July 7, 2003

VIA E-Mail

Financial Crimes Enforcement Network
United States Department of the Treasury
P.O. Box 39
Vienna, VA 22183-1618
regcomments@fincen.treas.gov

Attention: Section 352 Investment Adviser Rule Comments

Dear Sir or Madam:

The National Venture Capital Association (NVCA)[1] is pleased to comment on the proposed rules regarding the application of Section 352 of the USA PATRIOT Act to investment advisers ("Proposed Rule" or "Adviser Rule").[2] As we have stated in previous communications with government officials from the Department of Treasury (Treasury), the Securities and Exchange Commission, the Commodities Futures Trading Commission and the Federal Reserve Board, NVCA fully supports the efforts to reduce, detect, and deter incidents of money laundering and terrorist financing by requiring financial institutions to take precautions against their occurrence. We appreciate the deliberate and open manner in which the Treasury has carried out its Patriot Act

[1] The National Venture Capital Association (NVCA) represents more than 450 venture capital and private equity firms, the vast majority of the U.S. venture industry. NVCA's mission is to foster understanding of the importance of venture capital to the vitality of the U.S. and global economies, to stimulate the flow of equity capital to emerging growth companies by representing the venture capital and private equity communities on public policy matters, to promote high professional standards, and to develop high-quality data and educational opportunities for NVCA members.

Venture funding is a major factor promoting innovation and entrepreneurial businesses. NVCA member firms manage the VC funds that provide patient capital for start-up, and developing, companies that represent the future of American business. In 2002, venture capital funds invested over twenty-one billion dollars in more than two thousand five hundred companies. Venture capital investments in 2001 and 2002 were, respectively, the third, and fifth highest investment levels in history. Eighty-four percent of these investments were in companies in communications, information technology, medical/health or life sciences. These innovative sectors, in turn, enhance our economy, our health and our standard of living. The success of venture investing encourages greater capital flow to these investments. Venture capital firms now have an estimated $250 billion under management, compared to $32 billion in 1993.

[2] Anti-Money Laundering Programs for Investment Advisers, 68 Fed. Reg. 23646 (proposed May 5, 2003) (to be codified at 31 C.F.R. pt. 103).

responsibilities regarding venture capital. NVCA continues to advise its members of their ongoing responsibilities to comply with restrictions administered by the Office of Financial Assets Control and other related restrictions and currency transaction reporting obligations.

NVCA represents venture capital firms, which manage venture capital funds. The typical VC fund is organized as a limited partnership, or a limited liability company, in which the venture capital firm serves as the general partner ("GP"). The majority of the money in the fund comes from passive, limited partner investors ("LPs") who agree to a commitment of funds for a period that exceeds seven years and ranges up to twelve years.

The vast majority of venture capital funds are organized for the purpose of making equity investments in operating companies with the goal of capital gains from successful exit events, primarily public offerings, or the merger or sale of the companies. The typical fund portfolio includes between ten and fifty "portfolio companies." A representative of the fund GP usually sits on the board of each portfolio company, overseeing and supporting the management of the company for the purpose of enhancing the value of the fund's investment. It is not unusual for this support to include assistance in recruiting key personnel, strategic business advise, CEO mentoring, assistance in building business relationships and similar activities aimed at adding to the value of the portfolio company. While it is not the preferred use of the GP's time, he or she may, at times, become involved in the day-to-day management of a portfolio company to address management continuity concerns or other critical matters. All activities of the GP are intended to enhance the long-term investment value of the fund.

Venture capital firms, generally, offer potential investors a single "product," long-term investment in a number of operating companies with returns based on the value of those investments when the companies are sold, merged or taken public. Firms differentiate the product in terms of the strategy that a given fund will pursue. A fund may be a biotechnology-focused or software-focused, for example. One fund may seek to invest in ten portfolio companies that have shown clear signs of commercial viability, and another to "seed" fifty early stage companies with an initial round of venture capital. In all cases, venture capital is inherently illiquid investing in operating companies.

In order to maintain the focus necessary to succeed, few VC firms attempt to provide any service other than management of funds invested in operating companies. GPs see investors in the VC fund as partners, not clients. Their clients are funds and the GP's real work is at the portfolio company level. As noted, this is a hands-on endeavor. Indeed, the success of a VC fund depends on skillful oversight and evaluation of operating companies, rather than on any direct investment "advice" given to the LPs.

The Application of the Proposed Rule to Venture Capital Firms

Most venture capital firms fall within the terms of the Proposed Rule, based on the broad definition of "investment adviser," in Sec.103.150(a) of the proposed Adviser Rule.

Indeed, only firms that manage relatively small funds are clearly outside the scope of the Proposed Rule.

NVCA has participated fully in the development of Patriot Act rules related to private equity. We have met with groups of federal officials and provided all information they have sought, as well as, facts that NVCA thought would be most relevant to these important rules. We believe that both the responsible federal agencies and the venture capital industry have benefited from this open dialogue. Therefore, as in the past, we offer these comments in an effort to be constructive to the broad purposes of the Patriot Act, and to our mutual goal of fostering economic growth.

Specific Comments on the Adviser Rule

NVCA's principal comment on the Proposed Rule is that application of the Adviser Rule, to venture capital firms will negate what we believe is a sound policy choice made in the proposed Section 352 Rule on Unregistered Investment Companies ("the Companies Rule").[3] The proposed Companies Rule would exempt illiquid investment funds, i.e., "companies that offer interests that are not redeemable or that are redeemable only after a lengthy holding period or 'lock-up' period…."[4]

In our comment on the Companies Rule, NVCA expressed its support for this liquidity-based exemption in the following terms.

> "The experience of venture investing, which requires long-term investor commitments, is consistent with this conclusion. In addition, NVCA agrees that the liquidity distinction made in the [Companies] Rule is appropriate to avoid 'unnecessarily burden[ing] businesses not likely to be used to launder money," and helps achieve the stated purpose of 'balanc[ing] the need for a comprehensive national program to prevent money laundering against the burdens imposed by the [Bank Secrecy Act] on businesses, including small businesses….'"[5]

Our comment letter on the Companies Rule also gave some additional reasons why we believed the decision to exempt illiquid funds was a sound policy balance between comprehensive regulation, on the one hand, and the burden on the small business capital formation on the other.[6] Therefore, we are especially concerned that the Adviser Rule proposal appears to reflect a contradictory policy choice that will negate the well-balanced policy in the Companies Rule proposal.

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[3] Anti-Money Laundering Programs for Unregistered Investment Companies, 67 Fed. Reg. 60617, 60619 (proposed Sept. 26, 2002) (to be codified at 31 C.F.R. pt. 103).

[4] *Id.* at 60618.

[5] Letter from Mark Heesen, president, NVCA to Financial Crimes Enforcement Network, Attention: NPRM – Section 352 Unregistered Investment Company Regulations at p. 2, dated November 25, 2002, (*quoting from* the Companies Rule Proposing Release, *Id.* at 60618.)

[6] Id.

We believe this apparent contradiction is inadvertent. The proposed Companies Rule reflected significant sophistication regarding the structure of private equity and the ways that venture capital funds relate to their limited partner investors. The Adviser Rule Release reflects a broader, less differentiated, approach. Given the relatively small size of venture capital compared to the many trillions of dollars under control of registered investment advisers, it is understandable that the proposal does not consider the, perhaps, unique relationship of venture capital funds to the firms that provide management for them. Therefore, NVCA is pleased to take the opportunity of this comment letter to describe the near unity between VC funds and the firms that form them and serve as general partners.

In general, from our perspective, if anti-money laundering program requirements are not warranted for most VC funds, we see no other aspect of the typical VC firm that would call for a different requirement. Stated somewhat differently, it is difficult to separate the question of money laundering risk at the fund, or "company," level from the risk at the firm, or "adviser," level. Therefore, we urge that the exception in the Companies Rule for illiquid funds be carried through to the Adviser Rule.

Explanation of NVCA Views

As noted above, a venture capital firm will be the general partner of a VC fund, its "adviser client." Many VC firms manage only one fund as general partner, and do nothing else. Over time, successful firms may form and act as the general partner in several venture capital limited partnership funds. However, in each instance, the nature of the fund client, and the GP's relationship to the fund's LP investors, will be essentially the same as with the first fund. The long-term illiquid nature of venture capital investing requires that the venture firm, acting as the fund GP, focus on the investment value of the fund's portfolio companies.

Venture capital may be unique in today's full-service, multi-product world of financial services. Most venture capitalists focus exclusively on venture capital or closely related types of private equity investing. This means, generally, that their only clients are the types of illiquid pooled investment vehicles that the Proposed Companies Rule would exempt from the requirements of Section 352. To apply Section 352's anti-money laundering program requirements to venture capital firms as investment advisers will have the same practical effect as the application of those requirements to illiquid venture capital funds. Therefore, a venture capital firm "adviser," whose only clients are funds exempt from the requirements of the Companies Rule, would nonetheless need to comply with the requirements of Section 352. This result is in conflict with the solid policy choice made in the Companies Rule regarding illiquid funds and the proper balance of our understanding of the law enforcement benefit and the regulatory burden.

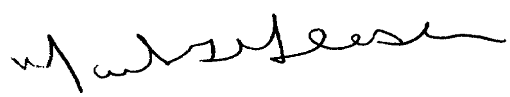
Venture capital firms are, themselves, small businesses. They must be staffed to operate for the many lean years of work needed to invest in and develop the value of portfolio companies. Therefore, even a risk-based plan, tailored to the very low risk that illiquid fund clients present, coupled with registration and examination, is a significant burden to a VC firm’s staff. Particularly, if the incremental money laundering deterrent is negligible, the burden far outweighs the regulatory benefit. Moreover, application of the Adviser Rule to these firms will require federal agencies to devote examination and registration resources to the task of regulating businesses that have been judged at negligible risk for money laundering. These results seem to contradict the obvious intent in the Companies Rule, and in other parts of the Adviser Rule, to avoid creating duplicative and unproductive compliance exercises.

Conclusion

Therefore, NVCA respectfully suggests that the sound policy choice reflected in the exemption of illiquid funds from the Companies Rule be clearly reflected in the final version of the Adviser Rule. NVCA believes that any firm, whether a registered investment adviser or not, whose clients include only funds exempt from the requirements of the Companies Rule should be exempt from the requirements of the Adviser Rule.

Please feel free to contact NVCA regulatory counsel, Brian Borders, NVCA vice president Jennifer Dowling or me, if we can render any assistance.

Sincerely yours,



Mark G. Heesen
President

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