SEWARD & KISSEL LLP

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Memorandum

Insurance Dedicated Funds

This memorandum describes the impact of a recently issued Treasury Regulation that may require the restructuring of a private investment fund into which segregated asset accounts of one or more insurance companies that issue variable life insurance contracts and variable annuity contracts (collectively, "Variable Contracts") invest.[1]

Section 817(h) of the Internal Revenue Code of 1986, as amended, provides that in order for the owner of a Variable Contract to avoid current taxation on the annual increases in the value of the Variable Contract, the investments of any account on which the Variable Contract is based must be "adequately diversified".

Treasury Regulation section 1.817-5(b)(1) provides that, in general, investments of a segregated asset account are considered adequately diversified if (i) no more than 55% of the value of the total assets of the account is represented by any one investment; (ii) no more than 70% of the value of the total assets of the account is represented by any two investments; (iii) no more than 80% of the value of the total assets of the account is represented by any three investments; and (iv) no more than 90% of the value of the total assets of the account is represented by any four investments (the "Diversification Test"). For these purposes all securities of the same issuer are treated as a single investment.

Under the "look-through rule" of Treasury Regulation section 1.817-5(f), an interest in a regulated investment company (i.e., a mutual fund), a REIT, a partnership[2] or a grantor trust is not treated as a single investment, and instead a pro rata portion of each asset of such entity is treated as an asset of the segregated asset account, if certain requirements are met (the "Look-Through Rule"). Thus, if a partnership is eligible to utilize the Look-Through Rule, a segregated asset account could invest virtually all of its assets (rather than 55% of its assets) in such partnership, provided that the partnership itself satisfies the Diversification Test.

Historically, a partnership interest that is not registered under a federal or state law regulating the offering or sale of securities qualified for the Look-Through Rule. However, earlier this year, the Internal Revenue Service (the "IRS") issued regulations that modify the applicability of the Look-Through Rule with respect to unregistered partnerships (the "New

[1] Such a fund will be referred to herein as an "Insurance Dedicated Fund".

[2] For purposes of this memorandum, all references to a partnership shall include a limited liability company treated as a partnership for Federal income tax purposes.

Regulations"). Arrangements that were in existence before March 1, 2005 must be brought into compliance with the New Regulations by **December 31, 2005**.

Under the New Regulations, in order to qualify for the Look-Through Rule, unregistered partnerships will have to meet certain requirements that are currently applicable to other investment entities, such as regulated investment companies. Specifically, with certain exceptions, (i) all the beneficial interests in the partnership must be held by insurance company segregated accounts, and (ii) public access to the partnership must be available exclusively through the purchase of a Variable Contract. Under current regulations, satisfaction of these two requirements is not prevented by reason of ownership of interests in the partnership by the manager of the partnership[3] if (i) the holding of the interests is in connection with the creation or management of the partnership, (ii) the return on such interest is computed in the same manner as the return on an interest held by a segregated asset account is computed, except for expenses attributable to Variable Contracts (the "Identical Computation Requirement"), and (iii) there is no intent to sell such interests to the public.

Since the New Regulations did not eliminate or modify the Identical Computation Requirement, it will be difficult for a typical hedge fund to qualify for the Look-Through Rule under the New Regulations. For example, the receipt of an incentive allocation by a general partner of a hedge fund seems to violate the Identical Computation Requirement since the general partner receives an allocation of profits that is disproportionate to its capital investment. Other potential problem areas include fee waivers and special allocations of profits and losses derived from "new issues" (sometimes referred to as "hot issues").[4]

It appears that an Insurance Dedicated Fund in which the fund manager receives an incentive allocation will need to be restructured in light of the New Regulations. One possibility would be to restructure the Insurance Dedicated Fund as a limited liability company (an "LLC") that retains the fund manager to manage the Insurance Dedicated Fund in a non-member capacity pursuant to an investment management contract between the manager and the LLC. Since the Insurance Dedicated Fund would be structured as an LLC, there would be no need for a general partner. Also, since the fund manager would not hold a membership interest in the LLC and would receive its compensation pursuant to an investment management contract, rather than pursuant to the terms of the LLC agreement, any incentive fee paid by the LLC to the manager should not violate the Identical Computation Requirement. As part of such restructuring, in order to reduce the risk that the IRS could recharacterize the new incentive fee as an incentive

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[3] Certain corporations related to the manager are also permitted to own interests in the partnership. However, the regulations do not explicitly permit a partnership or limited liability company related to the manager to own such interests.

[4] The IRS proposed the modification of the Look-Through Rule for unregistered partnerships in July 2003. In October 2003, Seward & Kissel submitted a comment letter regarding the proposal to the IRS and suggested, among other things, that the Identical Computation Requirement be eliminated. The IRS issued the final regulations on February 28, 2005 but did not adopt Seward & Kissel's comments (or for that matter the comments of various other tax professionals regarding this issue and other issues). The IRS indicated that it would consider the various comments it received in the event future regulations were issued. However, since the IRS has not yet issued any additional regulations regarding this issue, we believe that fund managers should now consider the need to restructure any Insurance Dedicated Funds that they manage.

allocation that violates the Identical Computation Requirement (which risk cannot be dismissed in light of the economic similarity of the fee and the allocation), it would be prudent to have the incentive fee received by an entity that is different from the entity that previously received the incentive allocation.

Even where an incentive allocation is not charged, an Insurance Dedicated Fund may need to amend its management fee arrangement to comply with the Identical Computation Requirement. For example, it is not unusual for a partnership agreement to provide that limited partners are subject to a quarterly management fee without subjecting the general partner's investment in the partnership to the same management fee. Arguably, such a fee arrangement violates the Identical Computation Requirement. Accordingly, we recommend that an Insurance Dedicated Fund that has such a fee arrangement consider amending the arrangement to provide that the general partner's investment is subject to the same management fee that is applicable to the insurance company limited partners.

We will advise you promptly if the IRS were to issue any pronouncements prior to December 31, 2005 regarding the applicability of the Look-Through Rule to unregistered investment partnerships.

If you have any questions regarding this Memorandum or wish to discuss whether your Insurance Dedicated Fund should be restructured in light of the New Regulations, please contact Daniel Murphy (212-574-1210) or Peter Pront (212-574-1221) of our Tax Group.

Seward & Kissel LLP

99188.0020 #599624