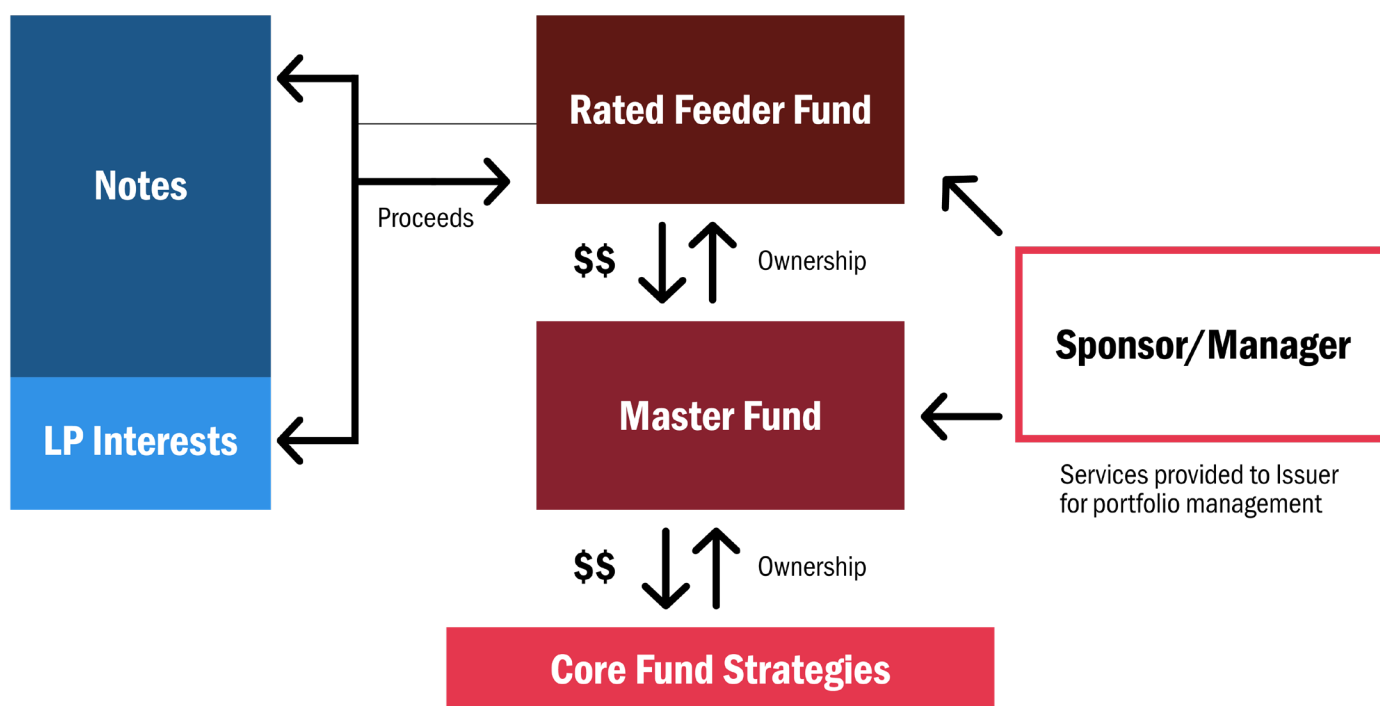


An Introduction to Rated Note Feeders

I. Introduction:

A rated note feeder is an investment vehicle that allows investors to access alternative investment funds via a debt as opposed to a more traditional equity offering. When structured properly, the debt, which takes the form of a note, is rated by a credit agency. The rated debt allows insurance companies and certain other investors to participate in the underlying fund's investments more efficiently by qualifying for more favorable treatment under risk-based capital requirements and/or other requirements imposed on those investors.



Rated note feeder fund structures can make a manager's strategy more attractive to these regulated investors, thereby allowing managers to bring in additional and larger investments from this pool of capital.

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II. Types of Investors for Rated Note Feeders:

Rated note feeders are designed principally for certain institutional investors, including insurance companies, pension plans, sovereign wealth funds and banks, who may be subject to regulatory capital requirements (dependent on the credit rating of their assets) or who have other operational requirements that cause them to prefer debt investments.

Among the reasons most often cited for the increased demand for these products are:

- **Regulatory Capital Treatment.** Certain types of investors, such as insurance companies, must hold capital reserves based on the perceived risk of their investments. Rated note feeders issue structured notes with payment priorities and other credit support features borrowed from the securitization space. These features allow certain portions of the investor's overall investment in a fund to achieve credit ratings sufficient to qualify as lower risk investments than a direct equity investment in the same fund. Accordingly, the investment would impose a lower regulatory capital burden on the investor.
- **Increased Yield and Diversification.** Since the interest rates paid in rated note feeders tend to be higher than many interest income-generating investments, they provide an alternative investment outlet for investors who seek access to alternative investments within a framework that only allows them to earn interest income.
- **Different Risk Exposure.** Investors who have a greater level of risk tolerance have the ability to choose a more junior, higher yielding tranche and vice versa.
- **Tailored Investment.** The notes may be customized to meet the specific needs of the investor.
- **Greater Oversight.** In light of their structuring, rated note feeders often require the use of independent service providers such as administrators, trustees and rating agencies, which provide extra comfort to many institutional investors.

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III. Types of Alternative Investment Funds Best Suited for Rated Note Feeders:

Rated note feeder funds were initially developed for private credit managers, and were typically formed for closed-end private credit funds, but their use has expanded.

Closed-end debt funds work well for ratings agencies because their portfolios often produce cash flows immediately, and those cash flows tend to be regular and predictable. Further, the closed-end fund structures makes it relatively straightforward to align the maturity and payment timing of the notes with the underlying fund's distribution schedule and life span.

While closed-end credit funds still predominate, ratings agencies and managers have increasingly been able to structure rated note feeders for various other investment strategies across both closed-end and open-end structures (including credit, other fixed income, infrastructure, equity and multi-strategy). However, it should be noted that coordinating terms for notes to be issued in connection with an open-end hedge fund structure does present additional complexities that need to be worked through closely with the ratings agency involved and fund counsel, especially relating to payment schedule and maturity terms for the note.

IV. Key Issues to Consider When Establishing a Rated Note Feeder:

While a rated note feeder has the possibility of significantly increasing capital inflows into alternative investment funds, managers contemplating such an undertaking should be mindful of the following:

- **Structural and Legal Complexity.** There are numerous actions that a manager will need to take when establishing a rated note feeder, including determining the ideal legal structure, drafting the relevant features and terms of the feeder and note documents, working with a rating agency to underwrite the portfolio and achieve the desired ratings, and engaging outside service providers.
- **Ongoing Administration.** Beyond maintaining the necessary credit rating, the manager will need to be mindful of issues such as reporting requirements, treasury management, monitoring of the collateral and any ongoing note obligations and conditions, tax considerations, and an evolving regulatory environment.
- **Increased Costs.** There will be increased costs associated with a rated note feeder. While some may be borne by the feeder's investors, other expenses will need to be paid by the manager.

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If you have additional input that you would like to share with us, or have any questions, please contact your primary attorney in Seward & Kissel's [Investment Management Group](#).

Recognitions:

The Investment Management practice and partners have been widely recognized by industry organizations for our representation of investment managers, including but not limited to recognition by the following organizations:

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