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Why the SEC (and Congress) Should Recognize the 3(c)(1) Plus Exemption

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Introduction

In a no-action letter dated July 9, 2008[1] ("Townsend No-Action Letter"), the Commission declined granting no action relief to The Townsend Group, Inc. ("Townsend") regarding the possibility of combining the Section 3(c)(1) exemption under the Investment Company Act of 1940 ("Investment Company Act") and the Section 3(c)(7) exemption under the Investment Company Act into a Section 3(c)(1) plus exemption ("3(c)(1) Plus Exemption"). Under the hypothetical 3(c)(1) Plus Exemption, two core private equity funds managed by Townsend, one of which was eligible for an exemption under Section 3(c)(1) and the other of which was eligible for an exemption under Section 3(c)(7), would have been combined into a single Section 3(c)(1) exempt fund ("3(c)(1) Plus Fund"). The hypothetical 3(c)(1) Plus Fund would have been limited to no more than 100 non-qualified purchaser "accredited investor"

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beneficial owners and an unlimited number of qualified purchaser beneficial owners, and would have effectively allowed parallel funds to operate as a single legal entity. The nature and quantity of beneficial owners in the 3(c)(1) Plus Fund would have been exactly the same as in parallel 3(c)(1) and 3(c)(7) exempt funds.

Under the present state of the law, funds must either rely upon Section 3(c)(1) or Section 3(c)(7) in order to obtain an exemption from the provisions of the Investment Company Act.[2] Section 3(c)(1) provides an exemption to funds that have not more than 100 accredited investors, while Section 3(c)(7) provides an exemption to funds that consist solely of "qualified purchasers." Both Section 3(c)(1) and Section 3(c)(7) funds must be offered and sold in valid private placements under Rule 506 promulgated under Regulation D of the Securities Act of 1933 ("Securities Act").

In order to satisfy the current interpretation that Section 3(c)(1) and Section 3(c)(7) cannot be combined, funds seeking exemption under the Investment Company Act have three basic options: (i) to operate as parallel Section 3(c)(1) and Section 3(c)(7) exempt funds, (ii) to start operations as a Section 3(c)(1) exempt fund and subsequently convert to a Section 3(c)(7) exempt fund when the fund has reached a certain capital threshold (and is approaching over 100 beneficial owners) or (iii) to commence operations as a Section 3(c)(7) exempt fund and exclude non-qualified purchasers. If a fund chooses to operate as parallel funds, duplicative administrative costs and expenses are incurred and, typically, the Section 3(c)(1) investors disproportionately bear their share of fund expenses. If a fund has elected to start operations as a Section 3(c)(1) exempt fund, Section 3(c)(1) "accredited investors" have in many cases subsequently been redeemed and frozen out of the fund once the fund is in a position to become a Section 3(c)(7) exempt fund (because it is attracting larger blocks of capital from larger, more institutional investors). Alternatively, in certain cases Section 3(c)(1) "accredited investors" are excluded from funds from the start because such funds do not want the administrative burden of maintaining a separate fund with comparatively low capitalization.

If a fund desires to admit Section 3(c)(1) "accredited investors" and "qualified purchasers" into one fund, Section 3(c)(7)(E) permits parallel Section 3(c)(1) and Section 3(c)(7) fund structuring, without requiring integration[3] and destroying the availability of either Section 3(c)(1) or Section 3(c)(7). Because of Section 3(c)(7)(E), Townsend was allowed to have two parallel Section 3(c)(1) and Section 3(c)(7) funds that had essentially the same investment objectives, overlapping investment portfolios and substantially similar risk/return characteristics.

In denying Townsend's request, the Commission relied in part on their rejection in 1992 of a similar – although different – proposal.[4] In its publication, *Protecting Investors*, the SEC chose not to recommend a mechanism that would exclude "sophisticated investors" from the 100 investor limit in 3(c)(1) funds. The SEC explained that "the 100 investor limit in the current private investment company exception reasonably reflects the point at which federal regulatory concerns are raised if any unsophisticated investors are involved."[5] We agree that during that time, not only was that statement correct but passing 3(c)(7) appeared to be the best solution available. But as the private equity and hedge fund world has grown up in the past 15 years, it does not provide a reasoned response why permitting an unlimited number of 3(c)(7) "qualified purchasers" into a 3(c)(1) "accredited investor" fund would not be an acceptable next step in the evolution of Investment Company Act exemptive relief.

Townsend desired to combine the parallel core funds into the hypothetical 3(c)(1) Plus Fund due to the fact that combining parallel funds would allow the funds to achieve significant administrative and cost savings. In particular, smaller "accredited investor" beneficial owners in Section 3(c)(1) exempt funds would have benefited from such administrative and cost savings due to the fact that such costs in the combined Section 3(c)(1) Plus Fund would have been mostly absorbed by the larger "qualified purchaser" beneficial owners. If the two funds were combined, costs for both sets of investors were projected to go down, due to economy of scale, but the reduction for the 3(c)(1) investors was especially profound. Investors in Townsend's Section 3(c)(1) exempt fund were projected to save nearly two thirds of their current fund costs. The SEC concluded that it could not assure Townsend that it would not recommend enforcement. It should be noted that the SEC did not conclude that permitting a Section 3(c)(1) Plus fund is a bad idea. Rather, given that the SEC chose not to recommend excluding "sophisticated investors" from the 100 investor limit in 3(c)(1) funds in *Protecting Investors*,[6] it is possible that the SEC views the requested no-action assurance as beyond their interpretive purview. For this reason, we would urge Congress to consider its adoption, either as part of the Hedge Fund Transparency Act or on a stand-alone basis.

Part I of this Article summarizes Townsend's arguments in favor of the Section 3(c)(1) Plus Exemption. Part II evaluates the Commission's denial of Townsend's proposed position. Part III provides suggestions regarding the future of the 3(c)(1) Plus Exemption.

I. Townsend's Arguments In Favor of the 3(c)(1) Plus Exemption

Townsend presented several arguments for why the hypothetical 3(c)(1) Plus Fund should be granted no-action relief. Below, we present these arguments.

(a) The Policy of Section 3(c)(7) and Changes to the Fund Market Since NSMIA

The major policy goals behind Section 3(c)(7) were (i) to enhance capital raising, and (ii) to preserve investor protection.[7] H.R. Report No. 104-622 noted, with respect to the bill that established the "qualified purchaser" exemption, that "[t]he Committee on Commerce, to whom was referred the bill (H.R. 3005) to amend the Federal securities laws in order to promote efficiency and capital formation in the financial markets, and to amend the Investment Company Act of 1940 to … protect investors, and provide more effective and less burdensome regulation, having considered the same, report favorably thereon with an amendment and recommend that the bill as amended do pass."[8] The policy in H.R. Report No. 104-622 is particularly important because it was the House bill that was passed.[9]

Although the broad policy goals of Section 3(c)(7) may have supported the 3(c)(1) Plus Exemption, Townsend acknowledged that the legislative history of Section 3(c)(7) reflected an intention that blending Section 3(c)(1) and Section 3(c)(7) could potentially allow larger "qualified purchasers" to oppress smaller fund owners, even though the 3(c)(1) Plus Fund could give rise to no additional economic issues as the parallel core funds operated effectively as one fund. Prior to the enactment of Section 3(c)(7), the ABA Task Force on Hedge Funds noted in a report the fear that commingling funds will result "in the enrichment of sophisticated investors at the expense of their less sophisticated counterparts."[10] However, the ABA Task Force on Hedge Funds also noted that there did "not appear to be any evidence" for such a phenomenon.[11] Likewise, in 1992 the SEC stated that commingling funds would result in "risks for the financially unsophisticated," without citing any evidence to support such a result.[12]

Addressing these concerns, Townsend noted that in 1996, the average private investment partnership was approximately $25 to $55 million.[13] Six years later, a 2002 study noted that "nineteen funds in 2000 alone exceeded the entire investments of the venture capital industry in 1994, 1995 and 1996 combined."[14] By comparison, the hedge fund industry at the time of the Townsend No-Action Letter alone was estimated to be a $2 trillion industry with approximately 10,000 active funds.[15] With respect to private equity buy-out funds, in 2006 the ten largest such funds raised $101 billion,[16] reflecting an average among the ten largest private equity buy-out funds of approximately $10 billion per fund. In today's market, investment funds are larger by an order of magnitude. It is common for investors in Section 3(c)(7) funds to invest amounts ranging from $1 million to several hundred million dollars. As a result, the relative size disparity in 1996 between "qualified purchaser" investors and non-qualified purchaser investors is dwarfed by the size disparity between "qualified purchaser" investors in today's Section 3(c)(7) funds.[17] There have been no systemic complaints that smaller "qualified purchaser" investors have been oppressed by the larger "qualified purchasers." The fact that now larger and smaller "qualified purchasers" exist side by side without oppression further cuts against the SEC's unfounded belief that mixing larger and smaller investors "implicate[s] the public interest."[18] Considering this, Townsend did not believe that the size disparity between "qualified purchaser" investors and non-qualified purchaser investors would provide a basis for oppression in the event the two invested in a single fund.[19]

Townsend also noted that since the National Securities Markets Improvement Act of 1996, Section 3(c)(1) "accredited investors" have often either been forced to disproportionately bear fund expenses or be systematically excluded from funds. Townsend argued that this current practice – requiring a fixed differentiation between 3(c)(1) funds and 3(c)(7) funds – runs counter to the capital raising policy goals of the Investment Company Act, does not promote investor protection and is not required under the language of the statute.

(b) Section 4(1½) under the Securities Act as Extrinsic Evidence in Favor of the 3(c)(1) Plus Exemption

Section 4(1½) under the Securities Act is a hybrid exemption much like the hypothetical 3(c)(1) Plus Exemption. Section 4(1) of the Securities Act exempts transactions by any person other than an issuer, underwriter or dealer. Section 4(2) of the Securities Act exempts transactions by an issuer not involving any public offering. The reason for the Section 4(1½) exemption arose because by the plain meaning of Section 4(2), non-issuer transactions could not qualify for private placements. Section 4(1½) addressed this problem by providing that non-issuer transactions would be deemed to be transactions that were not "underwriting" within the meaning of Section 4(1), provided that such transactions satisfied Section 4(2) type private placement-like criteria.

The Commission expressly acknowledged the Section 4(1 ½) Exemption for the first time in Employee Benefit Plans Release No. 6188.[20] Prior to such acknowledgment, the SEC, in no-action letters and other pronouncements, frequently required that such resales meet at least some of the established criteria for exemptions under both Section 4(1) and Section 4(2).[21] Townsend accordingly argued that the Commission had the power to grant no-action relief with respect to the 3(c)(1) Plus Exemption.

Townsend asserted that the Section 4(1½) exemption was founded upon (A) the view that not allowing the Section 4(1½) exemption would have been an unnecessary burden and of little practical benefit to investors;[22] (B) the view that there is no meaningful difference between issuer and non-issuer transactions that meet all of the criteria for the Section 4(2) private offering exemption[23] (and by extension, on the view that where the purpose of a securities act is to regulate "public" matters as opposed to "private" matters, a hybrid exemption should apply where the hybrid exemption would effectively satisfy all "private" criteria) and; (C) the view that the Section 4(1½) exemption, although not specifically provided for in the Securities Act, was clearly within its intended purpose.[24]

Townsend analogized that satisfying these essential conditions for a hybrid private securities exemption justified not seeking enforcement against a 3(c)(1) Plus Fund (even if such a fund was not specifically authorized). Townsend argued that not allowing the 3(c)(1) Plus Exemption to exist resulted in material economic drag imposed on 3(c)(1) exempt fund "accredited investors." Second, Townsend noted that the private criteria for Section 3(c)(1) and Section 3(c)(7) were each individually satisfied. Third, Townsend noted that the 3(c)(1) Plus Exemption would fall within the intended purposes of the Investment Company Act by promoting capital raising and benefiting investors without derogating any of the protections investors currently enjoy. Besides, Section 3(c)(7)(E) functionally allows a 3(c)(1) Plus Fund now (by permitting parallel funds), just at significant added expense.

(c) The Investment Company Act as a Whole as Extrinsic Evidence in Favor of the 3(c)(1) Plus Exemption

Townsend noted that the legislative history of the Investment Company Act in several instances states that Congress intended to regulate public investment companies. Senate Report No. 1775 states that "investment companies are essentially institutions which provide a medium for public investment in common stocks and other securities."[25] In addition, Section 1(a) of the Investment Company Act refers to securities distributed by investment companies that are *publicly* offered and distributed. More recently, the House and Senate Reports which accompanied the 1980 amendments to the Investment Company Act reaffirm the premise that the rationale for an exemption under the Investment Company Act is that the exemption is private. "Section 3(c)(1) was intended to exclude from the [Investment Company] Act private companies in which there is no significant public interest and which are therefore not appropriate subjects of federal regulation."[26]

House Report No. 2639 noted that "[i]nvestment trusts and investment companies are in essence institutions for the investment of the savings of small investors in securities…."[27] At the time the Investment Company Act was enacted, Senate Report No. 1866 stated that "approximately one-half of common-stock holders in management investment companies hold common shares with a market value of $500 or less."[28] Based on the Department of Labor's CPI index, $500 in 1940 would be equivalent to an investment of about $7,400 in 2007.[29]

Townsend noted that neither "accredited investors" nor "qualified purchasers" were small investors, the type of investor that the Investment Company Act sought to protect. Townsend stated that the average investment in its Section 3(c)(1) exempt core fund was 20.73 times as large (taking into consideration inflation) as the average investment company investment at the time the Investment Company Act was enacted. Townsend also noted that since performance fees are frequently charged by funds, in many cases, "accredited investors" are augmented to "qualified clients." Moreover, under the proposed "natural accredited person" standard, "accredited investors" would have to have $2.5 million in investments, which would further nullify any argument that "accredited investors" were not small investors.

Townsend also argued that the 3(c)(1) Plus Fund was private because it consisted of a combination of funds each of which were individually private under the Investment Company Act. Due to the Commission's restrictions on integrating Section 3(c)(1) and Section 3(c)(7) exempt parallel funds, Townsend believed that combining private exempt parallel Section 3(c)(1) and Section 3(c)(7) funds in the 3(c)(1) Plus Fund maintained the private character of the respective exemptions. Townsend drew an analogy to Rule 506 of Regulation D in which "accredited investors" are not counted toward the 35 purchaser limit therein, which suggested that adding an unlimited number of investors with sufficient accreditation levels to a limited number of ordinary investors is consistent with the notion of a private exemption.

Townsend also asserted that the purposes of the Investment Company Act would be served by allowing the 3(c)(1) Plus Fund because the arsenal of the Investment Adviser's Act of 1940 enforcement mechanisms would provide sufficient protections against abusive practices, given the private character of the 3(c)(1) Plus Fund. The Commission could deal with any inherently abusive practices through Section 206 and Rule 206(4)-8 of the Advisers Act, which together provide much broader disclosure requirements and anti-fraud remedies than under Rule 10b-5 by itself.

(d) Townsend's Responses to Concerns Against the 3(c)(1) Plus Exemption

Townsend acknowledged the various policy considerations that could argue in favor of having the hypothetical 3(c)(1) Plus Exemption, but noted that such concerns were inapposite.

(i) Oppression

As noted above, Townsend believed that the 3(c)(1) Plus Fund did not form a basis for comparatively larger "qualified purchasers" to oppress Section 3(c)(1) "accredited investors." Changes in the size of funds discussed above had altered market conditions so that comparatively larger "qualified purchasers" were existing in funds side by side with smaller "qualified purchasers," without outcries of oppression, regardless of whether Section 3(c)(1) "accredited investors" were excluded from investing side by side with Section 3(c)(7) "qualified purchasers." These changes in the size of investors in the private equity and hedge fund world further cut against the SEC's belief that mixing larger and smaller investors will "implicate the public interest."[30]

However, if oppression were to occur, Townsend proposed to cure any problems by providing appropriate disclosure and adequate notice and opportunity to redeem, which features would be consistent with the grandfather clause in Section 3(c)(7)(B). Section 3(c)(7)(B) allows certain pre-1996 Section 3(c)(1) companies to convert to Section 3(c)(7) companies and "grandfather" their existing investors that are not "qualified purchasers," provided that those investors receive appropriate disclosure and adequate notice and opportunity to redeem their investments. Townsend thus attempted to show that having Section 3(c)(1) "accredited investors" side by side with Section 3(c)(7) "qualified purchasers" was legislatively appropriate from a policy perspective if the spirit of the grandfather clause was followed.

(ii) Exceeding 100 Investors

One SEC no-action letter indicated a concern that certain investors may not want to be in a fund with more than 100 beneficial owners.[31] Townsend argued that (i) adequate notice, disclosure and an opportunity to redeem, along with (ii) the supply and demand dynamics of the fund market would provide an effective safeguard to investors that did not want to be in funds with more than 100 investors. Townsend noted that the Commission had once determined that with respect to the "grandfather" provision in Section 3(c)(7), the Commission found that a fund's partnership agreement could prohibit the fund from having more than 100 investors.[32] Finally, Townsend pointed out that the limits on general solicitation for private placements and Section 12(g) of the Securities Exchange Act of 1934 ("Exchange Act") would have placed effective limitations on the size of 3(c)(1) Plus Funds becoming too large.

(iii) Integration

Townsend viewed the 3(c)(1) Plus Fund as an extension of Section 3(c)(1), much like the Section 4(1½) exemption is viewed as an extension of Section 4(1). That the 3(c)(1) Plus Exemption is a subset of Section 3(c)(1) prevents integration circumvention concerns. For example, if the Section 3(c)(1) Plus Exemption were considered as a sub-set of Section 3(c)(7), there could be a danger that a series of parallel funds similar to the 3(c)(1) Plus Fund would not be subject to integration both with respect to one another and with respect to Section 3(c)(1) exempt funds due to Section 3(c)(7)(E), which would result in more than one hundred non-qualified purchaser investors being able to participate in a series of funds that were in economic substance one fund. In such event, the nature and quantity of investors in the 3(c)(1) Plus Fund could have been different from the nature and quantity of Section 3(c)(1) and Section 3(c)(7) that may currently be allowed in parallel funds under existing interpretations. The Commission had expressed a similar concern with regard to the "grandfather clause" in Section 3(c)(7)(B).[33] Townsend argued that the Section 3(c)(1) status of the 3(c)(1) Plus Fund eliminated that the possibility that the 3(c)(1) Plus Fund could be used to place more than 100 Section 3(c)(1) "accredited investors" in a series of parallel funds that were in economic substance one fund.

(iv) Side Letters

The Commission has recently begun to focus on abusive side letter practices in the hedge fund and private equity fund industries. Townsend argued that the 3(c)(1) Plus Exemption would not present a greater (or lesser) danger with respect to side letter abuses. As in existing Section 3(c)(1) and Section 3(c)(7) funds, side letter abuses can be addressed under Rule 10b-5 of the Exchange Act and Section 206 and Rule 206(4)-8 of the Advisers Act. Under Rule 10b-5, Section 206 and Rule 206(4)-8, an investment adviser must disclose any side letters that involve conflicts of interest or that may constitute a material fact. To the extent that Rule 10b-5 and, in particular, Section 206 and Rule 206(4)-8 are acceptable and effective enforcement mechanisms with respect to abusive side letters in Section 3(c)(1) and Section 3(c)(7) exempt funds, they will be similarly acceptable and effective enforcement mechanisms with regard to 3(c)(1) Plus Funds.

(v) Release No. 33-8828

In Release 33-8828,[34] the Commission is currently proposing (i) increasing the minimum qualifications for individuals that invest in pooled investment vehicles, and (ii) broadening Regulation D to allow tombstone style public advertisements under proposed Rule 507 similar to those allowed prior to registration if an offering is made to "large accredited investors."

The first part of the Commission's proposal would require natural persons that invest in Section 3(c)(1) exempt pooled investment vehicles to be "accredited natural persons," who hold over $2.5 million in investments. The "accredited natural person" standard would not apply to Section 3(c)(7) exempt funds. The policy for increasing the minimum qualifications for individuals that invest in Section 3(c)(1) exempt pooled investment vehicles reflected a "concern that some further level of protection may be necessary to safeguard investors seeking to make an investment in [Section 3(c)(1)] vehicles in light of their unique risks, including risks with respect to undisclosed conflicts of interest, complex fee structures, and the higher risk that may accompany such vehicles' anticipated returns."[35]

Townsend responded to the above policy concern by noting that the 3(c)(1) Plus Exemption does not lower the minimum sophistication of investors in funds exempt under the Investment Company Act, rather it merely combines into a single fund two separate categories of sophisticated investors. Since the Section 3(c)(1) Plus Exemption is a subset of Section 3(c)(1), the proposed "accredited natural person" standard would apply to investors in the 3(c)(1) Plus Fund and would also raise the minimum sophistication level of Section 3(c)(1) "accredited investors." Second, the Section 3(c)(1) Plus Exemption is also consistent with the proposed "natural accredited person" standard because the adoption of such a standard would further reduce the disparity between "accredited investors" and "qualified purchasers" in Section 3(c)(1) exempt funds, thereby further nullifying oppression concerns.

Townsend also addressed the fact that the Commission's proposal to broaden Regulation D to allow tombstone style public advertisements under proposed Rule 507 similar to those allowed prior to registration if an offering is made to "large accredited investors" does not apply to Section 3(c)(1) and Section 3(c)(7) exempt funds. That such proposal did not apply to such funds potentially suggested a reluctance on the part of the Commission to expand the scope of the Section 3(c)(1) and Section 3(c)(7) exemptions. Townsend argued that the 3(c)(1) Plus Exemption would not affect the scope of the Section 3(c)(1) and Section 3(c)(7) exemptions to the extent that the 3(c)(1) Plus Exemption would not broaden the marketing or distribution of funds. Townsend believed that the reason why Rule 507 did not apply to Section 3(c)(1) and Section 3(c)(7) was because Rule 507 would have allowed such exempt funds to more broadly contact public investors, which would have run contrary to the purposes of the Investment Company Act. However, Townsend noted that the 3(c)(1) Plus Fund would not expand the reach of targeted investors, since the 3(c)(1) Plus Fund would merely combine the types of investors that are separately targeted in parallel funds into a single fund.

(vi) Power of the Commission to Grant No-Action Relief

Based on the history of the Section 4(1½) exemption, Townsend argued that the Commission had power to grant no-action relief to allow the 3(c)(1) Plus Exemption. The Commission acknowledged the Section 4(1½) exemption in footnote 178 in the Employee Benefit Plans Release No. 6188.[36] In footnote 178, the Commission did not promulgate a rule and no legislation was necessary to acknowledge the existence of the Section 4(1½) exemption. Furthermore, prior to Release No. 6188, the Commission allowed private resales to meet at least some of the established criteria for exemptions under both Section 4(1) and Section 4(2) in no-action letters.[37]

II. Analysis of the Commission's Denial of the 3(c)(1) Plus Exemption

(a) Plain Meaning and its Exceptions

Whether the Commission properly denied the 3(c)(1) Plus Exemption presents a question of statutory interpretation. Clearly, based on the history of the Section 4(1½) exemption as discussed above, the Commission had the power to grant no-action relief to allow the 3(c)(1) Plus Exemption.

The Supreme Court of the United States has declared that "the meaning of the statute must, in the first instance, be sought in the language in which the act is framed, and if that is plain, the sole function of the courts is to enforce it according to its terms."[38] "This generally means that when the language of the statute is clear and not unreasonable or illogical in its operation, the court may not go outside the statute to give it a different meaning.[39] "One who questions the application of the plain meaning rule to a provision of an act must show either that some other section of the act expands or restricts its meaning, that the provision itself is repugnant to the general purview of the act, or that the act considered in pari materia with other acts, or with the legislative history of the subject matter, imports a different meaning."[40]

The Seventh Circuit has stated that notwithstanding the plain meaning rule as the starting point of statutory analysis, the Seventh Circuit does not interpret statutes in a vacuum.[41] "The plain meaning rule is applicable when the statutory language is clear, unambiguous, and not controlled by other parts of the act or other acts on the same subject. Thus, the meaning of statutory language, plain or not, depends on context.[42] It is a fundamental canon of statutory construction that the words of a statute must be read in their context and with a view to their place in the overall statutory scheme.[43] Thus, the meaning of a statute may be affected by a related act, especially if that act provides greater specificity on the issue at hand."[44]

Although Section 3(c)(1) and Section 3(c)(7) have clear meanings without ambiguities, the plain meaning rule is subject to the overall statutory scheme of the Investment Company Act as well as related acts. Whether the 3(c)(1) Plus Fund is within the intended purposes of the Investment Company Act presents a difficult question. The SEC apparently concluded that the 3(c)(1) Plus Fund runs against the plain meaning of Section 3(c)(7). We think that is the wrong perspective. Rather, the SEC should have concluded that the Section 3(c)(1) Plus Exemption is not *authorized* by Section 3(c)(7), neither is it *prohibited* by it. Consistent with the Seventh Circuit's position discussed above, the Second Circuit has noted that statutes should be interpreted "consistent with the tenor and structure of the whole act or statutory scheme of which it is a part."[45] "Statutes must be construed to further the intent of the legislature as evidence by the entire statutory scheme."[46]

If the plain meaning of Section 3(c)(7) is that qualified purchaser funds may not have non-qualified purchasers, then, with regard to the 3(c)(1) Plus Exemption, the purpose of the Investment Company Act as a whole conflicts with the plain meaning of Section 3(c)(7). As discussed in Section I(c), it is indisputable that the Investment Company Act intended to provide an exemption from its provisions to private as opposed to public funds. It is difficult, if not absurd, to argue that the 3(c)(1) Plus Fund would be a public fund, since the nature and quantity of investors in the 3(c)(1) Plus Fund would effectively be the same as the nature and quantity of investors in parallel 3(c)(1) and 3(c)(7) funds. Moreover, the types of investors targeted by the 3(c)(1) Plus Fund would be well in excess of the size of "small investors" that the Investment Company Act intended to protect as discussed above.

(b) Pragmatic Considerations

Courts sometimes interpret statutes based on pragmatic considerations. The thrust of pragmatism is considering the practical meaning of a decision.[47] Even Justice Scalia, a strong textualist, has written that "consideration of policy consequences" is a "traditional tool of statutory construction.[48]

Pragmatism argues in favor of the 3(c)(1) Plus Exemption. The positive consequences of the exemption are that Section 3(c)(1) "accredited investors" will achieve considerable administrative and cost savings and any investing advantages appurtenant to having their capital aggregated with "qualified purchasers." In today's market, many of the most desirable investment opportunities are foreclosed to fund entity investors who are not "qualified purchasers." When Section 3(c)(1) "accredited investors" are not aggregated with "qualified purchasers," it becomes increasingly likely that the Section 3(c)(1) fund will not qualify as a "qualified purchaser" when investing in portfolio funds. As a result, Section 3(c)(1) funds may be at a competitive disadvantage in the portfolio fund market. Finally, the 3(c)(1) Plus Fund would help to prevent Section 3(c)(1) "accredited investors" from being frozen out of many of the most desirable funds.

Another advantage is that contrary to the Commission's concerns that side letters may have disadvantageous consequences for smaller investors, our experience is that larger investors often are in a position to negotiate systematic changes to the terms of the fund or global side letters provisions that are available to all investors in the fund. Even when side letter terms are not global, it is often the case that larger investors are able to use side letter terms to exercise limitations on restraints on fund management, which have the effect of protecting smaller investors against the excesses of certain fund managers.

We therefore believe that larger "qualified purchasers" will serve as positive intermediaries between potentially abusive fund managers and Section 3(c)(1) "accredited investors," rather than that "qualified purchasers" will oppress smaller investors. To the extent that "qualified purchasers" negotiate side letter terms that are subject to conflicts of interest, the fund would currently under Section 206 and Rule 206(4)-8 be required to disclose such conflicts to investors. Given that side letters and systematic fund negotiations led by "qualified purchasers" will ultimately benefit and protect their smaller counterparts, "accredited investors" should be allowed to decide whether to invest in 3(c)(1) Plus Funds, particularly after adequate disclosure, notice and opportunity to redeem in the spirit of the "grandfather clause," since the Advisers Act allows "accredited investors" in Section 3(c)(1) exempt funds to approve side letter conflicts of interest.

On the other hand, the negative consequences of allowing the 3(c)(1) Plus Exemption are remote. The changes in the fund industry since NSMIA as discussed in Section II(a) have reduced the likelihood of oppression to the extent such a possibility ever existed, and to the extent the qualification thresholds for Section 3(c)(1) funds are increased by Release No. 33-8828, oppression will be even more remote. We also believe that the comparative strength of "qualified purchasers" may have a beneficial effect because "qualified purchasers" watchdogs against abusive fund managers, particularly since any inherently abusive conflicts of interest favoring "qualified purchasers," including side letters, would continue to be subject to the broad anti-fraud provisions of Section 206 and Rule 206(4)-8 of the Advisers Act.

In addition, we maintain that the 3(c)(1) Plus Exemption would not have other negative consequences. First, the 3(c)(1) Plus Exemption would not expand the nature and quantity of parallel Section 3(c)(1) and Section 3(c)(7) exempt fund investors. Second, Section 3(c)(1) "accredited investors" would not be forced to take part in a 3(c)(1) Plus Fund because such investors would receive adequate disclosure, notice and opportunity to redeem, but would be able to make their own independent determinations about whether to invest in 3(c)(1) Plus Funds. Third, as discussed above, 3(c)(1) Plus Funds would present no additional integration circumvention or side letter concerns.

We believe that the time has come for the SEC to reconsider its policy from nearly fifteen years ago,[49] and to permit a 3(c)(1) Plus Fund. Not only would this be beneficial to 3(c)(1) "accredited investors" but it would be an acceptable next step in the evolution of Investment Company Act exemptive relief.

III. The Future of the 3(c)(1) Plus Exemption

Although the Commission refused to acknowledge the 3(c)(1) Plus Exemption in the Townsend No-Action Letter, the possibility remains that the Commission could in the future grant no-action relief with respect to the 3(c)(1) Plus Exemption. Alternatively, Congress could specifically authorize the 3(c)(1) Plus Exemption, perhaps in a future draft of the recently proposed Hedge Fund Transparency Act.

Until the Commission acknowledges the 3(c)(1) Plus Exemption, we believe it would be dangerous for funds to rely on the 3(c)(1) Plus Exemption and await SEC enforcement and judicial determination. We urge funds to lobby the Commission and Congress to support the 3(c)(1) Plus Exemption, whether by legislation or future no-action relief.

NOTES

1. Townsend Group, SEC No-Action Letter (July 9, 2008) *available at* http://sec.gov/divisions/investment/noaction/2008/townsendgroup070908-sec7.htm.

2. The Hedge Fund Transparency Act, introduced on January 29, 2009, would strike the Section 3(c)(1) and Section 3(c)(7) exemptions, and replace them with the Section 6(a)(6) and Section 6(a)(7) exemptions respectively. As a general matter, the Section 6(a)(6) and Section 6(a)(7) exemptions are functionally equivalent to the Section 3(c)(1) and Section 3(c)(7) exemptions, except that the Section 6(a)(6) and Section 6(a)(7) exemptions would be subjected to special registration, filing, disclosure and anti-money laundering obligations. However, the arguments presented in this article would apply equally to Section 6(a)(6) and Section 6(a)(7) exempt investment companies.

3. With respect to the Investment Company Act, the Commission has stated that "[t]he integration concept allows the Commission to look behind ostensibly separate issues, issuers, or transactions to determine if, in economic reality, they are actually a single issue, issuer, or transaction." Joseph H. Moss, SEC No-Action Letter, 1984 WL 45009 (Feb. 27, 1994); Santa Barbara Securities, SEC No-Action Letter, 1983 WL 28585 (April 8, 1983). The Commission has also stated that it "considers several factors in determining whether integration is appropriate, and generally will require integration

if a reasonable purchaser qualified to invest in both offerings would view an interest in one offering as not materially different from another. In making this determination, the staff will consider whether the entities share the same investment objectives, investment portfolios, and portfolio risk/return characteristics. Pasadena Investment Trust, SEC No-Action Letter, 1993 WL 26719 (Jan. 22, 1993).

4. *See Protecting Investors: A Half Century of Investment Company Regulation,* Divisions of Investment Management 115-116 (May 1992).

5. *Id*. at 115.

6. *See Protecting Investors*, *supra* note vi.

7. We note that Section 3(c)(7) also had an additional policy goal of placing American markets on par with foreign markets. *See* H.R. Rep. NO. 104-622, at 18.

8. H.R. Rep. NO. 104-622, at 1.

9. *Id*.

10. The Task Force on Hedge Funds, Report on Section 3(c)(1) of the Investment Company Act of 1940 and Proposals to Create an Exception for Qualified Purchasers.

11. *Id*.

12. *Protecting Investors*, *supra* note vi, at 115-116.

13. Congress noted that "[a]lthough there is no exact accounting of the total number and size of these private investment partnerships, estimates indicate that the total number may be as high as 3,000, with assets estimated between $75 and $160 billion." H.R. REP. No. 106-622, 104th Cong. (1996).

14. Jeffrey E. Sohl, The Private Equity Market in the USA: Lessons from Volatility (Oct. 17, 2002), *available at* http://www.angelcapitalassociation.org/dir_downloads/resources/Research_LessonsVolatility.pdf.

15. Hedge Fund Association, *About Hedge Fund Strategies*, *available at* http://www.thehfa.org/Aboutus.cfm?CFID=470401&CFTOKEN=35430329.

16. *See* Wikipedia, *Private Equity*, *available at* http://en.wikipedia.org/wiki/Private_equity.

17. Note that the "natural accredited person" standard proposed in Release 33-8828 would further reduce size disparity, since natural person investors would have to own at least $2.5 million in investments in order to invest in Section 3(c)(1) exempt funds.

18. *Protecting Investors*, *supra* note vi, at 115-116.

19. Oppression concerns are discussed in more detail in Section III.A.

20. Employee Benefit Plans, Release No. 6188, 1980 WL 29482 (Feb. 1, 1980).

21. *See Section "4(1-1/2)" Phenomenon: Private Resales of "Restricted Securities", a Report to the Committee on Federal Regulation of Securities of the ABA from the Study Group on Section "4(1-1/2)" of the Subcommittee on 1933 Act*, 34 Bus. Law. 1961 (1979).

22. *See Section "4(1-1/2)" Phenomenon: Private Resales of "Restricted Securities", a Report to the Committee on Federal Regulation of Securities of the ABA from the Study Group on Section "4(1-1/2)" of the Subcommittee on 1933 Act*, 34 Bus. Law. 1961 (1979).

23. *See* Matthew Bender & Company, Inc., 1-4 Federal Securities Act of 1933, §4.05[1].

24. *See* Employee Benefit Plans, Release No. 33-6281, 21 S.E.C. Docket 1372, 1981 WL 36298 (Feb. 1, 1980).

25. S. REP. NO. 1775, at 2.

26. H.R. REP. No. 1341, 96th Cong., 2d Sess. 35 (1980); S. REP. No. 958, 96th Cong., 2d Sess. 20

(1980).

[27.] H.R. Rep. NO. 2639, at 6.

[28.] S. Rep. NO. 1775, at 4.

[29.] *See* Department of Labor CPI calculator, *available* at http://data.bls.gov/cgi-bin/cpicalc.pl.

[30.] *Protecting Investors*, *supra* note vi, at 115-116.

[31.] Privately Offered Investment Companies, Release No. IC-22597, SEC No-Action Letter, 64 S.E.C. Docket 550, 1997 WL 156653, fn. 88 (April 3, 1997).

[32.] *Id*., at 68.

[33.] *See* Privately Offered Investment Companies, Release No. IC-22597, SEC No-Action Letter, 64 S.E.C. Docket 550, 1997 WL 156653 (April 3, 1997).

[34.] Rel. No. 33-8828, Revisions of Limited Offering Exemptions in Regulation D (Aug. 3, 2007).

[35.] *Id*.

[36.] Employee Benefit Plans, Release No. 33-6281, 21 S.E.C. Docket 1372, 1981 WL 36298 (Feb. 1, 1980).

[37.] "This variety of sale has become popularly known as "section (4)(1½)" transactions, primarily because the SEC, in no-action letters and other pronouncements, frequently has required that such resales meet at least some of the established criteria for exemptions under both section 4(1) and section 4(2)." *Section "4(1-1/2)" Phenomenon: Private Resales of "Restricted Securities", a Report to the Committee on Federal Regulation of Securities of the ABA from the Study Group on Section "4(1-1/2)" of the Subcommittee on 1933 Act*, 34 Bus. Law. 1961 (1979). For example, in *Colorado & Western Properties*, the Commission indicated that certain private resales could be made in reliance upon Section 4(2). Colorado & Western Properties, Inc., SEC No-Action Letter, 1977 WL 10542 (July 14, 1977).

[38.] *Caminetti v. U.S.*, 242 U.S. 470, 485 (1917).

[39.] Norman J. Singer & J.D. Shambie Singer, Statutes and Statutory Construction (7th ed.), § 46:1.

[40.] *Id*.

[41.] *See Smith v. Zachary,* 255 F.3d 446, 448 (7th Cir. 2001).

[42.] *Id.* (citing *Holloway v. United States*, 526 U.S. 1, 7 (1999)).

[43.] *Id.* (citing *FDA v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120, 133 (2000)).

[44.] *Id*.

[45.] *U.S. v. Bonanno Organized Crime Family of La Cosa Nostra*, 879 F.2d 20 (2d Cir. 1989).

[46.] Norman J. Singer & J.D. Shambie Singer, Statutes and Statutory Construction (7th ed.), § 46:5.

[47.] Frank B. Cross, *The Significance of Statutory Interpretive Methodologies*, 82 Notre Dame L. Rev. 1971, 1976 (2007).

[48..] Antonin Scalia, *Judicial Deference to Administrative Interpretations of Law*, 1989 Duke L.J. 511, 515 (1989).

[49.] *See Protecting Investors*, *supra* note vi.