

Fund Finance Insights

The Growing Focus on Collateralised Fund Obligations (CFOs)

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Introduction

A “collateralised fund obligation” or “CFO” is an increasingly popular (but not entirely new) product in the fund finance market.

CFOs have gained prominence due to: (i) institutional investors seeking rated, capital-efficient access to private funds; (ii) fund sponsors requiring flexible liquidity solutions whilst creating compelling opportunities for diverse investor bases; and (iii) inefficiencies in the secondaries market that can render LP interest sales economically unattractive. With increasing focus on CFOs, it is important for all participants in the market to understand these structures and how they are being used.

What are CFOs and what differentiates them from CLOs and RNFs?

CFOs share features with collateralised loan obligations (“CLOs”) and rated note funds (“RNFs”) but differ in some crucial ways. CLOs use corporate loans with steady cash flows as collateral, while CFOs can include assets with less predictable

returns, like interests in equity-focused funds. While both CFOs and RNFs let regulated investors access fund-like products through rated debt for better capital treatment than equity, RNFs are typically private funds with a single asset pool, whereas CFOs typically invest in a portfolio of funds.

The structure typically involves the sponsor setting up a special purpose vehicle (“SPV”) that issues one or several tranches of rated debt and a tranche of equity (structured as straight equity or subordinated notes), which, as the first-loss tranche, provides the over collateralisation required for the ratings analysis.

The size of each tranche relative to the overall size of the structure is predominantly determined so as to achieve the ratings required by the debt investors and the size of the equity tranche (both any common equity and preferred equity) is a factor of this determination. The SPV, in turn, makes commitments as a limited partner to one or more funds and uses the proceeds of the debt and equity to fund capital calls. Although not always the case, it is typical for the underlying funds to be managed by the same sponsor as the sponsor that manages the SPV, and this article is written on the basis of this typical structure.

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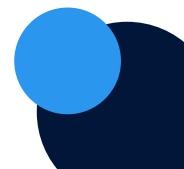
CFOs allow fixed-income investors to gain exposure to the private funds asset class via a rated debt instrument.”

The attraction of CFOs - Why and Who?

There are a variety of drivers for the growing interest in CFOs from both investor and sponsor perspectives.

Investors:

- (i) CFOs allow fixed-income investors to gain exposure to the private funds asset class via a rated debt instrument. In addition, U.S. regulated insurance companies rely on the debt characterisation of the structured debt obligations for more attractive risk-based



capital (“RBC”) treatment. If the investment is categorised as a bond under statutory accounting and RBC rules, it will benefit from more attractive RBC charges compared to equity investments;

- (ii) CFOs may also purchase existing fund interests from various investors thereby offering a secondary solution for investors in private funds seeking liquidity against their existing positions;
- (iii) For investors in the equity tranche, CFOs offer an opportunity to invest in the underlying funds on a levered basis.

Sponsors:

- (i) CFOs provide sponsors with an additional mechanism to increase assets under management by raising additional primary capital from regulated investors who might not otherwise be willing to invest directly as equity participants in their underlying managed fund or funds;
- (ii) Given that a CFO vehicle typically holds a diversified portfolio of perhaps five or six underlying fund investments, the structure provides sponsors with flexibility to allocate capital across funds with varying levels of investor demand;
- (iii) Similar to the above, CFOs can also be used as a capital formation tool. Where investor appetite for a given fund is limited on a standalone basis, a sponsor may establish a CFO alongside one of its flagship funds, thereby leveraging demand for the flagship strategy.



Who are the key players in the CFO structure?

Although each CFO is bespoke according to the investors’ and the sponsor’s needs, the following are the typical principal players in a CFO transaction.

- (i) To date, the debt investors have often been U.S. regulated insurance companies seeking to make investments on a capital-efficient basis. More recently, there has been institutional interest in other jurisdictions, including the UK (see more below), from investors who are seeking investment-grade rated, long-dated, steady-income generating investment assets.
- (ii) Traditionally, the equity tranche has been funded by the sponsor but, as the number and transaction value of CFO transactions have increased, it has created pressure on how sponsors fund this commitment. To address this, sponsors are increasingly structuring the equity tranche with a tranche of preferred equity to attract investors (typically hybrid equity/credit funds) seeking levered plays in the private funds market. The common equity is often taken by the sponsor “on balance sheet” and may be placed with key relationship LPs.
- (iii) Sponsors in the CFO market are typically private equity secondaries, credit secondaries and credit funds and may also include private equity funds.
- (iv) The rating agencies are a critical party in any CFO (see more below).

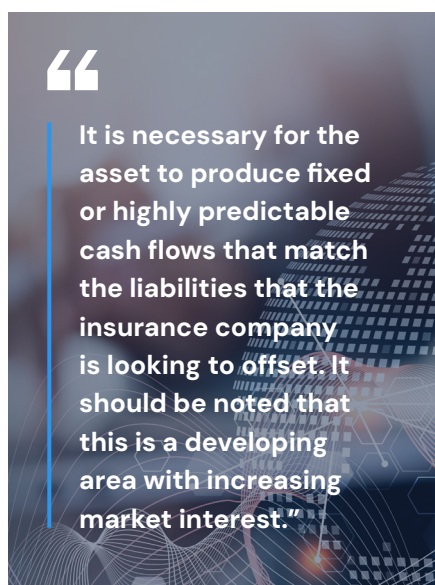
- (v) Finally, it is typical for a debt advisor to be appointed to assist in the placement of the debt and/or equity tranches, as well as any modelling and the execution of the transaction.

Key Regulatory and Other Considerations

The regulatory treatment of the rated debt issued by CFOs is central to their purpose and how they are structured:

(i) US Insurance Regulations:

- a 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 its Securities Valuation Office (SVO) procedures, which (if implemented) could affect the reporting and capital treatment of structured notes obligations, rated note feeder vehicles and similar structures.
- b Based on the current NAIC guidance, a CFO transaction is typically structured to ensure the notes’ debt investments are classified as a “bond” under statutory accounting rules as this design achieves favourable RBC treatment for U.S. insurance companies.





- (ii) **UK Insurance Regulations:** For CFO tranches placed with UK life insurers, the regulatory analysis is driven by Solvency UK requirements, with a particular focus on whether the instrument is eligible for the matching adjustment (“MA”). MA eligibility can materially enhance the capital efficiency of an investment by allowing insurers to recognise a portion of the illiquidity premium in the discount rate applied to matching liabilities. For MA eligibility, it is necessary for the asset to produce fixed or highly predictable cash flows that match the liabilities that the insurance company is looking to offset. It should be noted that this is a developing area with increasing market interest.

- (iii) **EU Securitisation Regulation:** It is important to consider whether the CFO structure is a “securitisation” under the EU securitisation regulation (Regulation (EU) 2017/2402). If it is a securitisation, originators and sponsors are required to retain a material net economic interest of not less than 5% in the securitisation, and satisfy disclosure and other requirements. Some institutional investors, including insurance companies, are required to verify that the risk retention requirements have been complied with, and satisfy certain other due diligence and ongoing monitoring requirements.

The determination of whether a structure is a securitisation is complex and nuanced. A similar analysis is required with respect to the UK’s securitisation framework.

- (iv) **US Risk Retention Rules:** The U.S. Securities Exchange Act of 1934 (and the related implementing regulations issued by, among others, the SEC collectively, the “**Risk Retention Rules**”) requires the “sponsor” of a “securitisation transaction” to retain an economic interest in a portion of the credit risk for all assets that the securitisation transfers, sells or conveys to a third party through the issuance of asset-backed securities. The term “asset-backed security” for the purposes of the Risk Retention Rules is defined in the Exchange Act as “a fixed-income or other security collateralised 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 that asset.” Therefore, whether the notes issued as part of the CFO constitute asset-backed securities depends on whether the underlying LP fund interests are “self-liquidating financial asset[s]” and whether the holders will receive payments that “depend primarily on cash flow” from the LP fund interests. This determination is complex and requires nuanced analysis from a CFO issuer’s specialist counsel.

- (v) **EU Solvency II – Solvency Capital Requirements:** A CFO structure may, in some cases, reduce the Solvency II capital requirements for a European insurer relative to a direct or fund investment in private equity-style assets, but that outcome is highly fact-specific. Under Solvency II, insurers generally must apply look-through to investments packaged as funds, so the capital requirement is based on the underlying exposures. That may make a material difference where the underlying assets are unlisted equities, which typically attract a higher capital charge requirement than bonds or loans. Where look-through does not apply, a rated CFO note could in some cases produce a lower capital charge than a pool of unrated or equity-like underlying assets. However, that conclusion depends on the legal and regulatory characterisation of the note and whether the rating is eligible for Solvency II purposes. The look-through analysis is therefore nuanced and structure-specific.

- (vi) **Other Regulations:** Other regulatory considerations include compliance with the Investment Advisers Act, SEC private funds rules and applicable securities laws. These are beyond the scope of this article.

- (vii) **Underlying Funds:** The investment by the CFO in the underlying funds is also subject to various legal, tax and regulatory considerations due to the nature of the underlying investments (being private funds) that make the portfolio construction more complex than a CLO or other structured product, such as an ABL. It is therefore necessary to ensure compliance with the underlying fund documents (including its conflict provisions) as well as any laws or regulations which apply to investments in private funds. To the extent there is a transfer of LP interests to the SPV through secondary purchases of the relevant fund interests (rather than a primary investment) to “seed” the CFO portfolio, the process to procure the transfer is subject to legal, tax and commercial considerations which can add time and cost to the establishment of the CFO.



The Role of Rating Agencies

The rating agencies play a critical role in ensuring the CFO is a capital efficient product for its debt investors and an investment grade credit rating may be an essential prerequisite for certain investors' investment in the relevant tranche of debt. Several leading rating agencies in this space have developed a dedicated methodology for rating CFOs, with others expected to do the same. This is a positive development as the NAIC has increasingly signaled concern about the soundness and consistency of private credit and structured-product ratings (including for products like CFOs), and this has led to regulatory proposals to manage reliance on a single rating and could prompt greater scrutiny or require enhanced supporting rationale.

The agencies' analysis typically includes a focus on: (A) the transaction terms, including the priority of payments under the waterfall, amortisation triggers, distributions to equity and events of default; (B) the quality, characteristics and diversification of the collateral (i.e., the underlying funds); (C) the cash flows receivable by the issuer (i.e. from the underlying funds); and (D) the manager of the underlying funds, including its experience and track record, investment strategy and underwriting discipline, valuation methodologies and risk-management and compliance framework.



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New Frontiers and Challenges

As interest in this market grows we foresee several developments and challenges to be aware of:

- (i) **Equity tranche:** Historically, it has been challenging to raise the equity tranche in a sufficient amount to achieve the required credit rating. Recent market developments to resolve this issue have included raising a preferred equity tranche together with a common equity tranche. Preferred equity ensures preferred returns over those to the common equity and, therefore, may be more attractive to prospective investors. This will in turn reduce the size of the common equity tranche, which is often the more difficult tranche to market. Alternatively, 100% of the equity tranche of the CFO may be purchased by a single-purpose vehicle that is capitalised through the issuance of principal-protected notes.
- (ii) **UK insurance capital:** In the UK, there has been increasing interest in whether CFOs can be a MA eligible asset which would significantly reduce the amount of technical provisions required to be held by life insurance companies against their long-term guaranteed liabilities such as annuities. Solving this question is a challenge and an opportunity for market participants.

(iii) **Evergreen funds:** As evergreen funds are growing in popularity in private funds offerings, sponsors and investors are eager to structure CFOs to include evergreen funds in the portfolio of assets and to structure the CFO itself as evergreen/perpetual. Where the CFO invests in an evergreen fund, the key question is how it will generate liquidity from that investment to service the structure and, where the CFO itself is evergreen, the key question is how equity investors in the CFO will be able to redeem their interests (which would be a restricted payment from the point of view of the debt).

(iv) **CVs and CFOs:** We are also seeing the use of continuation vehicles (“CVs”) in the underlying collateral pool of CFOs. Like CFOs, CVs are a growing product in the private funds space and it is interesting to see the confluence of these trends. A mix of primary and CV fund interests supports a portfolio of diversified maturing interests. Amongst other things, CFOs offer sponsors an opportunity to leverage tail demand for assets from a flagship strategy with a concurrent raising of a CV.

(v) **Documentation standardisation:** The CFO market continues to mature and, with maturity, it is likely that we will see some standardisation of documentation. This would be welcome in the interests of efficiency. However, as this article makes clear, these are complex products which are often bespoke to the needs of the applicable sponsor and/or investors and we foresee significant innovation in structures and terms in this space, both factors which limit the likelihood of documents becoming standardised (at least in the near-term).



Looking Ahead

Against a backdrop of innovation, regulatory change and growing investor appetite, CFOs are set to become an increasingly important feature of the market. As these structures continue to develop, market participants will need clarity, shared understanding and practical guidance to navigate an evolving landscape. The LMA will continue to support this by promoting education, dialogue and transparency. In addition, the LMA will be providing further insights on alternative liquidity solutions, helping to ensure that market participants are equipped to navigate the opportunities and challenges ahead.

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To learn more about the LMA's work to support efficiency, liquidity and transparency in the fund finance market, please visit the LMA's Fund Finance Microsite:

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