TO IDF OR NOT TO IDF:
CAN INSURANCE COMPANIES ALLOCATE TO PUBLICLY AVAILABLE HEDGE FUNDS?

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Once one purchases a variable universal insurance or annuity contract such as private placement life insurance ("PPLI"), the next question is where to invest the net cash value, often as high as 98% of the initial premium. These assets, which are invested free of income tax so long as they are deemed to be owned by the insurance company, are often destined for hedge funds as hedge funds are among the highest yielding and most tax-inefficient managed investments available. To be granted tax favorable treatment the accounts must be fully compliant with the law and rules governing, among other things, the nature of the underlying hedge fund investments. The body of the law has recently increased with several Internal Revenue Service actions addressing diversification and investor control as it relates to whether hedge funds acquired by insurance companies may be available to the general public or must be available only to insurance companies.

In the wake of these actions I recently polled 15 colleagues in the insurance/hedge fund/legal community with a simple question: in your opinion, has the Internal Revenue Service's recent pronouncements and actions on diversification and investor control mandated the use of insurance dedicated funds ("IDFs") by insurance carriers to invest their separate account assets? Or, to state the corollary, may these insurance companies invest in funds available to investors other than (as a general rule) insurance companies, i.e. publicly available funds ("PAFs")? This has relevance throughout the variable insurance and annuity marketplace but is particularly pertinent for those high-end life insurance programs sometimes referred to as private placement life insurance ("PPLI"), the assets within which are often destined for hedge funds. When factoring in all the various twists and turns deemed most important to whomever it was I was speaking with at that moment, I received almost 15 different answers to what was putatively a yes/no question as well as, in several cases, invaluable insights by brilliant minds. These answers ranged from consternation that I would even find this a question worth asking ("of course they can invest in PAFs") to those who were flabbergasted that anyone would use anything other than an insurance dedicated fund and think the Service would sit back while its rulings were being flouted, and shades in between.

This confusion can be traced to those pronouncements—two revenue rulings (Rev. Rul. 2003-91; Rev. Rul 2003-92), a private letter ruling (LTR 200420017) and an amendment to the regulations (Treas. Reg. §1.817-5(f)(2)(i)) effectively setting forth in detail some new, and some re-treaded, rules governing the investments of insurance company separate accounts into hedge funds. These directives speak specifically to both the investor control rules and the diversification rule. However, once analyzed microscopically they illuminate the Service's position on this issue, providing something to work with in relative safety. Thus, notwithstanding this confusion the unassailable answer, in the author's opinion, is that insurance companies may invest in PAFs but within strict boundaries.

THE TAX RULES

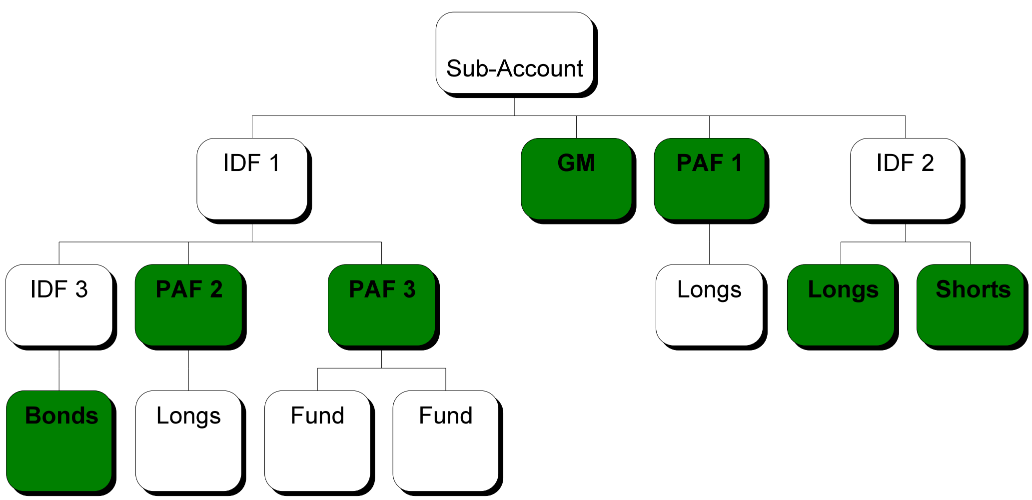
As of this writing we know several things for sure. We know that insurance company separate accounts must be diversified;[1] that is each account (subject to several exceptions and safe harbors) must hold at least five investments not to exceed specified maximum proportions.[2] When the investment is in a regulated investment company ("RIC") in which investments are limited to insurance companies the RIC can be looked through and its underlying investments are counted in computing diversification.[3] Thus an investment in a single RIC can achieve diversification.

With the amended regulation, we know that an investment by the insurance company in a single nonregistered limited partnership (such as the typical hedge fund) can be looked through only if the partnership is available only insurance companies, with certain exceptions not material here.

It is generally accepted, if without formal Service guidance beyond private letter rulings,[4] that look-through is potentially cascading (sometimes referred to somewhat narrowly as "double look-through"); once the investment is made in the top tier IDF (and PAF for a limited time) look-through for diversification testing will continue to cascade through subsidiary funds. Look-through will proceed through only IDFs and the cascade will cease at the first instance of a PAF, at which point that fund is counted as a single investment for diversification purposes.[5]

For example these rules will apply as follows (see Diagram 1): A sub-account holds (a) a long position in GM stock, (b) IDF1 (a fund of funds), (c) IDF2 (a clone long-short fund) and (d) PAF1 that holds only long equity positions. In turn IDF1 holds interests in (a) IDF3 that holds long equity positions, (b) PAF2 that holds long equity positions and (c) PAF3 that is itself a fund of funds. In computing diversification, the rules stated above would count the GM stock, PAF1, PAF2, PAF3 and each position held by IDF2 and IDF3 as a single investment. None of the positions held by PAF1, PAF2 or the funds held

Diagram 1: The Mechanics of Look-Through to Determine Diversification



Each white box is looked through; count only the investments within each green box—without going beyond it—to determine if the account is adequately diversified.

[1] I.R.C. §817(h); Treas. Reg. §1.817-5

[2] Treas. Reg. §1.817-5(b)

[3] I.R.C. §817(h)(4); Treas. Reg. §1.817-5(f)(2)(i)

[4] see, e.g., LTR 200115028

[5] LTR 200420017

by PAF3 would be counted separately.

We also are clear that policy owners cannot direct the investments within their policies beyond giving basic guidance to the insurance company (the subjective aspect of the investor control rule). After all, the argument goes, once the premium is paid it is no longer the policy owner's money. The money instead belongs to the insurance company and only the insurance company as *bona fide* owner can make the investment decisions and other decisions incidental to ownership. How far the policy owner may go or, more accurately, how far she may not go, in the Service's view, was described in Revenue Ruling 2003-91. The Service's view on subjective investor control can be summarized as follows:

> the policy holder may specify an allocation of premium paid among then-available sub-accounts within the separate account and may reallocate from time to time;
> other than the allocations among the sub-accounts all investment decisions concerning the separate account and the sub-accounts are made by the insurance company or its investment advisor in their sole and absolute discretion;
> there is no arrangement, plan, contract or agreement between the policy holder and either the insurance company or the allocator regarding the specific investments or investment objectives of a sub-account;
> policy holder cannot communicate directly or indirectly with any investment officer of the insurance company or the allocator regarding the selection, quality or rate of return of any specific investment or group of investments.

If we understand the diversification rules and we accept for argument's sake the subjective investor control rule as interpreted by the Service in Revenue Ruling 2003-91, where, one might ask, is the confusion? Where does one come up with the interpretation that insurance company separate account investments are prohibited from investing in publicly available hedge funds? The only explanation is that this is an overly broad, albeit rational, extrapolation from statements the Service has made over several years, culminating most recently in Revenue Ruling 2003-92, which should instead be interpreted narrowly within its facts.

INTERPRETING THE RULINGS

In Revenue Ruling 2003-92 the Service described situations where a contract holder owned variable annuity contracts and variable life insurance policies. In two situations each sub-account held a single publicly available hedge fund and in the third it held a single insurance dedicated hedge fund. The contract holder in the first two situations was deemed to be the owner of the partnership interests held by the sub-account for federal income tax purposes but in the third the insurance company was deemed to be the owner of the partnership interests. This Ruling must be read strictly on its facts and in the context of Revenue Ruling 2003-91 and LTR 200420017 to determine exactly why the third situation mandated a result (the preferable result) different than the first two and to understand the parameters of the objective aspects of the investor control rule.

The facts of Revenue Ruling 2003-92 clearly indicate that there is an identity between each sub-account and the single hedge fund in which it is invested. In light of Revenue Ruling 2003-91, which states favorably under its facts that "the investment strategies of the Sub-accounts currently available are sufficiently broad to prevent Holder from making particular investment decisions through investment in a Sub-account," and LTR 200420017 which reminds us that look-through applies to an IDF fund of funds, it is this author's view that these pronouncements do not stand for the blanket proposition that insurance company separate accounts may never invest in PAFs; rather they imply a much narrower holding—that the investment strategies of the sub-accounts must not be limited to a single hedge fund but instead must have several investment options available to it within the defined strategy. A sub-account limited to a single hedge fund would permit the policy owner to, in effect, choose a hedge fund by simply choosing the sub-account identified with that hedge fund, taking all investment discretion away from the insurance company and its investment advisor. Once compliant with this caveat (and the requirements of the subjective investor control rule that the contract holder not control the investment decisions in any overt way), sub-account investments in PAFs are permissible so long as diversification is also achieved within the separate account.

Under this interpretation then it is the author's opinion that the following rules and conditions maintain in order to be down the middle of the Service's fairway:

The cash value in an insurance company's separate account may be allocated by the policy owner to sub-accounts, each of which should be broadly defined by investment criteria, such as a Large Cap Equity Growth sub-account or an Event Driven sub-account. No sub-account should be defined by a single underlying fund, such as the XYZ sub-account, with 100% correlation to the XYZ Fund.

Any sub-account may invest in any valid and permissible investment, including, for instance, a managed portfolio of stock, debt securities, options, futures, commodities, or funds.

Diversification testing occurs generally at the first investment tier. The separate account's sub-accounts altogether must have five or more holdings in the proper proportions, subject to the various exceptions and safe harbors, for the separate account to be deemed diversified.

When the sub-account is invested in hedge funds it is relevant whether the fund is publicly available or insurance dedicated.

- If the sub-account is invested in PAFs the sub-account should be defined broadly enough and the allocator have available to him a sufficient number of publicly available funds within that criteria. The Service would then be hard pressed to claim that an allocation by the policy owner to that sub-account was a disguised allocation to a specific fund.
- An IDF may, on the other hand, be structured as a strategy specific hedge fund (perhaps a clone fund mimicking a well known PAF of the same manager) or as a fund of hedge funds and still qualify for look-through for diversification and be compliant with the objective investor control rule.

Subject to these conditions the separate account will be tested for diversification under the amended regulation by counting as a discrete investment each position held directly, each PAF and each position within each IDF in each sub-account to which cash value had been allocated by the policy owner. Conceivably, diversification of the separate account might rest on a single investment in an IDF through a single sub-account so long as look-through will yield sufficient relative holdings, as would be expected. If none of the funds chosen in any sub-account is an IDF, then for the separate account to be diversified there must be at least five PAFs and other direct holdings in the proper proportions within the separate account across all the sub-accounts. Assuming there has not been any overt subjective investor control, the separate account will not only be diversified, it will also avoid the objective investor control rule since the managed portfolio of funds will be sufficiently diversified (in the colloquial sense) to make any attempt to use the sub-account as a back door to controlling the investments a practical impossibility.

WHEN TO IDF AND WHEN TO PAF

This world is big enough for both IDFs and PAFs. The decision of which to use in any particular case may come down to the tangible element of costs. How different is an allocator's charges for managing a portfolio of PAFs than the FOF's fees on top of the hedge fund fees?

Or it may come down to qualitative controls. A fund manager managing an insurance dedicated fund of hedge funds would undoubtedly point to his finely tuned business model based on risk controls and manager due diligence to differentiate himself or herself. But it should not be too difficult to find managers who allocate to PAFs who would argue that he or she brings no less discipline.

Or the decision may come down to the desire to stick with one particular hedge fund manager. If the investment manager (and it is truly the insurance company's investment manager's decision from among the available universe and not the disguised guidance of the policy owner) is enamored with the performance of one particular hedge fund manager and one of his specific strategies, and if that manager offers an IDF cloned off his publicly available fund, the sub-account can invest all of its assets in that particular cloned IDF. Otherwise in order to get the PAF version of this fund into the sub-account he would be able to invest no more than 55% of the cash value in this PAF, thereby diluting the investment with less preferred holdings.

Or it may be that simplicity and risk aversion govern the decision, with an insurance company's management more comfortable with the knowledge that the separate account will be diversified virtually automatically with an investment in a properly vetted IDF organized as a business entity (e.g. an LLC or a Delaware business trust) than they are with the risk that the account might lack diversification from an inadvertent failure to be in a sufficient number or proportion of PAFs within what is simply an account.

CONCLUSION

The Service's stamp of approval for IDFs and it prohibition of single-fund sub-accounts does not create the negative inference that all allocations to all PAFs are impermissible. Allowing such investments is proper and appropriate as a matter of tax policy. There is no opportunity to game the system, as is the Service's concern, and it matches the practices of the industry that reflect investment practicalities more than it reflects torturously twisted tax planning.

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