CASHING IN THE POLICY: WILL LOOMING FINANCIAL REGULATION END THE USE OF PRIVATE PLACEMENT LIFE INSURANCE IN ESTATE PLANNING?

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I. INTRODUCTION

The economic decline had many direct and clear consequences. However, what is not clear are the secondary and indirect effects some individuals will face as a consequence of the recent recession. One of the major and clear effects of the financial decline was the push towards reforming financial regulation.[1] The reformation of the regulatory structure and procedure, undoubtedly, will alter the face of the financial system. It is unknown how these new financial regulations will affect individual

1. Brody Mullins, *Family Trusts Lobby to Avoid New Rules*, WALL ST. J., Oct. 21, 2009, at A4, *available at* http://online.wsj.com/article/SB125600874032979791 7.html#printmode.

investors as well as estate planners and their clients. This comment will specifically focus on the increase in regulatory requirements for private pools of capital or hedge funds and its effect on estate planners.

Hedge funds in modern financial markets are playing a significant role in the financial system.[2] Significant growths in number, size, and capital under management have propelled private funds into becoming an integral part of the financial industry and overall economy.[3] Historically, hedge funds—although required to submit to anti-fraud requirements—are a largely unregulated sector of the financial industry.[4] The lack of oversight and the heavily publicized collapses of large private funds have resulted in a growing sentiment favoring an increase in the regulation of these funds.[5] Broad regulation proposals for hedge funds—largely focused on registration and transparency—may have significant effects on individual investors, including individuals using these investment vehicles for estate planning purposes.[6]

Estate planners use hedge funds or private funds as investment vehicles because of their history of earning significant returns.[7] Wealthier estates can use interests in private funds in a number of different ways when planning for the transfer of their estate at death.[8] When combined with insurance policies, trusts, and other estate planning instruments, individuals can minimize what would otherwise be significant income, gift, and estate taxes, while earning high returns on a large amount of capital.[9] These strategies, however, are exclusively limited to higher net worth individuals, who largely use these strategies for tax avoidance purposes.[10] Tax rules eroded these strategies, leaving the use of hedge funds in estate planning solely for estate planning objectives.[11]

This comment will evaluate the possible effect that increased regulation on private funds and hedge funds will have on estate planning strategies for wealthier individuals, as well as the compatibility of increased

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2. RICHARD BOOKSTABER, A DEMON OF OUR OWN DESIGN 243–53 (John Wiley & Sons 2007).

3. *Id.*

4. *Id.*

5. Louise Story, *Hedge Funds Step Up Efforts to Avert Tougher Rules*, THE NEW YORK TIMES, June 22, 2009 at B3, *available at* http://www.nytimes.com/2009/06/23/business/23hedge.html.

6. *Id.* The proposals stem from the Treasury Department, Congress, and the international community. *Id.*

7. James R. Cohen & Jeffery S. Bortnick, *Is Increasing Hedge Fund After-Tax Returns Using Private Placement Life Insurance and Annuities Still Viable*, J. OF WEALTH MGMT. 45 (Fall 2004), *available at* http://www.kkwc.com/docs/AR20040907001.pdf.

8. *Id.* at 46.

9. *Id.*

10. *See* Roger D. Silk, *How Privately Placed Tax Advantaged Products Can Benefit Hedge Fund Investors and Managers*, HEDGEFUNDNEWS.COM, http://www.hedgefundnews.com/news_n_info/article_detail.php?id=163.

11. Stephen D. Chu, *Job Well Done: Preventing the Use of Private Placement Life Insurance To Wrap Hedge Fund Investments*, 2008 COLUM. BUS. L. REV. 694, 698 (2008) [hereinafter *Job Well Done*].

regulatory standards and stringent tax requirements. The second section of this comment will outline a general estate planning strategy that uses a combination of life insurance and private funds interests as a medium to transfer wealth to future generations. This section will also include a description of the strict tax guidelines in these strategies. Part III will begin with a description of recently passed regulations and how these regulations will affect the private funds industry. The second portion of Part III will survey the regulatory proposals. The final section of this comment will evaluate the effect that increased regulations will have on estate planning strategies. Ultimately, this comment will conclude that, although there will be an elimination of the exemptions regularly used by private funds, an unclosed exemption will increase the number of private funds that cater to estate planners.

II. HEDGE FUND ASSETS IN THE CURRENT PLANNING PROCESS

Estate planning is the process of structuring an individual's estate (or assets) to provide an efficient transfer of wealth to future generations and to provide financial security to heirs or beneficiaries.[12] Although for a large percentage of the population interests in hedge funds are not part of an investment or estate plan, wealthier clients with access to hedge fund interests can include this type of investment vehicle in their estate plan.[13] Hedge fund interests are effective estate planning tools because of the tax benefits they provide to investors, if the investor meets all the necessary tax qualifications.[14] An investor's biggest draw to investing in a hedge fund is the fund's ability to generate higher returns and maximize the amount of wealth transferred to future generations.[15] Additionally, the ability of the investment to generate liquidity at the death of the investor is an important planning aspect in all estate plans.[16] Furthermore, the investment

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12. MODERN ESTATE PLANNING, § 36.02 (Matthew Bender & Co.) (2009) (stating that the process includes effectively minimizing tax liabilities on the estate while balancing needs for asset protection and return).

13. Investment in private funds is limited to qualified purchasers with at least $5 million in investable assets. Investment Company Act of 1940, 15 U.S.C. §§ 80a-2 to 3(c)(7). Additionally, Regulation D of the Securities Act of 1933 limits investments to persons meeting the accredited investor rules. 17 C.F.R. § 230.501 (2009) ("Any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase exceeds $1,000,000; Any natural person who had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year [.]").

14. *See* Cohen & Bortnick, *supra* note 7, at 45 (stating that tax inefficiencies of most hedge funds can be minimized by combining a hedge fund investment with life insurance and annuity plans).

15. *Id.* at 46.

16. *See* LOUIS A. MEZZULLO, AN ESTATE PLANNER'S GUIDE TO LIFE INSURANCE 3 (American Bar Association, 2nd Edition) (2009); *see also*, Cohen & Bortnick, *supra* note 7, at 46 (stating that liquidity is a large portion of the estate planning process because of the immediate need to pay for estate expenses).

agreement structures the investor's interest as a limited liability interest, which allows the investor to transfer the interest into a suitable trust.[17] Two methods of utilizing hedge fund investments are the following: (1) wrapping the interest from the hedge fund in a private placement insurance policy, and (2) transferring a limited interest in the fund to a trust that distributes the interest to designated beneficiaries.[18] To illustrate the effect that increased private fund regulation would have on estate plans, this section will outline private placement life insurance strategies.

A. Private Placement Life Insurance

Life insurance plans are a central aspect of almost all estate plans.[19] Upon death, life insurance proceeds provide liquidity for the death tax and probate expenses.[20] This liquidity allows the decedent's estate to meet any immediate financial needs while avoiding having to sell estate assets at depressed prices. However, life insurance policies, while tax advantageous, statistically are not suitable long-term investments because life insurance returns are relatively low.[21] The strategies geared towards capitalizing on the tax advantages, asset protection properties, and liquidity advantages of life insurance plans, along with the higher returns of more lucrative investment securities, are hedge fund life insurance policies or privately placed life insurance policies.[22]

Private placement life insurance (PPLI), a type of variable life insurance product, offers flexibility to the purchaser while providing a lump sum upon death.[23] A PPLI—open only to accredited investors—is a highly customizable insurance product specifically tailored to high net-worth individuals.[24] Although offered domestically, a large percentage of offshore insurance companies offer PPLI policies.[25] After the investor purchases the policy, the insuring company places the life insurance premium into an account segregated from its other assets.[26] The purchaser of the policy maintains some ability to choose investment strategies for the cash value of

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17. *See* Cohen & Bortnick, *supra* note 7, at 45.
18. *See infra* Part A.
19. See MEZZULLO, *supra* note 16, at 1 (stating most American adults own a life insurance policy and the need for estate planning advisors to be familiar with life insurance characteristics).
20. JAY A. SOLED, ESTATE PLANNING STRATEGIES: A LAWYER'S GUIDE TO RETIREMENT AND LIFETIME PLANNING 64 (Jay A. Soled, ed., American Bar Association) (2002).
21. *See* Silk, *supra* note 10; *see also*, MEZZULLO, *supra* note 16 at 2 (discussing the financial risk policy purchasers' face with permanent life insurance policies).
22. *See* Cohen & Bortnick, *supra* note 7, at 46.
23. Rachel Emma Silverman, *'Private Placement Policies' Draw More Wealthy Investors Despite Fees, Limited Control*, WALL ST. J., Oct. 18, 2006, at D1, *available at* http://www.tempewick.com/new/tempewickwealthmanagement/content.asp?contentID=2017267459.
24. *Id.*
25. *See* Silk, *supra* note 10.
26. *Id.*

paid premiums.[27] Since the purchaser is an accredited investor, the purchaser may invest in a hedge fund, or group of hedge funds, and is not limited to traditional investments.[28]

Since hedge funds historically earn a higher return when compared to traditional investment vehicles, the premium would accrue significant returns over the life of the policy.[29] The return can be particularly high if the investor purchases the policy and holds it for an extended period of time.[30] The use of a PPLI as an estate planning strategy includes weighing complex tax issues—income, estate, and gift—and creating specifically structured trusts.[31] However, when an insurance purchaser executes this type of strategy effectively, the plan can earn substantial returns and protect the estate from significant gift taxes.[32]

1. Jumping Through Tax Hoops: Avoiding Income Tax Liabilities

Aside from the liquidity and asset protection advantages of life insurance policies, the primary reason for investing in hedge funds through PPLIs is to benefit from the tax treatment of life insurance plans.[33] Life insurance carries two tax benefits for the policyholders: first, the gain in value of the policy and its underlying investments are free of income tax; and second, the death proceeds of the policy transfer free of estate and gift taxes.[34] In traditional life insurance plans, the rise in the value of the policy goes untaxed for income tax purposes, provided the purchaser does not withdraw or does not borrow against the contract.[35] Upon death, the policy pays out the value of the hedge fund investment plus any additional term life insurance to the beneficiaries of the estate.[36] If the insured does not cash in the policy before death and the structure of the insurance policy

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27. *See* Brad Cole, *Private Placement Life Insurance: The New Alternative in Insurance,* COLE PARTNERS, Apr. 2002, at 2 (stating the underlying investment of the policy is not limited as is with normal variable life insurance policies).

28. *Id.* at 3 (" . . . is essentially an unregistered variable universal policy. Because these policies are considered private placements, PPLI is only available to accredited investors.").

29. *See* Cohen & Bortnick, *supra* note 7, at 45.

30. *Id.* (illustrating that a $5 million dollar investment at a 12% annual rate of return would provide $350 million at the death of the insured if held for 40 years).

31. *See infra* Part II.A.1–2.

32. *See* Cohen & Bortnick, *supra* note 7, at 47 ("[T]he rate or even the existence of the estate tax far into the future is speculative, but we think it is very likely that there will continue to be an estate tax on very large estates, taxed at 50% or more.").

33. *See* MEZZULLO, *supra* note 16, at 1.

34. I.R.C. § 72(e) (2009) (stating that gains on investments within life insurance policies are not realized income); I.R.C. § 101(a) (2009) ("[G]ross income does not include amount received . . . under a life insurance contract, if such amount are paid by reason of the death of the insured.").

35. I.R.C. § 61 (2009) (stating that gains are not taxed until realized or controlled by the individual).

36. *See* Cohen & Bortnick, *supra* note 7, at 46.

meets all tax law formalities, the beneficiaries of the estate will receive the value of the policy free from federal income taxes.[37]

Recognizing that investors began to use PPLI policies as tax shelters, the IRS released a series of rulings and updated regulations to eliminate the use of PPLI policies solely for tax avoidance purposes.[38] The IRS's tightened regulations concerning PPLIs do not eliminate the ability of insurance purchasers from using interest earned from hedge funds as an underlying investment, but the regulations do create a rigid standard of compliance to execute the strategy and benefit from base exclusions from gross income.[39] In order to fall within the tax guidelines, the PPLI policy must meet two requirements: first, the investment of the premiums must meet diversification requirements; and second, the purchaser must lose a significant amount of control over the underlying investments.[40] Failing to meet these requirements would, for tax purposes, remove the policy from treatment as life insurance and make the purchaser liable for income and capital gains taxes.[41]

The application of the 1984 diversification requirement was the federal government's attempt to stop the use of life insurance policies as investment instruments.[42] Since the insurance company holds the insured's premiums in a segregated account, the diversification rules apply to the assets held by the insurance company, not to the assets of individual investors.[43] The IRS regulation requires life insurance companies with segregated accounts to diversify the premiums between at least five investments.[44] This rule creates the ability to "look through" the insurance

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37. *See* I.R.C. § 101.

38. Cole, *supra* note 27, at 3 ("The overall motive [for these products] is not for insurance, but for tax deferral."); *see also* Chu, *supra* note 11.

39. Chu, *supra* note 11, at 702 ("[P]rivate placement life insurance remains a viable planning tool, and the recent developments in the law affect only the design of these products.").

40. *Id.* at 702–08.

41. I.R.C. § 817(h) (2009) ("[A] variable [life insurance policy] which is otherwise described in this section and which is based on a segregated asset account shall not be treated as an annuity, endowment, or life insurance contract for any period (and any subsequent period) for which the investments made by such account are not, in accordance with [these] regulations."); I.R.C. §7702(g) (2009) ("If at any time any contract which is a life insurance contract under the applicable law does not meet the definition of life insurance contract under subsection (a), the income on the contract for any taxable year of the policyholder shall be treated as ordinary income received or accrued by the policyholder during such year."); *see also* I.R.C. § 1 (2009) (applicable income tax rate for high net worth individuals was set at 39.6% for 2009 with capital gains, depending on other capital consequences, taxable at 25%).

42. *See* Chu, *supra* note 11, at 702–03.

43. I.R.C. § 817(h)(4) (" Look-through in certain cases.—For purposes of this subsection, if all of the beneficial interests in a regulated investment company or in a trust are held by 1 or more . . . insurance companies (or affiliated companies) in their general account or in segregated asset accounts . . . the diversification requirements . . . shall be applied by taking into account the assets held by such regulated investment company or trust.").

44. Treas. Reg. § 1.817-5 (2009) ("[T]he investments of a segregated asset account shall be considered adequately diversified . . . only if—(A) No more than 55% of the value of the total assets of

company's investment holdings and count "each asset held by [the insurance company to determine] whether the segregated asset account is adequately diversified."[45] Additionally, if the insurance company holding the segregated premiums invests those premiums in a fund of funds or a clone fund available only through the PPLI, then the look through rule will apply to that particular fund.[46]

The second requirement is known as the "investor control doctrine." This doctrine limits the flexibility of the PPLI in two ways: first, the IRS minimizes the ability of the policyholder to control the underlying investments; and second, it limits investable options to funds only accessible through life insurance contracts.[47] In a 2003 Revenue Ruling, the IRS determined that the policy purchaser could not "select or direct . . . particular investment[s]" or "possess sufficient incidents of ownership over the assets."[48] If the policyholder had no particular incidents of ownership, beyond choosing a general investment strategy, then for tax purposes, the insurance company owns the policy and the individual investor only owns an interest in the policy.[49] The next part of the investor control doctrine limits the investment of life insurance premiums to investments or funds exclusively open to life insurance policies.[50] The logical response to this rule is for insurance companies to create a fund of funds, which is subject to look through requirements, then diversify the investment premiums among five private placement funds.[51]

The exclusivity in only using PPLI investments is advantageous to most private fund managers because of the access and the security of a large number of high net worth estates.[52] A fund comprised of ten investors each purchasing a policy with premiums in the range of $5 million to $10 million would create a fund comparable in size to most average-sized private funds. An additional upside for fund managers is the inability of investors to

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the account is represented by any one investment; (B) No more than 70% of the value of the total assets of the account is represented by any two investments; (C) No more than 80% of the value of the total assets of the account is represented by any three investments; and (D) No more than 90% of the value of the total assets of the account is represented by any four investments.").

45. Deborah M. Beers, *New Guidance on Structuring Hedge Fund Investments in Variable Life and Annuity Contracts*, Feb. 9, 2004, at 51-52 *available at* http://www.capco.com/files/pdf/69/03_PRESERVATION/06_New%20guidance%20on%20structuring%20hedge%20fund%20investments%20within%20variable%20life%20and%20annuity%20contracts.pdf (explaining that look through rules only apply to first-tier institutions and do not apply to subsequent investment intuitions).

46. Treas. Reg. § 1.817-5(f)(2)(i) (2009); *see also* Chu, *supra* note 11, at 702–03.

47. *See* Chu, *supra* note 11, at 702–03.

48. Rev. Rul. 2003-91, 2003-2 C.B. 347.

49. *See* Beers, *supra* note 45, at 55; *see also* Rev. Rul. 2003-91 (providing examples of incidents of ownership that regulate the amount of investor control over general investment decisions).

50. Chu, *supra* note 11, at 707 ("Thus, due to recent reform efforts, a hedge fund is accessible only through an insurance-dedicated fund and any investment by a variable contract in a fund that is also open to the general public is absolutely forbidden.").

51. *See* Beers, *supra* note 45, at 55.

52. *See* Cohen & Bortnick, *supra* note 7, at 45.

exercise control over investment decisions because of certain tax restrictions. This leaves the fund managers and the insurance company free to make investment decisions without investor scrutiny. However, a drawback for fund managers is the tax regulations that subject the dedicated fund to the look through requirements. The primary benefit of most hedge funds is the ability to execute complex trading and investment strategies in private, which allows exploitation of market inefficiencies. With the clarification of tax regulations and rulings, the estate planning industry is seeing a greater use of PPLI policies and hedge fund investments.[53]

2. *Getting the Trust Right: Minimizing Estate and Gift Taxes*

Although a PPLI policy allows investors to circumvent federal income taxes, the life insurance structure of the investment does not protect investors from estate and gift taxes.[54] The legislature repealed the federal estate tax for the 2010 taxable year; however, the legislature did not eliminate gift taxes and is allowing the estate tax to return in 2011. The 2011 estate tax will have a $5 million exclusion amount and a maximum tax rate of 35%. Using trusts to address estate and gift taxes requires careful consideration and knowledge of applicable tax regulations. The following general description of trust strategies is not only applicable to insurance strategies, but also to other estate planning strategies.

First, if an investor does not effectively remove the PPLI policy from his or her estate, then the value of the policy will be included in the investor's estate and subject to estate taxes.[55] Proceeds from a life insurance policy are included in the estate of the insured if:

> the amount receivable by all other beneficiaries as insurance under policies on the life of the decedent with respect to which the decedent possessed at his death any of the incidents of ownership, exercisable either alone or in conjunction with any other person. For purposes of the preceding sentence, the term "incident of ownership" includes a reversionary interest (whether arising by the express terms of the policy or other instrument or by operation of law) only if the value of such reversionary interest exceeded 5 percent of the value of the policy immediately before the death of the decedent.[56]

The preferred strategy to avoid estate taxes is to hold the policy in the assets of a trust with no incidents of ownership by the investor.[57] In order to avoid having the PPLI policy included in an investor's estate, estate

53. *See* Silverman, *supra* note 23, at D1.
54. *See* I.R.C. § 2042 (2009).
55. SOLED, *supra* note 20, at 146.
56. I.R.C. § 2042.
57. SOLED, *supra* note 20, at 146.

planners must exercise certain precautions.[58] First, the investors cannot retain any interest in the trust as a beneficiary or maintain the ability to borrow against or from the fund.[59] Additionally, the investor should not designate the beneficiaries of the trust, nor should the proceeds be payable to the executor of the insured's estate.[60] Rather, the grantor should name the trust as the beneficiary under the policy life insurance to avoid the perception of ownership by the grantor.[61] Finally, the investor should not structure the trust in a manner where the grantor would retain any revocation or termination rights in the trust.[62]

If the investor creates the trust and then transfers an existing policy to the trust, then the life insurance policy will be included in the investor's estate if he or she dies within three years of the transfer.[63] Alternatively, the investor could create the trust, nominally fund the trust, and then sell the PPLI policy to the trust. This method, however, may raise step transaction issues with the IRS.[64]

The ideal trust for this strategy is an irrevocable insurance trust that removes the policy from the estate of the investor.[65] The irrevocable trust should include *Crummey* withdrawal rights to the beneficiaries to obtain some of the gift tax exclusions available.[66] *Crummey* powers allow grantors to use the annual exclusion for gifts and give the beneficiaries an exercisable right to the property transferred into the trust.[67] The beneficiaries designated with *Crummey* powers have a period of time to withdraw an amount equal to the gift transferred to the trust.[68] When using this strategy, the beneficiaries should be aware of the circumstances surrounding the trust, their rights under the provisions of the trust, and the benefits of effectively executing the investor's strategy.[69]

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58. *See* I.R.C. §§ 2037, 2038, 2042(l) (2009).

59. I.R.C. § 2037.

60. I.R.C. § 2038.

61. SOLED, *supra* note 20, at 147.

62. I.R.C. § 2042.

63. *See* I.R.C. § 2035 (2009).

64. SOLED, *supra* note 20, at 147.

65. *See* Cohen & Bortnick, *supra* note 7, at 46.

66. The unified gift credit is an annual exclusion. I.R.C. § 2505 (2009). Therefore, with single premium variable life insurance, the investor may only take advantage of the credit for a single year as opposed to contributing an amount equal to or less then the annual credit amount. *Id.* Using a multiple premium insurance plan would limit the choices of available hedge funds the investor is capable of investing in and would hamper the total return earned from the interest in the hedge fund. *Id.* The unified credit for 2009 was set at $1,000,000, reducing the effective tax rate to 32% for the year. *Id.*; *see also* Crummey v. Comm'r, 397 F.2d 82 (9th Cir. 1968) (holding gifts to trusts structured with specific provisions are gifts of present interest, and therefore, qualify for the annual unified gift credit).

67. *See* SOLED, *supra* note 20, at 136.

68. *Id.* at 137.

69. Rev. Rul. 81-7, 1981-1 C.B. 474 ("A trust provision that gives a legally competent adult beneficiary the power to demand corpus does not qualify a transfer to the trust as a present interest eligible for the gift tax annual exclusion under section 2503(b) of the Code, if due to the donor's conduct, the beneficiary lacks knowledge of the power and does not have a reasonable opportunity to

Designed specifically to prevent taxpayers from circumventing estate tax requirements, the gift tax places a tax liability on transfers that would benefit a testator's beneficiaries after death.[70] However, "the gift tax is actually one-third lower than the estate tax, and it save[s] . . . one-third no matter what rate [is] earne[ed] on [the money], so long as the money giv[en] to the [trust] earns at the same rate as [other investments]."[71] Preferably, the investor would create and fund the trust, and the trust would purchase the policy in the name of the investor.[72] If the investor creates the trust and subsequently funds it, the transfer to the trust is a gift subject to gift tax requirements.[73] An investor's significant transfer to the trust (upwards of $10 million) would not avoid gift taxes, but an investor could structure the trust in a particular manner to mitigate the amount of gift taxes the trust would have to pay.[74] Alternatively, if the investor would prefer the trust to carry the liability for gift taxes, a grantor's trust could place an income tax burden on the trust and circumvent the gift tax burdens.[75] However, if the PPLI policy is structured according to tax requirements, the grantor will incur little-to-no income tax liabilities during the life of the contract.[76]

If the investor does not want to incur the 55% gift tax for the transfer, an investor's alternative option is to create an incomplete grantor trust.[77] Creating a grantor's trust would leave some interest in the grantor and leave the income tax liability in the investor.[78] If the investor is subject to income taxes, then the client can gift the funds to the trust free of gift taxes.[79] However, it is difficult for an investor to execute this strategy because it requires purposefully failing one of the requirements of a grantor trust with the intention of leaving the income tax burden on the investor while still effectively removing the policy from any future estate tax liability.[80] The planners should be cautious about the creation and execution of a trust to ensure the PPLI policy is not included in the investor's estate at the time of the client's death.[81] For estate tax purposes, the policy will remain in the

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exercise it before it lapses.") *See Crummey*, 397 F.2d at 87–88 (noting that beneficiaries are unlikely to be aware of their rights in most situations).

70. *See* SOLED, *supra* note 20, at 136.

71. *See* Cohen & Bortnick, *supra* note 7, at 47.

72. *See* SOLED, *supra* note 20, at 146; *see also* Treas. Reg. § 25.2512-6(a).

73. For a gift upwards of $10 million there is a required minimum tax rate of 42% with a maximum tax rate of 45% for the 2009 taxable year. I.R.C. § 2001 (2009). Unlike the estate tax, which the legislature repealed for a single year in 2010, the gift tax remained. *Id.*

74. *Id.*

75. *See* Cohen & Bortnick, *supra* note 7, at 47.

76. *See id.*

77. *See id.*

78. I.R.C. § 671–79 (2010); Carson v. Comm'r, 92 T.C. 1134, 1138 (1989) (holding that if the grantor retains any power to sprinkle the trust income to the beneficiaries, then he is "deemed to have retained [grantor] power under section 672(e)").

79. *See* Cohen & Bortnick, *supra* note 7, at 47.

80. *See id.* at 46.

81. *See id.*

client's estate during the period when he is liable for the income tax for the trust.[82] The trust should name the grantor's spouse as the beneficiary of the trust for this period.[83] Under this scenario, the investor would not pay annual income taxes on the unrealized gains. However, in the future, the investor may complete the trust to insure that it is removed from the investor's estate without the potential for a challenge by the IRS.[84] Completing the irrevocable trust would transfer any potential income tax burden to the trust itself.[85]

The strategies for utilizing private placement policies may be complex and technical, but the potential benefits to the large estates are tremendous.[86] The level of asset protection, liquidity, and higher rates of return are very beneficial to all estate planners.[87] The substantial returns provided by private funds, combined with the tax benefits created with life insurance structured assets and effective trust provisions, can be very alluring to high net worth individuals. This method of utilizing hedge fund investments in estate plans of wealthier individuals is a popular strategy for the transfer of wealth to heirs and future generations.[88]

III. CHANGE ON THE HORIZON: THE CURRENT PRIVATE FUND REGULATORY ENVIRONMENT, PAST ATTEMPTS AT REGULATION, AND NEW WAVES OF REGULATORY PROPOSALS

Having outlined an estate planning option for wealthier individuals, we now turn to the portion of the estate strategy that earns the significant returns: hedge funds. Frequently scrutinized over the previous decade, regulation of hedge funds and private funds is best described as avoidable, though not completely absent.[89] However, with the lingering stigma of the recent economic decline from 2007-2008 (particularly in the financial sectors) and the estimated percentage of trading volume that private funds account for in trading markets, lawmakers renewed calls to increase regulation on private funds.[90] Lawmakers and other financial regulators are concerned that private funds are marginalizing their ability to mitigate any undue systemic risk when sponsors of private funds effectively "opt out" of

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82. I.R.C. § 671 (2010).
83. *See* I.R.C. § 677 (2010).
84. *See* Cohen & Bortnick, *supra* note 7, at 46.
85. SOLED, *supra* note 20, at 147.
86. *Id.*
87. *Id.* at 64.
88. *See* Cohen & Bortnick, *supra* note 7, at 46.
89. *See generally*, *Regulating Hedge Funds and Other Private Investment Pools: Hearing Before the Subcomm. on Sec., Ins., and Inv. of the U.S. S. Comm. on Banking, Hous., and Urban Affairs*, 111th Cong. 2 (July, 15, 2009) [hereinafter *Hearing*] (testimony of Andrew J. Donohue, Director, Division of Inv. Mgmt, S.E.C.).
90. Emily Perryman, *Hedge Funds Will Face Increased Regulation, Survey Finds*, HEDGEWEEK, Dec. 12, 2009, http://www.hedgeweek.com/print/27135.

any regulatory oversight.[91] The lawmakers' goal is to obtain basic information from private funds that will aid in the government's ability to avoid unnecessary systemic risk and market inefficiencies.[92]

It is certainly arguable that private funds or single-family funds—the most common version of private funds used in family estate plans—pose no systemic risk to financial markets.[93] However, the new presidential administration and the Democratic-majority Congress, along with other international governments and organizations, proceeded with aggressive regulations to eliminate most regulatory exemptions and increase the transparency of private funds.[94] This section will discuss the previous state of regulation for all private funds, give an overview of previous attempts at private fund regulation, and survey newer approaches to regulating these types of funds.

A. The Old Regulatory Environment

As previously stated, registration and regulation of private funds were easily avoidable; characterized better through exemptions rather than actual regulatory requirements.[95] Although the different varieties of private funds have limited the government's ability to regulate each one individually, most private funds, along with private family investment funds, use the same exemptions to bypass regulation.[96] These exemptions, found in three different statues, were created to provide funds that are "too small to warrant government attention" relief from burdensome regulation.[97] However, these exemptions eventually covered funds that were limited to a small number of investors but had tremendous amounts of assets under management, and controlled a significant portion of the market capital.[98]

1. The Securities Act of 1933

Although private fund managers organize their funds as limited liability partnerships or limited liability corporations, federal statutes characterizes sales of interests in the fund as transactions of investment

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91. *Hearing*, *supra* note 89, at 2.
92. *Id.*
93. Mullins, *supra* note 1 at A4.
94. *See* Perryman, *supra* note 90; *see also* Arthur D. Postal, *Panel Making Progress on Financial Services Packages*, LIFE AND HEALTH INSURANCE NEWS, Dec. 28, 2009, http://www.lifeandhealthinsurancenews.com/News/2009/12/pages/panel-making-progress-on-financial-services-package.aspx# (quoting Senator Dodd as saying ". . .our regulatory structure needs to be modernized and streamlined").
95. *Hearing*, *supra* note 89, at 5 (testimony of Andrew J. Donohue).
96. Mullins, *supra* note 1, at A4.
97. *Hearing*, *supra* note 89, at 6 (testimony of Andrew J. Donohue).
98. *Id.* at 1.

securities.[99] Typically, sales of securities require registration with the SEC and the securities issuer must disclose any information deemed by the SEC to be "necessary or appropriate in the public interest or for the protection of investors."[100] However, section 4(2) of the Act exempted security sales and offerings not made to the general public from registration requirements.[101] Additionally, Rule 506 of Regulation D provides another registration exemption for securities that only sell shares to a maximum of thirty-five accredited investors.[102] To avoid registration and disclosure requirements, private fund managers only need to offer a limited number of shares in the fund to a small group of accredited investors in small private offerings.[103] Working together, these two exemptions allowed private funds to be less transparent than other securities or investment vehicles.[104]

2. The Investment Adviser Act of 1940

Designed to protect against fraud and overreaching by investment advisors, the Investment Advisers Act requires advisors to disclose fund information and business records, as well as comply with any other disclosure and regulatory requirements.[105] The exemption from this requirement released the fund's advisor, usually the general partner, from registering with the S.E.C. if the adviser had fewer than fifteen clients and did not "hold[ ] himself out generally to the public as an investment adviser."[106] Although, the exemption threshold limited the number of investors to a smaller number, the second portion of the exemption denying public offerings is similar to that in the Securities Act.[107]

Another exemption excludes private funds advisors whose clients are only limited to insurance companies.[108] All funds are still subject to anti-fraud regulations of the Investment Advisers Acts that prohibit advisers from defrauding investors in pooled investment vehicles.[109] However, the SEC only requires registered funds to submit to periodic examinations.[110]

99. The Securities Act of 1933, 15 U.S.C.S. § 77b(a)(1) (2009) ("The term "security" means any . . . certificate of interest or participation in any profit-sharing agreement").

100. *Id.* at § 77(b)(10).

101. *Id.* at § 77(d)(2).

102. 17 C.F.R. § 230.506(b)(2)(ii) (2009) ("Each purchaser [must have] such knowledge and experience in financial and business matters to make that he is capable of evaluating the merits and risks of the prospective investment.").

103. *Hearing*, *supra* note 89, at 5 (testimony of Andrew J. Donohue).

104. *Id.*

105. The Investment Advisors Act of 1940 § 203(c); 15 U.S.C. § 80b-3 to -6 (2009).

106. 15 U.S.C. § 80b-3(b)(3).

107. *Compare* 15 U.S.C. § 77d (2) ("transactions by an issuer not involving any public offering"), with 15 U.S.C. § 80b-3(b)(3) (saying "[A]ny investment adviser who neither holds himself out generally to the public as an investment advisor").

108. 15 U.S.C. § 80b-3(b)(2).

109. *Hearing*, *supra* note 89, at 7 (testimony of Andrew J. Donohue).

110. *Id.*

Funds that are not registered, or meet all the exemption standards, are not subject to examination.[111] Because of the disclosure requirements and the likelihood that wealthier families are investing in private funds, estate planners will invest in private funds that have no disclosure requirements and avoid any unnecessary regulation requirements.[112]

3. The Investment Company Act of 1940

Enacted "mainly [as] a registration and anti-fraud statute," the Investment Company Act of 1940, also allowed private funds to easily avoid regulation.[113] Fund managers used two exemptions in the Act to avoid auditing and transparency requirements.[114] Under the first exemption, the private fund is limited to one hundred total investors.[115] The limitation on the number of investors is not a significant hurdle given the other limiting requirements in the Securities Act and the Investment Advisors Act. The second exemption is the qualifying person exemption, where the fund is exempt from registration if investment in the fund is only open to "qualified purchasers" in private offerings.[116] Generally, a qualified purchaser is an investor with at least $5 million in investable assets or companies, with an average of $25 million in investable assets.[117] The qualified purchaser requirements are the primary reason why private funds are exclusively limited to wealthy individuals.

B. Failed Attempts at Private Fund Regulation

When Congress adopted exemptions allowing private funds to bypass regulation and disclosure requirements, it did so because it felt that private funds did not have a "substantial affect on the national securities exchanges . . . and the national economy."[118] However, as the size of private funds increased dramatically and their ties to the global economy became increasingly intertwined, the push for more stringent regulation increased.[119] After the collapse of Long-Term Capital Management, a study

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111. *Id.*
112. Mullins, *supra* note 1, at A4.
113. 15 U.S.C. § 80a-3(a)(1) (2009); *see* Goldstein v. S.E.C., 451 F.3d 873, 877 (D.C. Cir. 2006).
114. *Hearing*, *supra* note 89, at 5 (testimony of Andrew J. Donohue).
115. 15 U.S.C. § 80a-3(c)(1) ("Any issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities.").
116. 15 U.S.C. § 80a-3(c)(7)(A) ("[T]he outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers, and which is not making and does not at that time propose to make a public offering of such securities.").
117. 15 U.S.C § 80a-2(a)(51).
118. *See Goldstein*, 451 F.3d at 883.
119. *See Hearing*, *supra* note 89, at 3 (testimony of Richard Bookstaber).

by a group of financial regulators found three reasons why stringent regulation on private funds is necessary.[120]

First, over the five-year period between 1999 and 2004, the amount of assets controlled by private funds (measurement of relative size) grew by 260%.[121] Second, there was a growing indication that through vehicles such as pension funds, charitable organizations, and educational endowment funds, the general public was investing indirectly with greater frequency in these funds.[122] The last finding was that claims of fraud against hedge funds increased as public involvement in private funds increased.[123] The SEC found these findings, coupled with the dramatic collapse of some large hedge funds, as an indication that private funds were now capable of influencing the larger economic system and designed a rule to require greater disclosure from these private funds.[124] By altering the definition of "client" in the Investment Advisors Act, the SEC's new rule forced a substantial number, if not all, advisers to register under the act.[125]

In *Goldstein v. S.E.C.,* the hedge fund industry challenged the amendment to the rule.[126] Specifically, the industry challenged the SEC's authority as a federal agency to define a term in a statute.[127] The court found that the "reasonableness" of the SEC's definition of the term "client" did not fit within the statutory scheme of the provision.[128] The court reasoned that through the context of the statute and a subsequent amendment, the fiduciary responsibilities of the advisor was to the fund itself and not to the individual investors.[129] The fiduciary duties of the advisor did not extend to the individual investors because their interest became passive at the moment of investment; rather, the advisors investment strategy centered on the position of the fund as a whole and not to the position of each individual investor.[130]

The court found that no clear policy goal could be determined from the statute's language and therefore could not frustrate any inferred intent of limiting the exclusion to smaller funds.[131] The SEC did not appeal the D.C.

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120. *See Goldstein*, 451 F.3d at 877.
121. *Id.* at 876.
122. *Id.*
123. *Id.* ("[F]or purposes of determining the number of clients of an investment adviser under this paragraph, no shareholder, partner, or beneficial owner of a business development company . . . shall be deemed to be a client of such investment adviser unless such person is a client of such investment adviser separate and apart from his status as a shareholder, partner, or beneficial owner.").
124. *Id.* at 883.
125. *Hearing*, *supra* note 90, at 7 (testimony of Andrew J. Donohue) (testifying that around 800 fund advisors registered under the new Hedge Fund Rule).
126. *See Goldstein*, 451 F.3d at 877.
127. *Id.* at 881.
128. *Id.*
129. *Id.*
130. *Id.*
131. *Id.* at 883.

Circuit's invalidation of the Hedge Fund Rule, thus, indicating that any further attempts at regulation of the private fund industry would be a result of legislative action.[132] Congress, in the years prior to and after the *Goldstein* decision, held hearings on the subject of regulation but did not pass legislation eliminating any of the current exemptions.

C. A Once Unified Front

Although there was a strong pull towards increased regulation during the middle of the decade—especially following the *Goldstein* decision—the push for regulation took a back seat to other issues. However, with the economic downturn in early 2008, another push for system-wide financial regulation arose.[133] After evidence surfaced that retirement funds, pension plans, and university endowments had lost a substantial amount of capital because of failed investments in private funds, an increase in private fund regulation was inevitable.[134]

The difference between this movement for reform from previous reform attempts is that there is a general consensus between branches of government, partisan ideologies, and international governments that regulation is necessary partly because of the state of the domestic economy, and because of a call for regulatory reform in the international community.[135] The Obama Administration was the first to issue a full set of proposals for reforming financial regulatory systems.[136] Following these proposals, international groups such as the G-20, implemented regulatory requirements on member countries and financial firms.[137] Additionally, members of both Houses of Congress proposed legislation and the House of Representatives passed legislation that would increase regulation

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132. *Id.*

133. Perryman, *supra* note 90 ("Hedge funds were not a major contributor to the stock market crash of 2008 and 2009, but they are very likely to face increased regulation.").

134. *See generally* INTERNATIONAL FINANCIAL SERVICES LONDON, HEDGE FUNDS 2009 (April 2009), *available at* http://www.ifsl.org.uk/output/reportitem.aspx?newsID=73 (stating that on average hedge funds lost 15.7% in 2008 and a significant portion of hedge fund investment in 2009 was from institutional investors and pension funds.).

135. John Seher, *Investment Vehicles of the Ultra Draw Scrutiny*, WALL ST. J., Oct. 21, 2009, *available at* http://blogs.wsj.com/wealth/2009/10/21/investment-vehicles-of-the-ultra.

136. U.S. DEPT. OF TREAS., FINANCIAL REGULATORY REFORM: A NEW FOUNDATION 1 (2009) [hereinafter FINANCIAL REGULATORY REFORM]; *see also Obama Outlines Huge US Financial Overhaul*, SKYNEWS, June 17, 2009, http://news.sky.com/skynews/Home/World-News/Barack-Obama-Proposes-Biggest-Financial-And-Regulatory-Overhaul-Since-1930s-At-The-White-House/Article/200906315311063.

137. Simon Kennedy, Matthew Benjamin & John Rega, *G-20 Targets Hedge Funds as Leaders Near Consensus*, BLOOMBERG NEWS, March 20, 2009, http://www.bloomberg.com/apps/news?pid=20601068&sid=aPa3d0C4ewdo; *see also* Press Release, HFSB Proposes Toughening Standards and Announces New Signatories (July 1, 2009), *available at* http://www.hfsb.org/sites/10109/files/20090701_press_release_new_signatories_and_toughening_standards.pdf.

requirements for private funds.[138] This section will survey the reform proposals from the President and the pending legislation moving through Congress.

1. The New Administration

With the most severe portion of the economic decline occurring during a presidential election year, it is no surprise that the new administration entered office with a mandate to reform financial regulatory systems.[139] The notoriety of the fund collapses and scandals in 2008 and early 2009, only increased the incoming administration's position on reforming the nation's regulatory system.[140]

In July 2009, the Treasury Department unveiled the administration's proposals to reform financial regulation.[141] The proposal outlined five specific goals for overhauling the current regulatory system: (1) "Promote a Robust Supervision and Regulation of Financial Firms"; (2) "Establish Comprehensive Regulation of Financial Markets"; (3) "Protect Consumers and Investors from Financial Abuse"; (4) "Provide the Government with the Tools it Needs to Manage Financial Crises"; and (5) "Raise International Regulatory Standards and Improve International Cooperation."[142] Noting the strain some funds placed on the financial system during the market collapse, the proposal, entitled *Financial Regulatory Reform: A New Foundation*, called for registration requirements for hedge funds and other private funds as a method of reaching the administration's first goal to "Promote Robust Supervision and Regulation of Financial Firms."[143]

The Treasury department delivered two proposals to Congress that pushed the administration's goals.[144] The first proposal would influence registration requirements for private funds in a number of ways, including giving the SEC broad classification powers and rulemaking authority that the D.C. Circuit Court of Appeals denied the SEC in the *Goldstein* case.[145] Additionally, the proposed amendment to the Investment Advisors Act would include the term "private fund" in the definition of an investment company in the applicable statutes.[146] The inclusion of that term eliminates

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138. *See* discussion *infra* Part III.C.2.

139. FINANCIAL REGULATORY REFORM, *supra* note 136.

140. HEDGE FUNDS 2009, *supra* note 133, at 3 ("The Madoff investment scandal . . . has inflicted great reputational damage and reduced investor confidence in the hedge fund industry.").

141. FINANCIAL REGULATORY REFORM, *supra* note 136.

142. *Id*.

143. *Id.*

144. Private Fund Investment Advisors Registration Act of 2009, H.R. 3818, 11th Cong. § 7(a) (2009); *see generally* Investor Protection Act of 2009, H.R. 3817 § 1 (2009).

145. Private Fund Investment Advisers Registration Act of 2009, H.R. 3818, 111th Cong. § 7(a) (2009).

146. *Id.* at § 2.

section 203's exemption that most private funds used to escape classification as an investment company.[147] The proposal also limited exemptions for offshore funds to small international funds.[148] The final and most significant portion was the implication of disclosure requirements on private funds.[149] The reports and record requirements include any information "necessary or appropriate in the public interest and for . . . the assessment of systemic risk."[150] Additionally, the proposal eliminates section 210 of the Investment Act, which is a prohibition against the SEC collecting information on the identity of investors or their investments.[151]

The second proposal is the Investor Protection Act of 2009, designed to provide the SEC greater ability to enforce the requirements of the Investment Advisers Act of 1940.[152] Two significant portions of the proposed legislation are the imposition of fiduciary obligations on the investment adviser and the ability of the SEC to adopt new procedures to oversee and monitor private funds.[153] The reporting requirements mandate disclosure to the SEC. The disclosures made are confidential, but are shared with the Federal Reserve and require funds to report "the amount of assets under management, borrowings, off-balance sheet exposures, and other information necessary to assess whether the fund or fund family is so large, highly leveraged, or interconnected that it poses a threat to financial stability."[154]

However, the language of the proposal highlights the extent to which the administration wants to increase the transparency of private funds:

> For the purposes of evaluating its rules and programs and for considering, proposing, adopting, or engaging in rules or programs, the Commission is authorized to gather information, communicate with investors or other members of the public, and engage in such temporary or experimental programs as the Commission in its discretion determines is in the public

147. The Inv. Mgmt. and Private Funds Practices, *StayCurrent: Treasury Proposes Legislation for Regulation of Private Funds*, PAULHASTINGS, July 2009, at 1–2, http://www.paulhastings.com/assets/publications/1373.pdf?wt.mc_ID=1373.pdf [hereinafter *Treasury Proposes Legislation*].

148. H.R. 3818 § 2 ("'[F]oreign private fund adviser' means an investment adviser who—(A) has no place of business in the United States; (B) during the preceding twelve months has had—(i) fewer than 15 clients in the United States; and (ii) assets under management attributable to clients in the United States of less than $25,000,000.").

149. *See Treasury Proposes Legislation*, *supra* note 147.

150. H.R. 3818 § 4.

151. *Compare* 15 U.S.C. §80b-10(c) (2009) ("No provision of this subchapter shall be construed to require, or to authorize the Commission to require any investment adviser engaged in rendering investment supervisory services to disclose the identity, investments, or affairs of any client of such investment adviser . . ."), *with* H.R. 3818 § 5 ("Section 210 of the Investment Advisors Act of 1940 (15 U.S.C. 80b-10) is amended by striking subsection (c).").

152. *See generally* Investor Protection Act of 2009, H.R. 3817 § 1 (2009) (stating the purpose of the bill).

153. H.R. 3817 §§ 103, 218.

154. FINANCIAL REGULATORY REFORM, *supra* note 136, at 37–38.

> interest or for the protection of investors. The Commission may delegate to its staff some or all of the authority conferred by this subsection.[155]

If the SEC or Federal Reserve determines that the size of the fund or the fund's position potentially poses a threat to the financial stability of the economy, they may impose increased regulatory standards on the fund and the fund's advisor.[156] The administration's position on increasing regulation of these funds clearly demonstrates the momentum behind the push towards financial regulation.[157]

2. The Old Nemesis: Congressional Regulation

Through most of the economic fluctuations of the 90s and new millennium, Congress and its various subcommittees regularly discussed the possibility of increased regulation of private funds.[158] Although the amount of testimony on private fund regulation is quite significant, the amount of actual legislation introduced in the legislature prior to 2009 is limited, and neither house considered the issue fully.[159] Senator Grassley stated that before the financial crisis in 2008, "There wasn't much of an appetite for this sort of legislation . . . ."[160] However, with the significance of the economic decline and perceived mandate for the Democratic majority, Congressmen from both political parties introduced legislation early in the session.[161]

In December 2009, the House passed an amended version of the Private Fund Investment Advisers Registration Act of 2009.[162] House Financial Services committee member, Representative Mike Castle, believes the Legislature "should scrutinize money managers more carefully and begin to reclaim some order in equity markets."[163] The portion of the

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155. H.R. 3817 § 102(a).

156. FINANCIAL REGULATORY REFORM, *supra* note 136, at 37–38 ("The Federal Reserve should determine whether any of the funds or fund families meet the Tier 1 FHC criteria. If so, those funds should be supervised and regulated as Tier 1 FHCs.").

157. *See Treasury Proposes Legislation*, *supra* note 136.

158. Press Release, Senator Chuck Grassley of Iowa, *Grassley and Levin Introduce Hedge Fund Transparency Bill*, Jan. 29, 2009, http://grassley.senate.gov/news/Article.cfm?customel_dataPageID_1502=19024 [hereinafter *Grassley and Levin Introduce*].

159. *Id.*

160. *Id.*

161. *Id.*

162. Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. § 5001-11 (2009); *see also* Sean Lengell, *House Approves Major Financial Regulation Bill*, WASHINGTON TIMES, Dec. 11, 2009, http://www.washingtontimes.com/news/2009/dec/11/house-approves-sweeping-financial-package/ ("The bill passed by a vote of 223-202 with no Republicans in support. Only 27 Democrats voted against the measure.").

163. Press Release, Representative Michael E. Capuano, *Capuano, Castle Bill Would Improve Oversight of Hedge Funds Requires Money Managers to Register with SEC* Jan. 27, 2009, *available at* http://www.house.gov/capuano/news/2009/pr012709.shtml.

legislation concerning the regulation of private funds is similar to the legislation introduced by the President.[164] Although the bill also grants the SEC broad regulatory powers, it attempts to limit those powers with what appears to be exemptions for mid-sized private funds.[165] The language of the bill appears to grant the SEC the discretionary power to limit regulation and create exemptions based on its assessment of the risk level of a particular fund.[166] A clear exemption from regulation is for advisors who manage funds with less than $150 million in assets.[167] It is unclear whether the fund manager is exempt from registration if there is not a single fund in the managers fund family over $150 million.[168]

The House referred the approved bill to the Senate where it was read and referred to committee.[169] Early in the legislative session, the Senate proposed two bills: the Private Fund Transparency Act of 2009 and the Hedge Fund Transparency Act of 2009.[170] The bills would deny the exemption in the Investment Company Act and push towards greater transparency and disclosure with the SEC.[171] Additionally, the bills would place clear authority in the SEC to oversee and regulate private funds.[172] There would be an annual requirement to disclose the ownership structure of private funds; the names and addresses of any beneficial owners; the total number of limited partners, members, and investors; the required minimum investment amount; and the current amount of assets under management.[173] The Senate referred the bill to the Committee on Banking, Housing, and Urban Affairs.[174]

In July 2010, the House and Senate passed financial reform legislation.[175] In spite of lobbying efforts by private fund investors, fund advisors agreed to submit to registration requirements with federal agencies.[176] The similarities between the proposals from the Treasury, the legislation introduced in the Senate, and the Act passed in Congress, indicates that there will continue to be increased regulation of private funds

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164. *See* H.R. 4173 §§ 5001–11.

165. H.R. 4173 § 5007.

166. *Id.* ("In prescribing regulations to carry out the requirements of this section with respect to investment advisers acting as investment advisers to mid-sized private funds, the Commission shall take into account the size, governance, and investment strategy of such funds to determine whether they pose systemic risk, and shall provide for registration and examination procedures with respect to the investment advisers of such funds which reflect the level of systemic risk posed by such funds.").

167. *Id.*

168. *See Treasury Proposes Legislation*, *supra* note 135.

169. H.R. 4173.

170. Private Fund Transparency Act of 2009, S. 1276, 111th Cong. § 1(2009); Hedge Fund Transparency Act, S. 344, 111th Cong. § 1(2009).

171. S. 344; S. 1276.

172. S. 1276 § 6.

173. S. 344 § 2.

174. *Supra* note 171.

175. Dodd-Frank Wall St. Reform & Consumer Prot. Act, Pub. L. 111-203, 24 Stat. 1376 (2010).

176. Mullins, *supra* note 1, at A4.

in the future.[177] Lawmakers closed the larger exemptions in the Investment Advisors Act; however, the extent of the power lawmakers will grant government agencies still remains uncertain.[178] The increase in regulation will alter the operating and structural positions of private funds and will force individual investors to adapt to the changing financial environment.

IV. ARE THE RETURNS GONE: HOW IS THIS NEW REGULATION GOING TO AFFECT ESTATE PLANNERS?

The imposition of increasingly heightened regulatory restrictions on what is already a complicated estate planning strategy is, perceptively, the final blow to a very productive estate planning technique. It is no secret that increased regulation comes with additional compliance costs, thus lowering rates of returns on investments and securities.[179] The strongest argument against regulation has been that increased disclosure requirements will eliminate trading advantages and minimize returns for investors. In the competitive hedge fund industry, secret trading strategies and undisclosed market positions are the key to above average returns. With the imposition of strict tax requirements, which are already difficult to overcome, many fund advisors will be unwilling to open their services to estate planners. So, how can an estate planning strategy with high tax hurdles, complicated trust provisions, and now underlying assets that are likely to become less lucrative remain valid? By remembering that with private funds, exemptions are everything.

A. There's an Exemption for That

The push towards financial regulation and transparency of private funds, regardless of the political climate, is likely to occur in the future.[180] The regulatory reforms proposed by the executive and legislative branches would close the largest regulatory exemptions available to private funds.[181] The inclusion of "private funds" in the definition of an investment company is the broadest way to impose regulatory requirements on a large group of private funds.[182] Additionally, granting broad regulatory and interpretative

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177. Private Fund Investment Advisors Registrations Act of 2009, *supra* note 144.

178. Karey Wutkowski, *Real U.S. Financial Reform Out of Lawmakers Hands*, REUTERS, Jan. 6, 2010, http://www.reuters.com/article/idUSTRE6054RN20100106.

179. The Investment Mgmt. and Private Funds Practices, *StayCurrent: Hedge Fund Transparency Act*, at 3 PAULHASTINGS, July 2009, http://www.paulhastings.com/assets/publications/1188.pdf?wt.mc_ID=188.pdf.

180. *See* discussion *supra* Part III.C.

181. *Id.*

182. *Id.*

powers to governing agencies ensures that government agencies can close any remaining loopholes.[183]

However, in an attempt to close the largest regulatory exemption available to private fund managers and advisors, those writing and pushing for regulatory reform left an exemption open in the Investment Advisors Act of 1940. There is no regulatory proposal that addresses the exemption given to advisors whose clients are insurance companies.[184] If the proposed regulatory reform passes, advisors serving only insurance companies remain exempt from the new and more stringent regulatory requirements.[185]

It is arguable however, that private funds serving only insurance companies will need to submit to registration requirements according to the new definition of an investment company in the Securities Act. Section 203(b)(2) appears to exempt these funds from the increased regulation.[186] Under House Bill 4173, the relevant portion of the statute would read:

> (b) Investment advisers who need not be registered
>
> The provisions of subsection (a) of this section shall not apply to (1) any investment adviser except an investment adviser who acts as an investment adviser to any private fund; [or] (2) any investment adviser whose only clients are insurance companies.[187]

Section 203(b)(2) leaves the exemption open only to investment advisors serving insurance companies that do not advise private funds.[188] Additionally, none of the other proposals require private funds serving only insurance companies to disclose information to an overseeing regulatory agency.[189] To date, regulatory reform only grants extensive regulatory powers under the Investment Advisors Act and the Investment Company Act.[190] The Act passed by Congress carves out an exemption for funds with less than $150 million in assets under management.[191]

The natural implication of the available exemption and the exemption for small to mid-size funds is that funds servicing insurance companies will not suffer from changes to the regulatory environment of private funds; therefore, the exemption will have no negative impact on estate planners. Should the exemption hold true for estate planners, investors seeking to benefit from the tax advantages of PPLI instruments will not be met with

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183. *Id.*
184. *Id.*
185. 15 U.S.C. § 80b-3(2) (2009).
186. *See id.*
187. H.R. 4173 § 5007.
188. *See id.*
189. *See* discussion *supra* Part III.C.
190. *Id.*
191. H.R. 4173 § 5007.

the secondary costs associated with increased regulation or the possibility of significantly limiting return potential on the funds acting as the underlying asset for the policy.

1. Regulation a Boon for Private Placements

By all indications, PPLI played only a small role in the overall hedge fund industry. In 2006, it was estimated that 75–100 insurance-dedicated private funds were available to PPLI investors, controlling total assets of four to five billion.[192] Even with the clarification of tax requirements, the total amount of participation in this segment of the hedge fund market is nominal compared to the industry's overall size.[193] However, the elimination of the section 203(b)(3) exemption in the Investment Advisors Act could potentially be beneficial for investors choosing to use hedge fund interests in PPLI policies.

After the IRS took the position under the Investor Control Doctrine limiting the investable options of PPLI policies, the number of investable funds available to PPLI investors was quite small.[194] However, the increase in private fund regulation, like the clarification of tax policies, may push private funds that were once unavailable to PPLI users towards exploiting new consistencies between tax and investment regulations. While it is difficult to predict whether a large number of private funds will flock to the section 203(b)(2) exemption, the benefits to fund managers would indicate that private funds servicing the insurance companies would increase.[195] Hedge fund managers, in addition to avoiding disclosure regulations, benefit from the tax treatment to investors and the low turnover and redemption of investments.[196]

Although most funds would prefer little or no transparency requirements concerning their holding positions, on balance, it would appear that fund managers would prefer disclosure to the IRS. Disclosure imposes look through requirements entirely for ensuring diversification in the underlying investments of life insurance policies.[197] Few hedge funds would fail to meet the five-security investment requirement mandated for insurance dedicated funds.[198] The look through requirement, in comparison to the proposed transparency and regulatory efforts, seems particularly less intrusive and damaging.

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192. *See* Silverman, *supra* note 23.
193. *Id.* ("$1.23 trillion was invested in nearly 9,000 hedge funds and funds of funds.").
194. *See* discussion *supra* Part II.A.1.
195. *See* Cohen & Bortnick, *supra* note 7, at 48.
196. *Id.*
197. Treas. Reg. § 1.817-5 (2008).
198. *Id.*

Should the number of insurance dedicated funds increase as regulatory reforms invade the hedge fund industry, insurance companies and estate planners executing PPLI strategies would benefit from a bargaining position with private funds. The benefits of the bargaining position with private funds may lessen the current costs and fees associated with PPLI policies.[199] The hedge fund industry thrives on the exploitation of regulatory exemptions. Faced with impending regulatory requirements, the changes to private funds will likely play directly into the hands of estate planners and their wealthier clients.

V. CONCLUSION

With exemptions remaining for private funds servicing life insurance companies, the use of private fund interests in combination with PPLI policies is still a lucrative and viable estate planning strategy. A PPLI, as a strategy for estate planning, is a complicated strategy to execute. After stringent tax regulations, the advantages of the strategy seem to be fleeting as regulation for hedge funds appear to be inevitable. Opportunity, however, can be found in the most unlikely situation and is likely found in an exemption from a rule.

Estate planners have a myriad of tools and strategies available to address the needs and goals of their clients. In an industry with seemingly endless combinations for assets, investments, and legal avenues, changes in regulations and rules can indirectly eliminate once viable and effective strategies. Changes can also reopen strategies and plans that were once limited and inefficient. As the private fund industry adapts and attempts to maneuver around a tightening regulatory environment, a small window may lead a greater number of private funds into the planning strategies of estate planners.

by Rafael Rodriguez

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199. *See* Silverman, *supra* note 23 ("Hedge funds typically charge management fees of 2% and performance-based incentive fees of as much as 20% or more; funds of funds generally charge an extra layer of fees on top of that.").