NVCA

National Venture Capital Association

November 25, 2002

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: NPRM – Section 352 Unregistered Investment Company Regulations

Dear Sir or Madam:

The National Venture Capital Association (NVCA)* is pleased to comment on the proposed rules regarding the application of Section 352 of the USA PATRIOT Act to unregistered investment companies (Proposed Rule). NVCA appreciates the opportunities that the Department of Treasury (Treasury) has afforded it to discuss these important issues. NVCA fully supports the efforts of Treasury to reduce, detect, and deter incidents of money laundering and terrorist financing by requiring financial institutions to take the necessary precautions to avoid their occurrence. To this end, NVCA has advised, and will continue to advise, its members of their ongoing federal responsibilities, including compliance with restrictions administered by the Office of Financial Assets Control and other related restrictions, currency transaction reporting obligations, and the option of voluntary suspicious transaction reporting.

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* The National Venture Capital Association (NVCA) represents more than 450 venture capital and private equity firms. NVCA's mission is to foster the 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 public policy interests of the venture capital and private equity communities at all levels of government, to maintain high professional standards, and to provide research data and professional development for its members.

Venture funding is a major factor in promoting innovation and entrepreneurial businesses. In 2001, venture capital funds invested $41 billion in 3,000 companies. Eighty-five percent of these companies were in information technology, medical/health or life sciences. The success of venture investing is encouraging greater capital flow to these investments. While venture capital investing has fallen off over the past two years from its high in 2000, venture capitalists continue to invest in 2002 and will likely invest in the fourth largest amount ever in the history of venture capital this year. Venture capital firms now have an estimated $265 billion under management, up from $30 billion in 1990.

Scope of Proposed Unregistered Investment Company Rule.
NVCA supports the way in which Treasury defines the scope of the Proposed Rule according to a liquidity distinction based on the duration of a particular investment commitment, as outlined in the Supplemental Information of the Notice of Proposed Rulemaking (Notice), *i.e.*, that "companies that offer interests that are not redeemable or that are redeemable only after a lengthy holding period or 'lock-up' period lack the liquidity that makes certain financial institutions attractive to money launderers…."[1] 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 Proposed 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."[2]

Moreover, NVCA believes that exempting investment funds that do not give an investor a right to redeem within two-years from the anti-money laundering ("AML") program requirements is a fair liquidity-based distinction. From a venture investment perspective, we believe that the two-year lock-up is adequate, particularly in light of a number of other aspects inherent in such investments that make them unattractive for money laundering.[3] Specifically, in addition to the impediment that lock-ups present to the use of venture investing for "layering" purposes, venture capital investing typically does not afford an investor the opportunity to place a large amount of money at the time of the initial investment commitment. Therefore, consistent with the rationale for exempting companies with less than $1,000,000 in assets, venture investing "lack[s] the capacity to absorb significant amounts of illegal proceeds" at the time of the initial commitment.[4]

The Need for Clarification of the Liquidity Exemption.

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[1] 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).

[2] *Id*. at 60618.

[3] As the Notice says, the long-term and illiquid nature of venture capital investments are inconsistent with the objectives of money launderers and terrorist financiers. Second, given the limited investor base of venture capital investments, the secondary market for these investments is small and inefficient resulting in significant discounts of values. Liquidation, redemption and resale are generally not possible, and in the extremely limited cases where they are possible, such transfers are either subject to particular circumstances, or are at the sole and independent discretion of the managing partner or member.

[4] 67 Fed. Reg. at 60619, n.21. Venture investing requires investors to contribute the funds they commit to invest in stages in response to periodic capital calls. The fund manager, not the investor, determines both the amount and timing of the transfer of funds. This structure prevents a money launderer from placing a large investment quickly. Thus, one interested in layering would find the inability to quickly place a large amount of funds in a venture fund an additional disincentive to the use of venture capital.

While NVCA supports the liquidity-based exception contained in Section 103.132(a)(6)(i)(B) ("the exception"), we fear that the exception, as currently drafted, is not clear enough to accomplish the purpose of avoiding undue regulatory burdens on businesses that are unlikely to be used to launder money. We have encouraged our members to evaluate, in consultation with their legal counsel, whether the rule, as proposed, provides sufficient clarity to conclude that their funds are not covered. We find that the exception needs further specificity in order to legal certainty for many venture capital funds that Treasury seemingly intends to place outside the coverage of the Proposed Rule. This is because, while the "*right* to redeem" language used in the Supplemental Information section of the Notice has a clear legal meaning, the "*permits* an owner to redeem" language used in the actual proposed rule text creates uncertainty. This uncertainty is particularly troubling in the face of the severe consequences of failure to fully comply with Section 352.

We are mindful that Treasury needs to ensure that an exception does not swallows the rule. However, in light of the appropriately cautious counsel our members are receiving and the potential sanctions under the Bank Secrecy Act, we request that Treasury provide greater clarity in the liquidity exception. Accordingly, we submit the following recommended revisions to the Proposed Rule.

Suggested Revisions to the Proposed Rule.

One purpose of the rule, as stated in the Notice, is to exempt funds that impose a two-year investment lock-up from the requirement to implement an AML program under Section 352 of the USA PATRIOT Act. The exception recognizes that such investments funds are "not likely to be used to launder money."[5] It is a fact that such inherently illiquid investments, like venture capital funds, typically provide for an investor's withdrawal from the fund under circumstances such as those described below. This withdrawal can include a fund buy-back, as a last resort. As explained below, such highly circumstantial buy-backs should not be regulated as though they granted rights to redeem within two years of an investment.

We believe that either rule language can be amended or formally interpreted to accommodate situations where, based on the fund manager's determination of the best interests of the fund, an investor will be "redeemed out" of the fund by return of its pro-rata share of the investment fund.

Such redemption contingencies can arise from a number of circumstances. A majority of venture funds come from highly-regulated sources, such as pension funds, insurance companies, financial institutions, tax-exempt entities like college endowments, and tax-sensitive foreign investors. In certain circumstances, these investors fund may need to be redeemed out in order to avoid collateral consequences from the unexpected operation of an existing law or regulation, or the enactment of a new law or regulation. These consequences can impact the fund, the investor

[5] 67 Fed. Reg. at 60618.

or both. For example, venture funds are established on the assumption that they are exempt from the myriad requirements of the Employee Retirement Income Security Act (ERISA). However, a number of ERISA plan investors in a particular venture fund could, in the aggregate, cause the venture fund assets to constitute "plan assets" under ERISA, thus subjecting the fund to the burdensome provisions of ERISA. In these rare circumstances, it is necessary that the investor and the fund have the ability to "redeem out" all, or part of, an investment in order to avoid noncompliance with ERISA. This, of course, is method of last resort. However, many venture investments agreements contemplate actual buy-back of investor interests as one of the ways in which to avoid ERISA consequences.

Similar contingencies can affect either the venture capital fund or investors in the fund due to legal obligations of other highly-regulated investors, such as insurance companies, banks and non-ERISA pension funds. For example, the laws governing state pension funds usually restrict their investments in venture capital and other illiquid investments. Changes in a pension fund can place it in violation of such laws, making it mandatory for the investor to be "redeemed out" of all or a portion of its venture investments.

Likewise, laws and regulations governing insurance companies, banks, or non-profit foundations could change, and such a change similarly may necessitate a reduction of or exit from venture investments. For example, under merchant banking rules, a bank investor could be required to drastically increase its capital reserves if a venture investment causes the bank to exceed certain limits on merchant banking activity. A reduction in the venture investment is the only logical choice.

Changes in tax status can also result from the types of investments certain investors make. Endowments, foreign entities and other tax-sensitive investors need the opportunity to be redeemed out if continued investment would result in a change in tax status of other serious tax consequences.

Accordingly, in order to accept investments from insurance companies, banks and state pension funds, venture capital funds need the ability to "redeem out" investors under some circumstances and, in order to make venture investments, many investors require these types of circumstantial redemption rights.

While these terms do not constitute an absolute "right" to redeem since they require the occurrence of an unexpected set of facts, they could arguably be seen as terms that "permit" an owner to redeem. For these reasons, NVCA proposes some form of clarification along the lines of the alternatives set forth below.

Alternative 1: *Defining the term "redeem".*

One helpful way to clarify the rule would be to define the term "redeem" in terms of the types of transactions that are not "redemptions" for the purpose of the rule. For example,

> "The term 'redeem' does not include return of any portion of an investor's pro-rata interest, where the maintenance of the investor's interest would: (1) place either the fund or the investor in violation of law; (2) subject the fund or the investor to any or additional contractually specified new legal obligation, e.g., additional ERISA regulation; (3) change the tax status or tax jurisdiction of either the investor or the fund; or (4) be necessary to maintain compliance with applicable statutes, rules, regulations, rulings, or orders."

Alternative 2: *Modify the rule text.*

The Proposed Rule text could be harmonized with the intention of the Proposed Rule: to include "only those companies that give an investor a *right to redeem* any portion of his or her ownership interest within two years after that interest was purchased."[6] This approach addresses the risk that an official, or a court, could read the term "permits" as encompassing provisions that are meant to provide for resolution of untenable situations, which contracts often anticipate notwithstanding the fact that they are unlikely to occur. Such provisions are distinct from ones that confer unconditional rights to redeem shares on demand. Specifically, this could be addressed by revision such as:

> replace the term "permits an owner to" in the section 103.132(a)(6)(i)(B) of Proposed Rule text with "confers a right to" as used in the Notice to reflect the unconditional affirmative nature of a right conferred by contract.

To further clarify the point, the final rule should include language that further defines the meaning of the term "redeem" consistent with the suggested definition set forth above.

I hope that NVCA can assist you in your efforts to ensure that the Proposed Rule effectively addresses the threat of money laundering and avoids undue burdens. Again, NVCA would like to extend its thanks for the opportunity to participate in this rulemaking process. I reiterate our support for Treasury's efforts to an effective national anti-money laundering program.

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

Sincerely yours,

Mark G. Heesen
President

[6] 67 Fed. Reg. at 60619 (emphasis added).