

**KIRKLAND & ELLIS**  
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November 25, 2002

Via Electronic Mail

James F. Sloan  
Director  
Financial Crimes Enforcement Network  
Department of the Treasury  
1500 Pennsylvania Avenue, NW  
Washington, D.C. 20220

Re: NPRM - Section 352 Unregistered Investment Company Regulations

Dear Mr. Sloan:

We are pleased to have this opportunity to comment on the Financial Crimes Enforcement Network's (FinCEN) notice of proposed rulemaking (RIN 1506-AA26) regarding anti-money laundering program requirements for unregistered investment companies (the "Proposing Release"). Our firm acts as legal counsel for numerous venture capital and other private investment funds, including private equity and real estate investment funds ("Private Funds"). We believe that FinCEN's proposal to exclude most Private Funds from the anti-money laundering program requirements of the USA Patriot Act is appropriate given the nature of investors in Private Funds and the illiquidity of such an investment. However, we believe that the two-year redemption standard included in the definition of "unregistered investment company" in the Proposing Release should be clarified to exclude the customary limited transfer and withdrawal rights typically available to investors in Private Funds.

1. Private Fund Investment Structure.

As noted in the Proposing Release, investments in Private Funds are long-term, illiquid investments. In a typical Private Fund, investors subscribe for capital commitments which are then "called" (i.e., drawn down) by the Private Fund's general partner or manager (the "Sponsor") over a period of several years (e.g., three to five years) as needed from time to time to fund Private Fund investments and expenses. This arrangement allows investors to maintain control of their funds until such funds are called by the Private Fund. Private Fund investments are typically made in companies which are not publicly traded and which must be held by the Private Fund for a number of years before the Private Fund realizes a return on its investment.

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Accordingly, distributions to investors in Private Funds are typically made from time to time over the duration of a Private Fund's term, which may be up to ten years or more, only when and if a Private Fund realizes a distribution from an underlying investment. Other than as set forth in Paragraph 2, Private Fund investors are generally unable to redeem all or any portion of their investment during such time.

## 2. Customary Private Fund Limited Transfer and Withdrawal Provisions.

While investors in Private Funds view their investments as long-term, illiquid investments, occasionally such investors may have a need to transfer or withdraw their investment due to unforeseen regulatory<sup>1</sup> or economic circumstances. Sponsors generally desire to accommodate such concerns and therefore typically provide limited transfer and withdrawal rights intended to address such circumstances. Additionally, Sponsors usually reserve the right to unilaterally terminate an investor's investment in a Private Fund (an "Interest") in the event that an investor defaults on its capital commitment or subjects the Private Fund to adverse regulatory treatment. Although the specific terms and provisions of any Private Fund are determined through negotiation between the Sponsor and investors, the following is a summary of the customary limited transfer and withdrawal provisions typically available in most Private Funds.

### *Transfers*

Generally, investors may not transfer their Interest without the Sponsor's consent. Investor transfer requests are reviewed on a case by case basis, and no general right of transfer is created. In some cases, investors may negotiate to provide that the Sponsor shall not unreasonably withhold its consent for a transfer request, or that the Sponsor's consent is not required for a transfer; however, in these cases, the transferee must meet various eligibility requirements with respect to securities law (e.g., transferee must be an "accredited investor" and/or a "qualified purchaser," as applicable), tax law, regulatory considerations (e.g., applicable ERISA regulations), and financial suitability. In most cases, the original investor typically continues to be liable to the Private Fund for such investor's obligations unless the Sponsor consents to the substitution of the transferee in place of the original investor. Further, the Sponsor typically may require any transfer to

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<sup>1</sup> In addition to high net worth individuals, typical investors in Private Funds include trusts, pension plans, insurance companies, private foundations, bank and other entities, which may be subject to various regulations governing such entities' investments such as the Employee Retirement Income Security Act of 1974 ("ERISA"), the Bank Holding Company Act, and the Investment Company Act of 1940.

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be supported by a legal opinion and other reasonable documentation to show compliance with the Private Fund's transfer requirements.

### *Withdrawals*

Generally, investors in Private Funds do not have any withdrawal rights. Sponsors typically make limited exceptions to permit withdrawals on a case-by-case basis for investors in violation of applicable law or policy, or subject to materially burdensome tax, law, or regulation as a result of such investor's participation in the Private Fund. Additionally, Sponsors usually have the right to unilaterally purchase an investor's Interest in the event that an investor's participation in the Private Fund subjects the Private Fund to possible adverse regulation. Withdrawals are typically consummated by a purchase of the withdrawing investor's Interest for fair market value by the Private Fund or by sale of such Interest to another investor.

### *Default Provisions*

In the event that an investor defaults on its capital commitment to a Private Fund, a Sponsor typically has a number of remedies available to cure such default, including assisting a defaulting investor to sell such investor's Interest and full or partial purchase by the Private Fund of the defaulting investor's Interest. In the case of full or partial purchase, the defaulting investor often may only receive a non-recourse promissory note as payment.

In addition to the aforementioned provisions, a Sponsor may reserve the right to assist an investor in finding a purchaser for such investor's Interest at the request of an investor, and may grant other limited transfer and withdrawal rights to individual investors in consideration of special circumstances.

### 3. Proposed Definition of "Unregistered Investment Company".

The proposed Section 103.132(a)(6)(B) set forth in the Proposing Release defines, in relevant part, an "unregistered investment company" as a company that "permits an owner to redeem his or her ownership interest within two years of the purchase of that interest." Without further clarification of what qualifies as a redemption, it is uncertain whether such definition includes the limited transfer and withdrawal provisions described in Paragraph 2. In light of FinCEN's view stated in Part II(i)(A)(B) of the Proposing Release that the two-year redemption standard included in the definition of "unregistered investment company" is intended to exclude many Private Funds due to their illiquidity and the unlikelihood that Private Funds would be

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used by money launderers, we recommend that the two-year redemption standard of proposed Section 103.132(a)(6) be clarified to exclude the customary limited transfer and withdrawal provisions described in Paragraph 2. Otherwise, many Private Funds conclude that they could be subject to treatment as an unregistered investment company under the Proposing Release contrary to FinCEN's intention.

#### 4. Private Fund Redemptions Unlike Hedge Fund Redemptions.

Whereas the two-year redemption standard of proposed Section 103.132(a)(6)(B) may be appropriate for hedge funds, since hedge fund investors often have a general and regular right of redemption (in some cases, after an initial lock-up period)<sup>2</sup> which may be used to further money laundering efforts, the limited transfer and withdrawal rights described in Paragraph 2 do not pose the same money laundering concerns due to the terms and nature of Private Fund investments. In most cases, Private Fund transfers and withdrawals may not be consummated without a Sponsor's consent, which consent may be withheld in the Sponsor's sole discretion. In the case of Private Funds which permit investors to conduct transfers without the Sponsor's consent, the investor must find a purchaser for its Interest and such purchaser must meet the eligibility requirements of the Private Fund. Further, such limited transfer and withdrawal rights are the result of negotiation between the Sponsor and investors of a Private Fund, are typically provided to address specific regulatory or economic hardship concerns, and instances of such transfers are exceedingly rare. In fact, despite such limited transfer and withdrawal rights, investors in Private Funds typically acknowledge in their subscription representations that their investment is a long-term, illiquid investment.

In addition to the distinction between Private Fund and hedge fund redemption terms, the capital commitment investment structure of Private Funds (whereby an investor's total investment in a Private Fund is called down by the Private Fund from time to time over a number of years, and not, as is the case with hedge funds, fully funded upon subscription) makes Private Fund investment and redemption an unlikely method for money laundering. In summary, the limited transfer and withdrawal provisions described in Paragraph 2, the capital commitment structure of Private Fund investments, and the illiquid nature of Private Funds' underlying portfolio investments, are unlikely to create a reliable expectation of redemption for Private Fund investors and therefore do not pose a significant money laundering risk. Accordingly, subjecting

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<sup>2</sup> The right of redemption in a hedge fund is generally the ability of an investor (often after an initial lock-up period) to demand that the fund redeem the investor's interest at net asset value for cash and/or securities, which are usually marketable securities.

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Private Funds to the anti-money laundering program requirements due to the customary limited transfer and withdrawal rights available in most Private Funds would be an unnecessary burden on both Private Funds and federal regulatory agencies in the effort to prevent money laundering.

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We thank you for this opportunity to present our comments to you regarding the Proposing Release and would welcome the opportunity to discuss our views with you in more detail. Please feel free to contact either Scott A. Moehrke (312/861-2199) or Kamran S. Bajwa (312/861-2470) with any questions you may have.

Sincerely,

Kirkland & Ellis

By: Scott A. Moehrke  
Kamran S. Bajwa