holders. Protections may be necessary to ensure that the issuer receives the full draw amount needed, including defaulting noteholder or equity investor provisions and a requirement that the relevant debtholder or equity investor be an entity with an acceptable rating or benefit from parent support from a rated entity, or post a letter of credit from an acceptable letter of credit issuer to support its unfunded commitment. Finally, investors investing on a delayed draw basis may require drawing conditions, such as a ratings downgrade or a loan-to-value breach, in the event that the condition of the structured notes obligation has changed since the closing date. However, the matter of drawing conditions should be approached cautiously, as a draw stop may cause the issuer to become a defaulting limited partner with respect to some or all of the underlying funds, thereby exacerbating the problem.

Balance sheet considerations

While the issuer of a structured notes obligation is a special purpose vehicle, the equity in the issuer may be owned by a company that itself has debt obligations. If the issuer ends up being a subsidiary of an equity investor, the covenants in the parent's debt agreements may extend to the parent's subsidiaries and must be considered to ensure that the debt issuance by the issuer does not conflict with those covenants. In addition, the parent should consider whether it will be required to consolidate the notes issued by the issuer as debt on its balance sheet.

Liquidity facility

Many fund of funds structured notes structures include liquidity support, in the form of a revolving facility provided by a third-party lender, that can be used to bridge a funding shortfall. These liquidity facilities are generally available to fund fees and expenses, interest on the debt tranches and, usually, capital calls from the underlying funds. While these liquidity facilities are rarely used, including a liquidity facility in the structure provides stability to the structured notes obligation by supporting the ratings analysis, supporting the insurance company analysis permitting the treatment of structured notes as bonds under U.S. statutory accounting rules and reducing the possibility that the structure will fail.

Regulatory treatment

For U.S. insurance companies, the transaction structure for structured notes obligations is typically designed to achieve favourable RBC treatment of the notes' debt investments, which will be determined based on whether the investment is classified as a "bond" under statutory accounting rules. The NAIC, the standard-setting and regulatory support organisation created and governed by state insurance regulators, has for a number of years been exploring changes to statutory accounting principles and SVO procedures that could affect the reporting and capital treatment of structured notes obligations rated note feeder vehicles and similar structures.

On August 13, 2023, the NAIC adopted significant revisions to Statement of Statutory Accounting Principles (SSAP) No. 23R and No. 43R to implement a principles-based bond definition to determine whether an investment should be considered and reported as a bond on Schedule D-1 (Long-Term Bonds) of an insurance company's statutory financial statements. The revisions to SSAP No. 23R and No. 43R go into effect on January 1, 2025. The newly adopted statutory accounting rules define a bond as "any security representing a creditor relationship, whereby there is a fixed schedule for one or more future payments, and which qualifies as either an issuer credit obligation or an asset backed security". Structured notes obligations fall under the asset-backed security classification. In order to receive bond treatment, the notes' debt obligations will generally need to have pre-determined principal and interest payments (whether fixed interest or variable interest) with contractual amounts that do not vary based on the appreciation or depreciation (e.g., performance) of underlying collateral value or other non-debt variables and reflect underlying assets (e.g., the LP interests of debt funds) that generate a "meaningful" level of cash flows to service the debt obligations. In addition, the insurance company holder of the notes' debt obligations must be in a different economic position than if the holder owned the underlying fund investments directly. For purposes of this assessment, the holder of the instrument is considered to be in a different economic position if the instrument benefits from substantive credit enhancement through guarantees (or other similar forms of recourse), subordination and/or overcollateralisation. The principles-based bond definition adopted by the NAIC also contemplates a rebuttable presumption that debt investments collateralised by equity interests would not qualify as bonds because they would not reflect a creditor relationship in substance. Notwithstanding this rebuttable presumption, it is possible for such a debt investment to represent a creditor relationship if the characteristics of the underlying equity interests are expected to produce predictable cash flows and the underlying equity risks have been sufficiently redistributed through the capital structure of the fund issuer.

On June 14, 2023, the NAIC adopted changes to the RBC asset charges for first-loss tranches, or residual tranches, of asset-backed securities, which includes rated feeders, collateralised fund obligations and collateralised loan obligations, to implement (i) a 45% sensitivity test factor for such tranches held by U.S. insurance companies for purposes of 2023 year-end financial reporting (which reflects a disclosure item in a U.S. insurance company's statutory financial statements that projects the company's RBC if a 45% RBC asset charge were used for first-loss tranches (as opposed to the existing 30% RBC asset charge for equity investments)), and (ii) a 45% RBC asset charge for such tranches held by U.S. insurance companies for purposes of 2024 year-end financial reporting.

In addition, on June 15, 2023, the NAIC proposed to grant the SVO the discretion to revoke the "filing exempt" status of investments that allows insurance companies to rely on credit ratings assigned to the investment by nationally recognised statistical rating organisations for determining the investment's RBC asset charge. The proposal would permit the SVO to remove an investment from the "filing exempt" process, and thereby permit the SVO to determine the RBC asset charge on the basis of a filing of the investment documentation and related materials, if the SVO, following its own initiated review or review initiated by a U.S. state insurance regulator, determines that the resulting RBC asset charge determined based on the credit rating assigned to the investment by nationally recognised statistical rating organisations does not

“provide a reasonable assessment of the risk for regulatory purposes” and the credit rating used is three or more notches different than the SVO’s assessment of the risk of the investment. The proposal received significant industry pushback, as well as comments from Congress and other regulators, at the NAIC’s summer national meeting in August 2023. The NAIC has indicated that it will be further revising the proposal and re-exposing an amended proposal for comment at a later date.

The NAIC has also been considering changes to the methodologies for determining RBC charges for asset-backed securities to the extent that the risk profile of the asset is different from the risk profile for corporate bonds. This workstream is in the very early stages, and there is no framework at this time for developing or revising the RBC charges for asset-backed securities. The NAIC and the American Academy of Actuaries are expected to refine the principles that will be used to develop a potential framework, which would first be used to determine new RBC charges for collateralised loan obligations and is expected to be used as a model for other asset-backed securities.

Although the proposed changes to the process for determining RBC asset charges are not yet final and may impact the RBC treatment of these investments, we generally see the insurance company debtholders assume the risk of a change in law or of the structured notes obligation not achieving the desired capital or reporting treatment.

Tax considerations

The principal tax considerations of a rated note structure for a single fund or portfolio of funds are largely the same. The tax structure of these vehicles depends on a number of factors, including whether they are being marketed to U.S. or non-U.S. insurance company investors and the nature of the underlying investment strategy. For U.S. insurance company investors, the issuers are typically structured as partnerships for U.S. federal income tax purposes to avoid entity-level tax leakage. For non-U.S. insurance company investors, issuers may be structured as either a partnership or non-U.S. corporation for U.S. federal income tax purposes depending on whether the underlying fund or funds are expected to generate (or have options to block at the fund level) U.S. tax filing and payment obligations. If structured as a partnership, transfer restrictions may apply to both the debt and equity interests in the fund in order to mitigate the risk that the fund will instead be treated as a corporation for U.S. federal income tax purposes under the “publicly traded partnership” rules (the “taxable mortgage pool” rules should also be considered if the underlying portfolio includes real estate-secured debt). In addition, equity and potentially debt tranches may be restricted such that they can only be owned by U.S. holders, to avoid the risk of subjecting the structure to U.S. withholding tax. If structured as a non-U.S. corporation (and a concern for non-U.S. investors more generally), the issuer may need to “block” income effectively connected with a U.S. trade or business via a subsidiary entity and may incur U.S. withholding tax. In each case, the associated leakage will reduce returns to investors and should be taken into account in modelling. If it is important that a tranche of debt be respected as indebtedness (rather than treated as equity) for U.S. tax purposes (e.g., because the debt is not subject to transfer restrictions and the issuer is a passthrough entity), then the terms of the debt, expected ratings and repayment expectations will need to be scrutinised to ensure that they support such treatment – with investment grade ratings often used as the proxy for whether there is doubt as to the right characterisation. Limitations on tax deductions for interest may result in phantom income for holders of equity, particularly for natural persons.

Recent trends

- *Decoupling of Debt and Equity Commitments in Fund of Funds Structures:* While investors in some structured notes obligations are purchasing a vertical slice of the structure that includes both debt and equity, we are increasingly seeing structures that decouple the two. This strategy works well for insurance companies that wish to invest in rated debt instruments but not the equity, particularly

given the coming increase in RBC asset charges from 30% to 45% for the first-loss/equity tranche of the investment for 2024 year-end financial reporting. The equity is then purchased by investors such as a balance sheet fund of the firm forming the structured notes obligation, family offices and other third-party investors attracted to the combination of levered exposure to multiple funds and the potential for high returns. While equity holders may be required to make an initial funding, sometimes no further funding is required (subject to certain downside events such as a loss of rating for a period of time) until the debt has been funded in full. If the portfolio produces sufficient cash flows to service future capital calls, it is possible that the equity is never drawn again but still gets the benefit of excess cash distributions out of the system. Equity funded on a delayed draw basis may be an attractive investment for insurance companies to the extent that the unfunded commitment does not attract a capital charge.

- *Equity Credit Support:* In the fund of funds structure, to the extent that equity commitments are not funded in full on the closing date, equity holders may be required to have an eligible rating or provide adequate credit support from a person with an eligible rating. This credit support frequently takes the form of a parent guaranty, a letter of credit or cash collateralisation, in each case for the full amount of the equity commitment. This credit support not only supports the ratings analysis, but also provides comfort to the debtholders that the equity holders will fund when required to do so under the terms of the transaction documents.

Conclusion

In the current market environment, we expect to see more private equity firms and insurance companies develop and invest in these structures to maximise their access to liquidity and as a new investment opportunity. We also expect further innovations as market participants react to regulatory and other developments.



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**Pierre Maugué**

Tel: +44 20 7786 9190 / Email: pmaugue@debevoise.com

Pierre Maugué is a partner in the London office of Debevoise & Plimpton LLP. His practice focuses on acquisition and leveraged buyout financings and structured financings.

Mr. Maugué is recommended by *The Legal 500*, which has described him as “exceptional”, “responsive, commercial and creative”, “technically very strong” and a trusted adviser who helps clients achieve goals in the most efficient manner. Mr. Maugué is also recommended as a leading lawyer by *IFLR1000*.

Mr. Maugué brings a global perspective to his work, having lived and worked in Asia, Europe and the United States.

Mr. Maugué writes frequently on legal matters related to finance topics and is also a regular contributor to the Debevoise & Plimpton Private Equity Report.

**Ramya Tiller**

Tel: +1 212 909 6204 / Email: rstill@debevoise.com

Ramya S. Tiller is a partner in the New York office of Debevoise & Plimpton LLP. She has experience in a broad range of financing transactions, including complex acquisition and leveraged finance transactions, fund finance transactions and other alternative capital transactions.

Ms. Tiller is ranked as a Next Generation Partner by *The Legal 500 US*, where she has been described as an “ultimate professional”, and “highly rated”. She is also recognised as a Notable Practitioner by *IFLR1000*.

Prior to joining the firm, Ms. Tiller worked for a leading Indian law firm in Mumbai, India. Between 2010 and 2012, she served as a member of the Finance group at an international law firm in Munich, Germany.

Ms. Tiller is a frequent speaker on finance-related topics for the Practising Law Institute.

**Christine Gilleland**

Tel: +44 20 7786 5520 / Email: csgilleland@debevoise.com

Christine Shu Gilleland is an international counsel in the London office of Debevoise & Plimpton LLP.

A member of the firm’s Finance group, Ms. Gilleland has experience in a range of financing transactions, including major capital markets financings, leveraged financings, and structured and fund financings.

Debevoise & Plimpton LLP

919 Third Avenue, New York, NY 10022, USA

Tel: +1 212 909 6000 / URL: www.debevoise.com



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