

SEC's Exemptive Power in Regulating Investment Companies and Implication for China's Future Investment Fund Law

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Abstract:

Regulation of investment companies is a challenging task because investment is extremely complicated. It is difficult to make appropriate legal provisions for all investment tools under all circumstances. In the US, one solution for this problem has been to grant the SEC power to grant exemptions. This paper introduces the use of exemptive power in regulating investment companies by the SEC in the US. It argues that American investment regulatory history shows that granting exemption is an important part of successful investment company regulation. China's legislators should consider a similar clause in the upcoming Investment Fund Law.

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SEC's Exemptive Power in Regulating Investment Companies and Implication for China's Future Investment Fund Law¹

An investment company is an important pooled investment vehicle in the modern economy. Investment companies provide professional services, portfolio diversification and liquidity with relatively low costs. These benefits are difficult to attain for individual investors. Due to its many advantages, it is not surprising that the whole investment fund industry has been growing steadily since World War II. In 2001, mutual funds in the US alone managed \$6.97 trillion in assets. The world total reached \$11.6 trillion in that year.²

However, regulation of investment companies is a challenging task for policy makers. The main reason is because investment is extremely complicated. It is important to make legal provisions to protect investors. Otherwise the outcome could be catastrophic, as demonstrated by the history of the Great Depression (Seligman, 1995). But it is difficult to make legal provisions for all investment tools under all circumstances; and inappropriate regulation can cause enormous hardships for investors. Rapidly developing financial innovations further exacerbate the difficulty of making provisions. Many financial tools did

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not even exist when legislators passed regulatory laws. And a rigid investment company law could cripple financial innovation.

In the US, one important solution to this problem has been to grant the Securities and Exchange Commission (SEC) power to exempt companies, individuals or transactions from investment company regulation as long as the exemption is consistent with public interest, investor protection and the intent of law. This exemptive power gives regulators enormous flexibility in regulating investment companies. And it has been credited as an important factor for successfully regulating investment companies in the US (SEC Staff, 1992).

Right now China is in transition from a planned economy to a market economy. An Investment Fund Law is being drafted to legalize investment funds. One important policy question is whether China should borrow from the US experience and grant the Chinese Securities Regulation Commission (CSRC) exemptive power in regulating investment companies. Despite the importance of the topic, it has not been studied before. In fact, the concept of exemptive power for securities regulation is foreign to China. No exemptive power was provided to the CSRC in the 1998 People's Republic of China Securities Act.

The purpose of this essay is to introduce the concept of exemptive power in regulating investment companies, to give examples of its application in the US and to discuss its implications to China's investment fund law legislation. In the first section, this paper will review legislative history to trace the origin of

². Investment Company Institute, "Trend", December 2001, available online

exemptive power in the US. Then several cases will be presented in the second section to illustrate how this exemptive power is used in the US to provide relief from inappropriate regulation. The third section will discuss the mechanisms in the US that ensure that exemptive power is used appropriately. The fourth section will present reasons for why China's policy makers should consider granting similar power to China's regulatory agency. The last section concludes with a future research agenda on the issue.

1. Origin of Exemptive Power in the 1940 Investment Company Act

Granting the SEC exemptive power in regulating investment companies is an important aspect of investment company regulation in the US. Many sections of the 1940 Investment Company Act (hereafter 1940 Act) give the SEC discretion to grant exemption. Section 6(c) in the 1940 Act provides the SEC with a general power to exempt:

“The Commission, by rules and regulations upon its own motions, or by order upon application, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this title or of any rule or regulation thereunder, if and to the extent that such exemption is necessary or appropriate in

the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title.”

The language used in section 6(c) is broad. As long as the SEC can prove that an exemption is necessary for the public interest, and that it is consistent with protecting investors and with the purposes intended by law, the SEC has the discretion to exempt any person, company or transaction from 1940 Act regulation. It can do so by either issuing a rule to exempt a general situation or by issuing orders to exempt special cases.

The original reason for giving such a sweeping exemptive power to the SEC was because legislators believed that investment companies were too complicated to be regulated under a rigid law. They thought that it would be impossible for legislators to foresee every contingency and make correct provisions for regulating investment companies, no matter how carefully the Act was drafted. If section 6(c) had not been included, legislators felt that the 1940 Act would have been too rigid for the industry. As David Schenker, a major drafter of the 1940 Act, put it, “...[There was] the difficulty of making provision for regulating an industry which has so many variants and so many different types of activities...[It] is precisely to meet that sort of argument that section 6(c) is inserted”.³ He further asserted that “you cannot possibly anticipate a transaction which you feel should not come within any specific provision of this

bill, and you cannot possibly anticipate any person who may or may not come within the specific provisions of this bill.”⁴

The SEC believes that section 6(c) is an industry-friendly rule because it does not give the Commission power to add new regulation but gives the Commission power to relax regulation. The SEC said that it did not want the power just to satisfy its ego or its desire for power. Removing section 6(c) would only make the SEC’s operations easier because they would not have to handle incoming petitions for exemptions. But it would be tough for the industry to follow a rigid statute without flexibility. Judge Hughes defended section 6(c) by pointing out that, “ ...the Commission can stand it [the consequence of no section 6(c)] if the industry can stand it; but I do not think the industry can stand it”.⁵

In summary, the reason for granting the SEC exemptive power was because legislators acknowledged their limited understanding of investment companies and offered section 6(c) as a remedy. Both legislators and regulators believed that a wise exercise of the power would be critical to the success of regulating investment companies in the US (Jaretzki, 1940). The next section will review some cases to demonstrate the importance of using SEC exemptive power to offer relief for the investment industry.

2. The Application of Section 6(c) by the SEC

³ US Congress, 1940, 1940 Senate Hearing, P. 197.

⁴ Ibid.

Frankel and Schwing summarize two circumstances under which the SEC grants exemption (Frankel and Schwing, 2001). The first circumstance is where Congress “did not and perhaps could not” foresee the situation, and where an exemption is consistent with investor protection and the public interest. The second circumstance is where the Congress did not want the relevant regulations to apply to a special situation, and where an exemption is consistent with investor protection and the public interest.⁶ This first circumstance is normally the case when there are financial innovations. It is impossible for legislators to make provisions for investment tools that did not exist when the law was made. To handle this situation, the SEC normally begins by issuing exemptions for individual companies. Then as the exemption cases accumulate and the process becomes routine, the SEC summarizes the experiences and proposes a general solution to the problem. This process can be demonstrated by two cases: the regulatory history of venture capital limited partnerships and the valuation of money market funds.

2.1 Congress Didn't Foresee the Situation

Venture capital is a relatively new financing tool. The first venture capital firm, ARD, was formed in 1946. The first limited partnership venture capital

⁵ 1940 Senate Hearing, P. 874.

⁶ Frankel and Schwing, 2001, P. 2-9.

firm, Draper, Gaither and Anderson, didn't appear until 1958.⁷ When the 1940 Act was introduced, there were no venture capital funds at all. Inevitably some sections of the 1940 Act were cumbersome for venture capital funds. For example, the strict regulation of affiliate transactions is inconsistent with the common practices of venture capital firms.⁸

Fortunately, under the original 1940 Act, venture capital limited partnerships could avoid registration as public investment companies by using Section 3(c)(1).⁹ Section 3(c)(1) exemption is for "any issuers whose outstanding securities (other than short-term paper) are beneficially owned by not more than 100 persons and which is not making and does not presently propose to make a public offering of its securities."¹⁰ Most venture capital funds could satisfy this condition easily since the major venture capital fund investors are institutional investors. But an attribution rule associated with the 100-person limit exemption causes difficulty for venture capital fund-raising. To avoid circumventing the 100-person limit by pyramiding investment companies,¹¹ the 1940 Act made an "attribution" rule: in calculating the number of beneficiaries, all the beneficial

⁷ Gompers and Lerner, 2001, "The Venture Capital Revolution", *Journal of Economic Perspectives*, Spring 2001.

⁸ For an excellent discussion of regulation of affiliates in investment companies, please refer to Frankel and Schwing 2001, and Chapter 5 in Michael Halloran 2001.

⁹ Section 3(c)(1) is the most commonly used section to provide exemptions for venture capital funds. Other exemption clauses normally are too cumbersome for venture capital funds. For an excellent discussion of the exemption of venture capital funds, please refer to Halloran 2001, Chapter 5.

¹⁰ The 100 limit was set to reflect the outer limit of the extension of family and personal connection, not for venture capital funds. David Schenker, P 179, 1940 Senate Hearing.

¹¹ Suppose an individual forms an investment company which control another investment company. The controlling investment company is a public investment company and sells securities to the public. The controlled investment company will have only one investor, and thus need not register as a public investment company. But because the controlling investment company is a public investment company,

owners of any firms that owned more than 10% of the outstanding securities of the issuer should be counted as beneficial owners of the firm.

There is no question that this rule is necessary and justified. But the problem is that legislators could not have possibly imagined the existence of venture capital when they made the law, not to mention the fact that venture capital limited partnership would have to rely on section 3(c)(1) for exemption. The unexpected rise of venture capital investment made the well-intended rule problematic. Since institutional investors such as pension funds or university endowments often have tens of thousands of beneficiaries, the 100-person limit and the attribution rule meant practically that venture capital limited partnerships could not have an institutional investor who held more than 10% of the partnership interest.

These rules made venture capital fund-raising (in fact, private equity fund-raising) very challenging. In many institutional investors, a few professionals manage hundreds of million or even billions of dollar assets. To reduce the burden of supervision, many institutional investors set up minimum amount of investment, such as \$10 million or \$25 million. To attract an institutional investor that has a minimum investment amount of \$10 million, a venture capital limited partnership has to be larger than \$100 million for the attribution rule not to apply. Historically it has been difficult to form such a large limited partnership. In 1980, the average size of a venture capital fund was

the public will have indirect participation in the controlled investment company. The individual can avoid

\$28 million. Even in 1993, the average size of a venture capital fund reached only \$78.9 million.¹²

The industry sought relief from 1940 Act regulation by requesting SEC exemptions. In 1972, lawyers from the law firm Pierce, Lewis and Dolan wrote a letter to the SEC requesting the SEC to verify that interests in limited partnerships were not “voting securities” because limited partners could not elect directors.¹³ The SEC rejected this theory and argued that although technically limited partnership interests were not the same as rights to vote directors, in reality they had the same influence toward firm operation as voting securities. But the SEC also said that if a corporation expected to have an insubstantial income (such as less than 5%) from the investment in private investment companies, then the attribution rule wouldn’t be applied to the corporation.¹⁴ The SEC confirmed this stand later in a series of no-action letters,¹⁵ and it was codified into the 1980 Small Business Incentive Investment Act. Meanwhile, in 1976, the SEC asserted that some non-profit organizations, such as university endowments, should be deemed as having one beneficial owner even though they owned more than 10% of a partnership interest.¹⁶ In a series of no action letters in the late 1980s, the SEC finally took the position that limited

regulation by operating mainly through the controlled investment company.

¹² P. 13, Fenn, Liang and Prowse, 1995.

¹³ Pierce, Lewis & Dolan, April 21, 1972.

¹⁴ The “insubstantial income” exemption is consistent with the spirits of the attribution rule 1940 Senate Hearings, P. 179, David Schenker’s testimony.

¹⁵ Charter Oak, October 23, 1976, Westven, May 18, 1978, H&Q, April 10 1980.

¹⁶ Devonshire, Feb 15, 1978.

partnership interests would not be interpreted as “voting securities” if certain conditions were satisfied.¹⁷

These exemptions relaxed regulations and made it easier for venture capital limited partnerships to raise funds. But many institutional investors still had to satisfy many conditions to rely on either the “non-voting” theory or the “insubstantial” theory to obtain exemptions for investing in private equity limited partnerships. The final solution to the obstacle came in 1996. In 1990, the SEC finally realized that it was not wise to discourage institutional investors from investing heavily in limited partnerships.¹⁸ To deal with the problem, the SEC proposed adding a new section 3(c)(7), a “qualified purchaser exemption”, to exempt any issuer whose securities were owned exclusively by “qualified purchasers”. The definition of qualified purchasers includes wealthy persons, big trusts and institutional investors. A venture capital limited partnership could have as many qualified purchasers as it wanted, and these qualified purchasers could have an arbitrary percentage of interest in the partnership without losing the exemption to register under the 1940 Act. Congress passed the proposed legal change in 1996.

In the case of venture capital regulation, a general remedy was provided through legislative changes. In fact, the SEC can also provide a general remedy by using its rule-making authority, which is normally a quicker way to provide

¹⁷ Horsley, Keogh Venture Capital Fund, April 27, 1988, Kolberg, Kravis, Roberts & Co., September 9, 1985, Messrs. Robert N. Gordon and Thomas Hertzfeld, Nov. 30, 1987.

¹⁸ Chapter 2, SEC Staff, 1992.

general relief. The history of money market funds is illustrative. Money market funds are open-end investment companies that invest exclusively in short-term, high quality debts. The investors of money market funds normally are institutional investors such as banks. Institutional investors often have temporary cash balances or cash reserves that they plan to use in several months. Money market funds were developed to pool these temporary cash balances and buy high quality, short-term debts. The benefits of money market funds are clear: they provide interest income and maintain liquidity for institutional investors on the one hand, and decrease financing costs for borrowers on the other. Money market funds are very popular mutual funds. In 2001, the total assets in money market funds in the US reached \$1.8 trillion, about 25% of mutual fund assets.¹⁹

But money market funds encountered a valuation problem under the 1940 Act. To avoid the dilution problem, the 1940 Act stipulates that market quotation should be used to value investment company assets whenever they are readily available.²⁰ The actual prices for short-term debts fluctuate according to market risk and credit risk. Because the cash balances are only temporary, institutional investors expect a constant net asset value and steady interest income. Fluctuation of cash assets is a hassle to their internal control and accounting systems. Many institutional investors would rather not invest in money market

¹⁹ Investment Company Institute, "Trend", 2001

funds than suffer the hassles. To solve this problem, the investment industry used an amortized cost valuation method. This valuation method values the assets at cost in the beginning. Then the assets' value increases at a steady rate as the maturity date approaches without regard to the actual price variation in the market. Under this valuation method, investors are able to have a constant net asset value and steady interest income. Unfortunately, the amortized cost valuation is inconsistent with the 1940 Act.²¹

Many money market funds submitted applications for exemptions to use the amortized cost valuation method. They argued that in a well-managed market money fund, the dilution problem was quite small when the amortized cost valuation method was used. However, insistence on not using the amortized cost valuation would drive investors away.²² In 1978, after consulting with the investment community, the SEC granted exemptions for most of the applicants to use the amortized cost valuation method, given that some conditions were satisfied.²³ After these exemptions, the SEC received numerous applications from money market funds to use the amortized cost valuation. In 1982, the SEC issued a proposed rule to formalize the previous exemptive orders for money market funds to use either the amortized cost valuation method or the

²⁰ Dilution problem occurs when there is discrepancy between real securities price and redemption price and insiders can take advantage of the discrepancy at the costs of investors. For a detailed treatment of the subject refer to Chapter 16, Frankel, 1978.

²¹ Investment Company Act Release No. 9786, May 31, 1977.

²² Investment Company Act Release No. 10161, March 17, 1978, No. 9998, November 8, 1977, No. 9999, November 8, 1977, No. 10000, November 8, 1977 and No. 9992, November 4, 1977.

²³ Investment Company Act Release No. 10201, April 12, 1978.

penny-rounding method.²⁴ This rule was formally passed in 1983 as Rule 2a-4 and solved the valuation problem for money market funds. In this case, no legislative change is needed to resolve the valuation problem.

The two cases above demonstrate that the major advantage of granting the SEC exemptive power is to allow the SEC to address investment company legislative deficiencies in a timely manner. Compared with the remedy provided by the SEC's exemptive power, legislative remedies are usually very slow to come. In the case of venture capital regulation, twenty-four years passed from the first time the industry fought the issue to the final legislative solution. Even after the SEC decided that the regulation of institutional investors was not necessary in 1990, it took Congress six years to pass legislation. The American venture capital industry has experienced exponential growth from 1970 to 1996.²⁵ If there had been no SEC exemptive power, the industry would have developed more slowly. "Attribution" was not the only regulatory problem encountered by the venture capital industry in the US. Some regulations in the 1940 Investment Advisor Act were also inconsistent with venture capital practices. The conflict was also first resolved through SEC exemptions.²⁶ The SEC's use of exemptive power enabled venture capital to develop in the US without substantial legislative changes.

²⁴ Investment Company Act Release No. 12206, February 1, 1982.

²⁵ Fenn, Liang and Prowse, 1995.

²⁶ Halloran 2001, Chapter 5.

The slow legislative response shouldn't be a surprise, because Congress has limited time and energy, and many items on their agenda have higher priority than fixing deficiencies in the 1940 Act. For example, from 1970 to 1996 when the industry fought the attribution rule, America experienced the Vietnam War, the Watergate scandal, the Soviet invasion of Afghanistan, the arms race between the US and the Soviet Union, the collapse of the Berlin Wall and the Gulf War. Thus it is unrealistic to expect that Congress can respond to investment companies' problems in a timely manner. A more realistic expectation is that Congress can pay attention to investment companies every 10 to 20 years when problems have accumulated to enough of a critical mass to justify Congress attention. Without the SEC's exemptive power, either financial development would have been slowed, or the investment industry would not have obeyed the law. American legislators were foresighted in foreseeing the problem and granting the SEC the exemptive power as a remedy.

2.2 Congress Didn't Want the Regulations to Apply

The second circumstance of granting exemptions, where Congress did not want regulations to apply to a special situation, usually involves special situations and complicated facts. In this case, a strict enforcement of the current law would bring unreasonable hardships for relevant parties. One good example is that of an investment company, Great American Life Underwriters, that believed in good faith that it did not need to register as a public investment

company based on the recommendations of a legal counsel. But in fact it should have registered, and the investment company did not find out until 20 years later. According to section 47(b), all transactions and contracts conducted by the company in the past two decades should have been void. A strict enforcement of section 47(b) would have been very tough for investors in that investment company. The SEC granted an exemption so that investors didn't have to face that disastrous situation.²⁷

Another example for this is the exemption order for Drexel Burham Lambert (DBL), the famous underwriter for junk bonds, in 1989.²⁸ Section 9(a) disqualifies convicted felons from serving as investment advisers and underwriters. In 1989, due to misconduct by the High Yield and Convertible Bond Department, DBL was convicted of a felony and fined \$650 million. DBL filed an exemption application to the SEC to get exemption for serving as an underwriter and adviser for its non junk bond operations. It claimed that some DBL operations (1) were not involved in the charge, (2) had no connection with the junk bond operation and (3) were physically separated from the junk bond operation. DBL argued that since it had paid the fine and was taking necessary corporate restructuring to avoid further misconduct, it was not in investors' best interests to disqualify DBL as an adviser or underwriter for its other operations. The SEC reviewed the application and granted an exemption.

²⁷ Great American Life Underwriters, Inc., 41, SEC 1, 1960, From Frankel, 1978, P. 125

²⁸ Investment Company Act Release 17133, SEC, 1989

The DBL case and the Great American Life Underwriter case show that the second circumstance of granting exemptions usually involves special and rare cases. It is highly improbable for investment companies in these cases to seek relief from Congress since their situations are not general. SEC's exemptive power is the only reliable relief that they can count on. Without Section 6(c), investors in the two cases would have suffered heavily even though their losses may not have been consistent with public interest, investor protection and the purpose intended by the legislators.

2.3 Summary

The four cases discussed above are only a small portion of the thousands of exemptions granted by the SEC. But they show that the SEC's exemptive power is an integral part of successful investment company regulation by providing remedies for legislative deficiencies in a timely manner. The extensive use of exemptive power in the US cannot be attributed to low quality law making. The 1940 Act was widely acclaimed as a remarkable legislative success when it was passed. The fact that it was passed in 1940 with little controversy demonstrated the quality of the legislation (Frankel, 1978, Seligman 1995). But still it failed to make provisions for many important investment tools. The history of investment company regulation in the US highlights the complexity of regulating investment companies and the importance of incorporating flexibility into the regulatory structure.

3. Constraints on the SEC's Use of Exemptive Power

A big concern for exemptive power is that the SEC could abuse the exemptive power to the point that the law becomes meaningless. Many mechanisms are available in the US to ensure that this power is used wisely. The first mechanism is to ensure that the SEC is well funded and well staffed. The exercise of exemptive power is not a routine work. It is important that the staff are not only familiar with relevant laws and regulations, but also able to interpret general principles such as investor protection, public interest and legislator's intent correctly. Only top quality staff can handle the challenge properly. The SEC has historically been a funding priority in the US government to ensure that it can attract the best talent possible. Part of the reason why the 1940 Act was passed with relatively little controversy is the respect that the SEC won in implementing the 1933 Securities Act and the 1934 Securities Exchange Act (Seligman, 1995).

Second, SEC staff is extremely careful in exercising exemptive power. The SEC realizes that it is a grave responsibility to use the power. SEC staff are so careful that the major complaint against SEC staff is not that they have used the power excessively, but that they are too reluctant to use it.²⁹ To ensure that the use of exemptive power is consistent with the spirit of the law, the SEC has made

²⁹ Chapter 13, SEC staff, 1992.

strict rules regarding the promulgation of exemptive orders and rules. Investment Company Act Rule 0-5 governs the issuance of exemptions: it requires that the SEC announce its intent to issue exemptions publicly and give the public enough time to review and challenge them. A public hearing may be held if it is requested by an interested party. The final exemption is published openly and is easily accessible to the public. It is an open procedure that can reduce corruption effectively.

Third, Congress granted the exemptive power with strings attached. The SEC has to prove that an exemption is consistent with public interest, investor protection and the purposes intended by legislators. These strings give dissatisfied parties a chance to appeal in court to overrule the SEC's decisions. For example, in 1973, an SEC's decision to grant variable life insurance an exemption from the 1940 Act was challenged in the D.C. Circuit Court because the plaintiffs believed that the exemption was inconsistent with the spirit of the 1940 Act. The SEC withdrew the exemption later.³⁰

Fourth and last, Congress is the ultimate watchdog for the SEC. Congress gave exemptive power to the SEC, and it can take it away when appropriate. Congress can also decide the magnitude of the exemptive power. It can stipulate that the SEC cannot use exemptive power in a certain section, and it can add more strings to the use of power. For example, the 1996 National Securities Market Improvement Act limits SEC's exemptive power in the 1934

Securities Exchange Act by stipulating that the SEC may not grant exemption from section 15C.³¹

4. Implications for China's Policy Makers

This discussion of exemptive power should be of interest to China's legislators and scholars because granting the CSRC exemptive power may help China's legislators meet two challenges. The first challenge is the difficulty of drafting an investment fund law in China. To draft an Investment Fund Law is a daunting task for China's legislators. Comparing with the US, China has neither legislation experience in regulating investment companies, nor a history of investing in investment companies. China's legislators need draft a law that will foster the development of investment companies, rather than to regulate currently existing investment companies. Unlike their counterparts in the US, they cannot expect to get extensive help from the investment industry. This lack of investment company expertise is a serious challenge. To make the matter worse, there will be financial innovations that are unknown to China's legislators as of now. These difficulties make it inevitable that the drafted law will fail to make correct provisions for some investment tools. It can also be foreseen that China's legislators, like American legislators, would be too preoccupied with many things to respond to legislative deficiencies quickly. If

³⁰ Frankel, 1978, P. 97—98.

³¹ 1996 National Securities Market Improvement Act, 15 USC 78mm.

China's legislators fail to consider the existence of these legislative deficiencies and add some flexibility into the coming Investment Fund Law, these deficiencies plus slow legislative responses would make it difficult for investment companies to develop in China. Exemptive power would be a powerful tool to give regulators flexibility in handling these situations.

The history of legislation for regulating economic activities in China has shown that incorrect law provisions can make economic development difficult. For example, few people in China understood venture capital in 1994 when China's Corporation Law was drafted. As a result, the law is unfriendly to entrepreneurship and venture capital investment. First, it is difficult to form a high-tech corporation under the law. Article 24 and Article 80 of the law say that a corporation cannot have more than 20% intangible assets in its total registered assets. Second, it is practically impossible to form a venture capital investment corporation under the law. Article 12 stipulates that a corporation cannot invest more than 50% of its assets in other corporations. Third, the law also makes it difficult to dispose of investment in a corporation by restricting the transactions of "legal person shares". (Investment by institutions in a corporation falls into the category of legal person shares). The 1994 Corporation Law was not alone in being hostile to venture capital and entrepreneurship. The 1997 Partnership Law in China was equally venture capital unfriendly: it does not make provision for limited partnership. These provisions (or lack of provisions) make venture capital development very difficult in China, and the

difficulties that venture capital investment faces highlight the importance of having flexibility in regulation.

The second challenge is how to manage the de facto administrative discretion in regulating economic activities. One consequence of the unfriendliness of the Corporation Law and the Partnership Law toward venture capital and entrepreneurship has been to prompt investors to turn to local governments for help. Eager to develop venture capital investment, many local governments in China have made various local laws to facilitate venture capital investment. For example, Beijing's government passed a law to allow limited partnerships in the Zhongguanchun Science & Technology Park.³² Guangzhou's government announced that venture capital corporations in Guangzhou could invest more than 50% of their assets in portfolio firms.³³ Some central government ministries also made their own rules to provide relief. The Ministry of Science and Technology announced in 1997 that high-tech corporations approved by the Ministry of Science and Technology could have up to 35% of total registered assets as intangible assets.³⁴ Some of these local and ministerial laws are clearly inconsistent with the Corporation Law and the Partnership Law. But since they are actively providing protections to many firms and no one is challenging their legitimacy, these local and ministerial laws constitute de facto

³² "China's First Limited Partnership Venture Capital Firm Is Located in Zhongguanchun S&T Park", finance.sina.com.cn, August 17, 2001.

³³ "Guangzhou Promulgates Favorable Policies Toward Venture Capital Investment", SINA News, finance.sina.com.cn, August 23, 2001.

exemptions for the local firms. Should the coming Investment Fund Law also lacks flexibility and fails to provide correct provisions for some investment tools, similar local and ministerial laws would emerge to provide de facto exemptions from the Investment Fund Law.

Compared with the SEC's exemptive power that is stipulated in the 1940 Act, the de facto exemptive power in China is different in three ways. First, the legitimacy of the de facto exemption is shaky. In theory, laws made by China's central government legislation should be superior to laws made by China's local governments and or by the central government ministries. Local and ministerial laws that are inconsistent with the central government laws should be void automatically. In reality, it is difficult to enforce the legal hierarchy in China because these local and ministerial laws that provide de facto exemption benefit economic development. The disparity between theory and practice traps legislators in the central government in an awkward situation: if they insisted on the rule of law and enforced the legal hierarchy, economic development would suffer; but if they did not enforce the legal hierarchy, the rule of law would suffer. A well-defined exemptive power could avoid the awkward situation.

Second, the de facto exemptions make it more difficult for legislators to control the scope of exemptive power. American legislators stipulate the limits of exemptive power clearly. One limit is that it must be consistent with the

³⁴ "Some Rules about the Incorporation of High-Tech Research Products", July 4th, 1997, Committee of National Science and Technology (Current Ministry of Science and Technology), National Bureau of Industrial and Business Administration, Committee of National Science Development

purposes fairly intended by legislators. To satisfy this requirement, the SEC has to find evidence from Senate hearings and Congressional debates when it exercises exemptive power. Dissatisfied parties also have to find evidence from Congressional documents to challenge exemptions. The same can also be said to the other two requirements: investor protection and public interest. These limits help legislators control the use of exemptive power and improve the chances that the power is used appropriately. In contrast, no rule has been made to restrict the use of the de facto exemption power in China. This increases rather than decreases the chance of inappropriate exemptions.

One major concern for granting exemptive power in China is that due to the differences in institutional environments, exemptive power in China may not work as well as it does in the US. It shouldn't be controversial to predict the differences in performance. But from a policy perspective, whether the exemptive power in China can function as well as it does in the US is irrelevant. What truly matters is whether a well-defined exemptive power is better than the de facto exemptive power that currently exists in China. The existence of de facto exemption in China has transformed the discussion from whether China should allow exemptive power in regulating investment companies to which exemptive power is better, de facto or well-defined. The discussion above shows that compared with the de facto exemptive power in China, a well-defined exemptive power is better because it can simultaneously ensure the rule of law, promote economic growth and decrease the abuse of the power.

5. Conclusion

This paper demonstrates the importance of exemptive power in American investment company regulation and discusses the implications of exemptive power for investment company regulation in China. There is no doubt that whether to include exemptive power in China's Investment Fund Law is an important question for investment company regulation in China. This essay is only a beginning of the discussion. Many issues should be discussed before China grants exemptive power, such as how to ensure that the staff of the CSRC could handle the demanding job and how to deal with China's local governments. It would be an important change in China's legislation theory and practices if China decides to include exemptive power in investment company regulation. Many other reforms are necessary. For example, China's Congress should open the legislative debate so that regulators and the public could judge legislators' original purposes. These questions are important to China's investment company regulation and they should be pursued in future research.

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