

The Difficulties and Risks for Chinese Companies Using the VIE Structure to List on the U.S. Stock Market

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Abstract. When a company reaches a certain scale, it will seek broader markets to earn profits and pursue long-term development. Overseas listing is one of the avenues pursued by these companies. Through overseas listing, the company can issue an initial offering on the overseas stock market to achieve its purpose. In China, some companies, mainly Internet giants such as Alibaba, JD.com, and New Oriental, are prohibited from directly listing overseas because these companies hold important user data and national data. So, in this environment, these restricted companies discovered a structure called a variable interest entity (VIE) and used it to go public overseas. But leveraging this architecture doesn't mean it's easy and risk-free. My paper will focus on the difficulties and risks encountered by Chinese companies using VIE structures to list overseas, especially now that Sino-US relations have become special and will look into the future paths and prospects of Chinese companies listing overseas.

Keywords: Difficulties, Risks, VIE structure, Listing.

1. Introduction

1.1. Background

Many Chinese operating companies are listed on the Chinese stock market, selling shares to Chinese people and earning lucrative investments. However, due to China's policies and unfavorable situations, it has become more difficult to go public, resulting in many Chinese operating companies being unable to survive in the Chinese stock market. Fortunately, there is a typical structure called VIE. Its essence is a way for domestic entities to list overseas and allow Chinese companies to cash out and make profits in the U.S. stock market. For example, due to strict restrictions on Chinese policies and unfavorable market conditions, Tencent adopted a VIE structure to list in Hong Kong in 2004, which has less restrictive policies; Alibaba listed in New York in 2014 and then listed in Hong Kong in 2019. However, this type of structure has never been claimed to be legal or illegal in relevant countries, causing many potential or noticeable risks and difficulties to exist all along. Nowadays, with the strengthening of relations between the Chinese and American governments, the risks of VIE for foreign investors, the Chinese government, and so on not only increase but also become more complicated due to several factors. Thus, it deserves attention and research.

1.2. Related Research

Chen believes that VIEs have ambiguous legality. VIEs rely on the integrity of shareholders of operating entities. Once shareholders act in their own interests, At the expense of the value of Cayman-registered companies, foreign investors will face more risks (such as the Alipay incident); although both the U.S. and Hong Kong capital markets have made regulatory responses, the final decision-making power still remains in the hands of the Chinese authorities [1]. Cieřlik believes that VIEs provide opportunities for Chinese entities but also reveal numerous risks of not operating within the scope of the law. It is worth noting that foreign investors face a high risk of non-enforcement of their rights, and only a few of them are aware of this problem. Legalizing the structure or removing current restrictions on overseas listings seems unlikely [2]. Boer believes that some VIE shareholders have defrauded foreign investors, and protecting these investors should be the responsibility of the

US government, not the Chinese government. The U.S. Congress should improve laws to reduce VIE fraud and provide appropriate remedies [3].

Gillis and Lowry believe that VIE has regulatory risks, institutional risks, and the inconvenience of foreign exchange controls. Until 2014, the Chinese government had not taken extensive action against VIEs. The biggest risk faced by foreign investors is that the ambiguity of VIEs gives Chinese regulators significant influence over these companies; in addition, the owners of the main companies may unilaterally abolish the VIEs [4]. Jin and five other authors introduced VIE 2.0, and the geopolitical tensions between China and the United States have made an overnight freeze of the ADR listing market. The new rule should pinpoint operating companies that Chinese regulators truly consider too sensitive to allow foreign investment and then give the green light to those that do not affect public safety concerns [5]. Mark studied how relations between the US and China affect stock markets. The intensified relationship has pushed many Chinese companies listed in the US to transfer to Hong Kong. In addition, the US Securities and Exchange Commission claimed that it could not investigate 63 accounting firms that audit Chinese listed companies. China is the only country that refuses to do this [6].

Scott Murdoch and Kane Wu explained that the VIE works by setting up an offshore company to list US stock markets that allow foreigners to invest. Most companies using this structure are in sensitive fields, like education and the Internet. In VIE 2.0, which was approved in the wake of 2021, Chinese companies will need approval from the China Securities Regulatory Commission before they use VIE to list abroad [7]. Santoni believes that the introduction of the new foreign investment law may eliminate the existence of VIEs, but it will not prevent foreign investors from investing in China's Internet economy. In fact, China restricts the listing of VIE companies to prevent sensitive information from falling into the control of overseas entities [8].

Shi and three other writers studied whether the US-China trade war affected the stock markets of both. Most of the structural breakpoints between mainland China, Hong Kong, and the US stock markets occurred after July 6, 2018, when Sino-US relations escalated to severe tensions. The US-China trade war has reduced the risk management benefits of portfolio diversification when investing in both US and Chinese stocks [9]. Yang said that among companies listed using the VIE structure, our country should strictly supervise state-owned enterprises and relax its attitude slightly towards private enterprises. In the long run, we should build smooth financing channels, lower barriers to entry, and simplify processes. At the same time, we will improve the market supervision model [10].

1.3. Objective

This paper will examine the difficulties and risks for companies that intend to utilize the VIE structure to list overseas or have already done so in the face of increasing tensions between the U.S. and China, and notable cases will be cited to help explain the situation.

2. How Does the VIE Structure Operate, What Advantages, Situations of Companies Using It, Trends, And Examples?

The VIE structure is a device utilized by Chinese companies in order to go public overseas, as shown in Fig.1. Since Sina's initial listing on the NASDAQ in 2000, many of China's leading Internet companies, such as Alibaba, Jingdong, and Baidu, have utilized this structure. While Chinese authorities have explicitly banned overseas investors from investing in their own companies, so far, most companies have not been warned or penalized by the Chinese government, except for those that have engaged in behavior that threatens national security. This demonstrates the Chinese government's legal ambiguity about the VIE structure. In a VIE structure, the founder of the Chinese company owns the Chinese company, and at the same time, the founder registers an offshore company in the British Virgin Islands (for tax avoidance purposes). Next, the offshore company will register another offshore company in the Cayman Islands that can be listed in the US or Hong Kong for overseas investors. Subsequently, this Cayman company will register a pipeline company in Hong

Kong for the purpose of tax avoidance. The pipeline company would set up a wholly foreign-owned enterprise within the mainland with a contract with a Chinese entity operating the company so that the financing the company receives overseas can legally flow into the country, and the benefits will flow out of the country in the form of fees for technical services, which will be converted into the form of dividends.

How the VIE structure works

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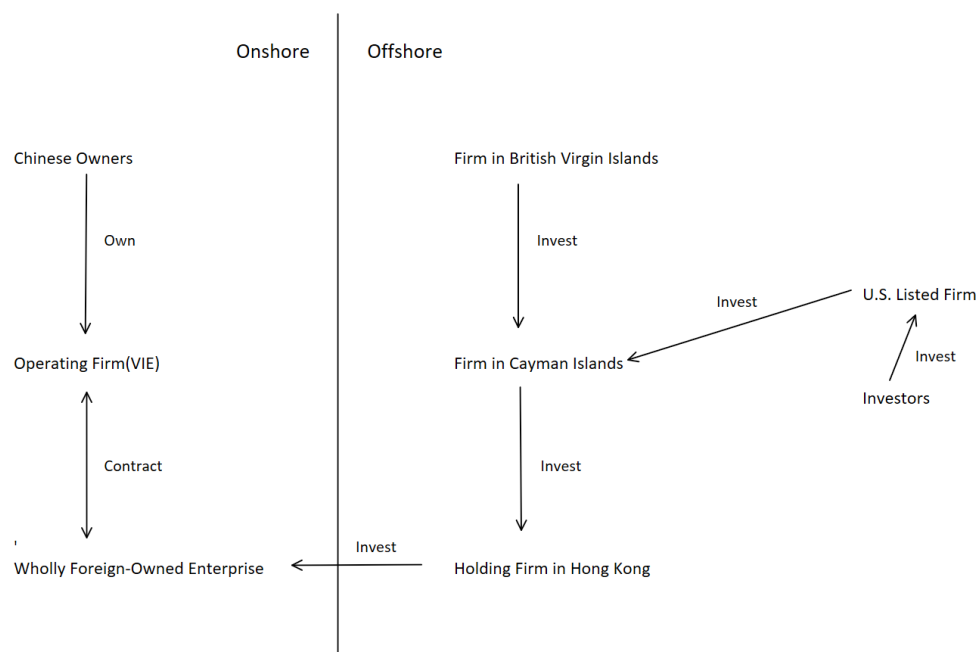


Figure 1. The mechanism of VIE structure

In the context of US-China competition, what are the risks to foreign investors? What are the problems for the Chinese government/firms?

2.1. Trade Uncertainty

Trade disputes between the U.S. and China may lead to tensions in bilateral trade relations, which in turn may affect the business activities of firms and investors. Due to the uncertainty of trade policies, it is difficult for companies to predict future changes in the market environment and demand, which may have a significant impact on them. In Prof. Shi's Event Study, China, Hong Kong, China, and the U.S. stock markets all experienced structural breakpoints after both China and the U.S. raised tariffs on imports to the other in July 2018. Two of the sectors, industrial and information, had the most pronounced reaction to the announcement (the increase in import tariffs), and most of the companies listed overseas utilizing VIE structures serve the information sector. The impact of the US-China trade friction on them is, therefore, incalculable.

2.2. Stricter Review Process

Friction between the United States and China may lead to disruptions or restrictions on cross-border investment activities. For example, stricter regulatory measures or restrictions on direct investment in certain areas (e.g., high-tech industries) have been introduced. This will make it more challenging for companies that rely on cross-border investment for expansion or growth and increase the risk that they will lose out to global competition. Bitauto is an internet service platform centered on auto finance, used car trading, insurance, and leasing. In 2021, Bitauto filed an IPO application with NASDAQ, but the SEC found its financial condition to be problematic and thus failed to pass the review. In the report, Bitauto was noted to have several errors and irregularities to the extent that the market was skeptical about its financial strength. In addition, in 2021, both governments put the brakes on IPOs of Chinese companies in New York, causing more and more Chinese companies to

turn to mainland China or Hong Kong, China, for their listings. There is no doubt that the tough US-China relationship has led to stricter scrutiny tactics on the U.S. side.

2.3. Volatility in Financial Markets

Escalating tensions between the U.S. and China could trigger volatility in global financial markets. Since the two countries are the world's largest economies, any kind of conflict has the potential to have an impact on global financial stability. All kinds of financial indicators, such as stocks, exchange rates, and commodity prices, can fluctuate wildly, affecting companies and investors. In VIE structures, for example, Chinese entities are required to take some of their profits out of the country and return them to overseas shareholders in yuan. However, as Sino-US relations intensify, the renminbi is depreciating. That means U.S. investors will receive lower dollar profits. But if this is in the form of dollar-denominated debt, such as bonds, Chinese companies will have to pay a fixed amount in dollars, which is more yuan.

2.4. Information Disclosure Involving National Security

Some of the companies involved in the technology industry undoubtedly have a handle on users' privacy and whereabouts. If these companies want to seek overseas listings, they must submit to U.S. agencies to audit their documents, including user data collected by the tech companies. In today's increasingly grim Sino-US relations, these figures are particularly important because once the other side has mastered the data of our people, our weaknesses will be exposed. The famous taxi-hailing app, Didi, was banned for a while and received severe punishment. As the most used taxi app in China, Didi controls users' personal privacy and driving records. In June 2021, Didi officially submitted a prospectus to the U.S. Securities Commission to apply for listing on NASDAQ or the New York Stock Exchange. At the end of the month, while the nation was asleep, Didi raised \$4 billion in its U.S. IPO. The next day, the Cyberspace Administration of China reviewed it and stopped Didi's new user registration function to prevent the risk from growing. This behavior of Didi undoubtedly jeopardized China's national security because the successful listing means that Didi's documents have been reviewed by the U.S. Securities Commission, including user privacy. Likewise, for the U.S. government, the privacy of its own people is a matter of national security. If overseas Chinese companies have access to critical user data, the U.S. government will not sit idly by. TikTok is a good example. ByteDance, the parent company of TikTok, began seeking a Nasdaq listing in 2021. At that time, the international version of TikTok was at its peak. According to statistics, the number of active users of the international version of TikTok in the United States has reached 150 million, which is half the population of the United States. However, as Sino-US relations deteriorated, the U.S. side kept putting pressure on ByteDance. Ultimately, the U.S. government believes that the user data collected by the international version of TikTok could be accessed and used by the Chinese government, and because of the large number of registered users, the U.S. government is concerned that its propaganda content could influence the 2024 presidential election. As a result, the U.S. government announced a ban on the international version of TikTok. But it could also choose to accept Microsoft's acquisition and continue to exist in the U.S. Internet market so that U.S. user data would be retained in the United States.

3. Prospect

When it comes to the legality of the VIE structure, the new rules continue the past "no negation" approach. First of all, it needs to be clear that the introduction of the new regulations in 2021 does not aim to restrict the overseas listing of enterprises. When answering the relevant questions, the CSRC mentioned that "improving the regulatory system of overseas listing of enterprises is not a tightening of the regulatory policy of overseas listing." The introduction of the new rules is actually to fill the previous regulatory gap of overseas listings. From another point of view, the new regulation

explicitly includes the VIE structure in the regulatory system, which can be regarded as a recognition of the VIE structure.

On the other hand, the use of the VIE structure is also limited. The emergence of VIE structure is a workaround measure under the contradiction between foreign investment access restrictions and financing needs, and no substantive approval and weak supervision are its advantages. The new regulation will unify the VIE structure into the regulatory system and adopt the above filing system to manage it, objectively increasing the regulatory intensity of the VIE structure and causing certain uncertainties to its overseas listing. The fundamental purpose of adopting the VIE structure is to go public overseas. Therefore, there is a possibility that the VIE structure will not be banned, but the application of the VIE structure will be reduced due to uncertainty about whether the VIE structure will be approved for overseas listing.

The VIE structure, which originated from a specific background, has made great contributions to Chinese enterprises going global and introducing foreign capital, especially providing financing help for the development of the Internet, education, information, and other industries. Before the new law was introduced, the legal regulation of the VIE structure in our country was generally relatively restrained. However, after the "Didi incident", network security and data security have become the focus of attention. The introduction of new regulations in 2021 "brings back old things", intending to supervise the VIE structure in the regulations clearly. We must deeply understand the great significance of building a new development pattern of international and domestic double cycles and make the right choices on issues such as the construction of enterprise structure, the introduction of investors, and the choice of listing so as to follow the trend and avoid repeating the past mistakes.

4. Conclusion

This paper examines how companies that utilize ongoing VIE structures to list overseas or have already listed successfully will be affected in the face of growing tensions between the United States and China. These impacts include trade uncertainty, more stringent review processes, financial market volatility, and information leakage related to national security. For the Chinese government, preventing the leakage of important national data is the most important thing, so it needs to improve the relevant laws to clarify the legality and illegality of the VIE structure. For the U.S. government, too many overseas companies obtaining investment in the local market is the biggest risk, and it needs to scrutinize more strictly in order to minimize the risk; for the entities, it is their responsibility to utilize the structure legally, and the companies should not violate the law and the national interest without violating the law and the national interest. Companies should make reasonable use of the relevant rules to arrange the listing process, raise funds effectively, and realize rapid development without violating the law and national interests.

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