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Via E-mail

Financial Crimes Enforcement Network (FinCEN)
United States Department of the Treasury
P.O. Box 39
Vienna, VA 22183-1618

Attn: Section 352 Investment Adviser Rule Comments

Dear Sirs or Madams:

We are writing to comment on FinCEN's proposed regulations under Section 352 of the USA Patriot Act, Public Law 107-56, with respect to anti-money laundering programs for investment advisers (the "Investment Adviser Rule"). The proposed Investment Adviser Rule, if adopted, will amend 31 C.F.R. Part 103, by adding a new Section 103.150. The proposed rule was published in the Federal Register on May 5, 2003 at pages 23646-23653.

Private Equity Experience of Testa, Hurwitz & Thibeault, LLP

Testa, Hurwitz & Thibeault, LLP has represented venture capital funds and other private equity firms for nearly thirty years. We presently represent over 300 separate venture capital fund groups. Our venture fund clients raised committed capital in excess of $45 billion during the period 2000 through 2002. We also represent a number of hedge fund and other private equity fund groups. Our venture capital and other private equity clients are located in every region of the United States, and in foreign countries including Canada, Israel and several in western Europe.

As part of our representation of venture capital and private equity fund groups, we have responsibility for drafting and negotiating with potential investors the terms of the limited partnership agreement that establishes the respective rights and obligations of the limited partner investors and the general partner, which typically is a limited partnership or limited liability company controlled by the principals of the venture capital or other private equity group. (Venture capital and other private equity funds sometimes are established as limited liability companies, but limited partnerships remain the most commonly used entity for the formation of venture capital and other private equity funds. In any event, the analysis presented below with respect to funds established as limited partnerships applies with equal force to funds established as limited liability companies.) We also represent on a regular basis corporations, foundations, universities and other institutional investors making investments as limited partners in venture capital and other private equity funds. In the course of these engagements, we have reviewed numerous limited partnership agreements relating to funds that we do not represent. Through our extensive representation of both funds and limited partner investors, we have gained what we believe is a comprehensive understanding of the structures and terms commonly found in venture capital and private equity limited partnership agreements.

Finally, we note that we have met with members of the Department of Treasury staff and others in connection with the USA Patriot Act. Specifically, on August 16, 2002, my colleague Thomas Frongillo and I met with representatives of the Investment Company study committee chaired by Mr. Charles Klingman of the Department of Treasury. This firm submitted a comment letter dated November 22, 2002 with respect to the proposed rule regarding anti-money laundering procedures to be applicable to certain unregistered investment companies, which proposed rule was published in the Federal Register on September 26, 2002 at pages 60617-60625 (the proposed "Unregistered Investment Company Rule"). More recently, I met with representatives of the Department of Treasury and the Securities and Exchange Commission on June 4, 2003 (together with representatives of the National Venture Capital Association) to discuss the proposed Investment Adviser Rule. At that time, I presented a perspective on the organizational framework of private venture capital partnerships, and in particular on what may be an unintended result of the Investment Adviser Rule given the premises and objectives of the proposed Unregistered Investment Company Rule published in September 2002. In this letter, we aim to identify and explain the potential conflicting results that we see between the Unregistered Investment Company Rule and the Investment Adviser Rule, and then to suggest a modest change to the proposed Investment Adviser Rule to resolve the issue.

Typical Structure of Private Equity Firms and Funds.

We believe that the proposed Investment Adviser Rule, as presently drafted, is broader than is necessary to accomplish its anti-money laundering objective, and that if adopted as proposed, it will contradict the carefully conceived and appropriate limitations on the scope of the proposed Unregistered Investment Company Rule. This potential conflict can best be appreciated in the context of a full understanding of the typical structure of private equity firms and funds.

When the principals of a private equity group take steps to raise a fund, they typically establish a limited partnership to serve as the fund (the "Fund"). The limited partnership structure is chosen principally for two features that are essential to the investors: (1) pass-through tax treatment *(i.e.*, no taxation at the fund level and preservation of capital gains tax treatment) and (2) limited liability of the investors/limited partners. In the typical fund structure, the fund will have a single general partner (the "Fund GP") and multiple limited partners – typically private or public pension plans, foundations, corporations, university endowments, and/or wealthy individuals – who invest the capital. While there can be variations in the structure of the Fund GP, the Fund GP usually is itself a limited partnership or a limited liability company (owing to same considerations of pass-through tax treatment and limited liability), with the principals serving as general partners or managing members, as the case may be, of the Fund GP. Whether a limited partnership or a limited liability company, however, the Fund GP is established solely for purposes of serving as the general partner of the Fund – i.e., to make investment decisions with respect to that dedicated pool of capital.

The Fund's limited partnership agreement establishes the relative rights and responsibilities of the parties, as well as the economic relationship between the investors and the principals. Key among the provisions in such an agreement are those that provide for the overall control that the Fund GP maintains over the investment and disposition activities of the Fund. The Fund's limited partnership agreement in addition will address how the profits attributable to the Fund's investments will be allocated and distributed among the limited partners on the one hand, and the Fund GP on the other hand.

Notwithstanding these economic arrangements between the Fund and the Fund GP, it remains that both entities serve as investment vehicles only and not as operating businesses. In the typical case, neither the Fund nor the Fund GP has any employees or leases any office space. The Fund's limited partnership agreement typically will require that the Fund enter into a management agreement with a management company (often owned by the principals of the Fund GP), pursuant to which the management company will provide research, advisory, due diligence and administrative services to the Fund in exchange for a fee. In most cases, for example, the management company is the lessee of the office space out of which the private equity group operates, and is the employer of the principals and the persons they employ to assist them to pursue their private equity business, such as financial analysts, internal finance and accounting staff, and administrative staff. That being said, private equity firms frequently are leanly staffed. It is not uncommon for the management company of a private equity group that manages hundreds of millions of dollars to have a dozen or fewer employees, including the principals themselves.

Two additional features of a typical private equity Fund are limited term and lack of liquidity for investors. A typical Fund will have a term of approximately 10-12 years. The early years of the Fund's term are called the "investment period," during with the principals seek to identify promising investment opportunities for the Fund and invest the Fund's capital in "portfolio" investments, typically illiquid securities of private operating companies. In venture capital investing, the Fund often will make multiple investments in series of financing "rounds" that the portfolio company completes, often spanning over several years. In the later years of the Fund's term, it is hoped that there will "exit" opportunities (e.g., sale of the company or initial public offering of stock) for the Fund's portfolio investments made years earlier. As a general rule, a limited partner investor will have no liquidity with respect to its investment in a Fund unless and until these "exits" arise.

From the perspective of the principals of the Fund GP, the investment period is the most time and labor intensive. As the Fund completes the investment of the capital that was raised from its limited partner investors, the principals sometimes will turn their attention and energies in part toward raising another Fund. It is not uncommon, particularly for a venture capital or other private equity group that has established an impressive track record, to raise additional pools of capital and thus have two or more Funds active at the same time -- albeit at different stages in their 10-12 year life span. Each of these Funds will be a distinct legal entity, often will be serially named (*e.g.*, XYZ Fund, L.P.; XYZ Fund II, L.P.; XYZ Fund III, L.P., and so forth) and each may have a large number of identical limited partner investors. In addition, a new Fund GP will be established for each successive Fund (*e.g.*, XYZ Partners, LLC; XYZ Partners II, LLC; XYZ Partners III, LLC, and so forth). A new Fund GP is necessary to reflect the changing economics and personnel among the principals -- due to differing roles and responsibilities, retirement of principals, the addition of principals needed to manage larger pools of capital, or other factors. Still, none of these additional Funds or Fund GPs will have employees or dedicated administrative staff. Instead, the private equity group's single management company will typically serve as the management company for each of the successive funds. A schematic chart showing the structural outline of a multiple partnership "family" of Funds is attached as an Appendix to this letter.

Legal Status of the Various Entities

Under Section 3(a)(1) of the Investment Company Act of 1940, as amended (the "Investment Company Act"), an "investment company" is any issuer that "[i]s or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities." A private equity Fund plainly falls within that broad definition of "investment company." The typical Fund, however, is not required to register under the Investment Company Act, owing generally to the exclusions provided in Sections 3(c)(1) and 3(c)(7) of the Investment Company Act. These exclusions are discussed in the release accompanying the proposed Unregistered Investment Company Rule.

Under Section 202(a)(11) of the Investment Advisers Act of 1940 ("Advisers Act"), an "investment adviser" is, subject to certain exclusions, "any person who, for compensation, engages in the business of advising others . . . as to the value of securities or as to the advisability of investing in, purchasing, or selling securities . . . ." In light of the decision-making and investment control exercised with respect to a Fund, a Fund GP may be considered to be an "investment adviser" within that definition. (It is less likely that a management company would fall within this definition due to the limited scope of services that it provides to each Fund with which it has a management agreement.) The typical Fund GP, is generally not required to register as an investment adviser under the Advisers Act, however, because Section 203(b)(3) of the Advisers Act provides that advisers that have fewer than 15 clients and do not hold themselves out generally to the public as investment advisers are exempt from the registration requirement. Under applicable SEC rules, a Fund is generally regarded as a single client no matter how many limited partner investors it might have. See Investment Advisers Act Rule 203(b)(3)-1. While there are some Fund GPs which, due to their investment policies or limited partner constituencies, are themselves (or have as their members) registered investment advisers, most Fund GPs (including each Fund GP within a multiple Fund organization) would be considered as "unregistered investment advisers" under the Investment Advisers Rule.

The Unregistered Investment Company Rule

In the release accompanying the proposed Unregistered Investment Company Rule, FinCEN correctly concluded that venture capital and private equity funds are "illiquid companies" that "are not likely to be used by money launderers." 67 Fed. Reg. at 60619. FinCEN consequently crafted a definition of "unregistered investment company" that will exempt most venture capital and other private equity funds from the burden and expense of implementing anti-money laundering programs (so long as such funds does not permit "an owner to redeem his or her ownership interest within two years of the purchase of that interest"). The release accompanying the proposed Unregistered Investment Company Rule observes that the "redeemability" limitation incorporated into the "unregistered investment company" definition "is likely to exclude . . . many private equity and venture capital funds." 67 Fed. Reg. at 60619. We believe that the proposed Unregistered Investment Company Rule anti-money laundering regulations reflect a principled and common sense conclusion by FinCEN that anti-money laundering regulations should not be applied to persons or entities that are unlikely to be used by or involved in dealings with money launders.[1]

The Unintended Results of the Investment Adviser Rule and a Proposed Resolution

We respectfully suggest that the proposed Investment Adviser Rule creates certain unintended results so as to potentially conflict with the stated intent of the proposed Unregistered Investment Company Rule.

In the proposed Unregistered Investment Company Rule, FinCEN took pains to exclude typical venture capital and private equity firms from anti-money laundering requirements based on FinCEN's conclusion that venture capital and private equity funds are "illiquid companies" that "are not likely to be used by money launderers." However, the proposed Investment Adviser Rule, as currently drafted, applies to broadly to *all* registered investment advisers and *all* unregistered advisers that have $30 million or more under management, even if those investment advisers (namely, venture capital and private equity management companies) provide services exclusively to investment funds that themselves are excluded from the coverage of the proposed Investment Company Rule because they (the Funds) are illiquid companies that are not likely to

[1] We submitted a comment letter to the proposed Unregistered Investment Company Rule based on our concern that the language of the proposed "redeemability requirement" contained in that proposed rule might not conclusively exclude from the "unregistered investment company" definition many venture capital and private equity funds that FinCEN seemingly intends to place outside the coverage of the anti-money laundering program regulations. We pointed out that in many venture capital and other private equity fund limited partnership agreements, the general prohibition on a limited partner investor's right to withdraw capital frequently is subject to one or more narrowly-tailored exceptions. These exceptions are typically designed to enable the fund and certain types of its limited partner investors to ensure that they comply with applicable regulatory requirements, or to avoid certain adverse and unexpected legal and tax consequences. We suggested certain potential revisions to the draft language that we believe will eliminate any ambiguity and make unmistakably clear that venture capital and private equity funds will be outside of the coverage of the proposed rule, notwithstanding that their limited partnership agreements might permit redemptions to be effected within two years of purchase, based on the material likelihood that such redemption is necessary to maintain compliance with applicable statutes, rules, regulations, rulings or orders, or to avoid adverse changes in the owner's legal, regulatory or tax status or position that may occur as a consequence of circumstances outside of such owner's control.

be used by money launders. Accordingly, if applied to the typical multiple-Fund structure, the Investment Adviser Rule would require each Fund GP (and perhaps even the management company) to adopt a full anti-money laundering program, regardless of the nature of the "clients" of such Fund GP.

In the proposed Investment Adviser Rule, the drafters seemingly attempted to avoid duplicative or otherwise unnecessary regulation where possible. We note, for example, the provision stating that the covered investment adviser "may exclude from its anti-money laundering program any pooled investment vehicle it advises that is subject to an anti-money laundering program requirement under another provision of this subpart." We believe that this exclusion is entirely appropriate, but we also believe that "flip-side" of that principle should be given equal force and effect. If an investment adviser provides services solely to one or more pooled investment vehicles that are expressly *excluded* from anti-money laundering requirements, then that investment adviser should similarly be excluded from the requirement to develop and implement an anti-money laundering program.

To implement this proposed change, we recommend that a subsection (3) be added to the proposed text of Section 103.150(b), as follows:

> (3) Notwithstanding the foregoing, an investment adviser otherwise required by this Section 103.150 to develop and implement an anti-money laundering program shall have no such obligations hereunder if each of the clients to whom such investment adviser provides investment advisory services is a company that would be deemed an "unregistered investment company" under Section 103.132 of Part 103, but is otherwise excluded from such definition due to the provisions of Sections 103.132(a)(6)(i)(B), (C) or (D).

We believe that this proposed change will harmonize the proposed Investment Adviser Rule with the proposed Unregistered Investment Company Rule without impairing the effectiveness of either rule. In addition, we believe that such a change will strike the appropriate balance between ensuring that would-be money launderers are not able to utilize venture capital and private equity funds as vehicles for illicit investments of cash, and ensuring that Funds and Fund GPs are excepted from the unnecessary burdens of establishing anti-money laundering programs.

We appreciate your consideration of our comments on the proposed Investment Adviser Rule. We would be happy to answer any questions that you may have or to supply you with additional information that you might request. Please feel free to contact me at (617) 248-7562.

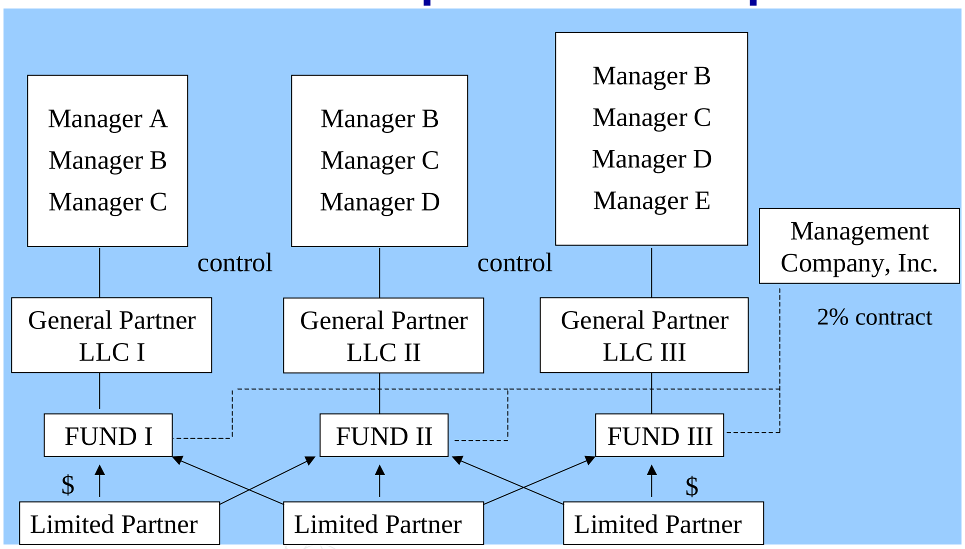
Very truly yours,

/s/ Howard S. Rosenblum

Howard S. Rosenblum

cc: Ms. Jennifer C. Dowling (NVCA)
Brian Borders, Esq.

Organizational Framework - Multiple Venture Capital Partnerships



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