The Future of Chinese Variable Interest Entity Structure: Do Recent Policies Have Positive or Negative Effects on It?

Youli Wu*

Wuhan Britain-China School, Wuhan, China

* Corresponding Author Email: skuldwu@outlook.com

Abstract. Variable interest entity (VIE) is a solution to China's tight foreign investment policy. At the beginning of reform and open-up in China, the VIE structure brought domestic companies opportunities to have more financial support, and it made investing in Chinese companies an easy thing for U.S. investors. However, both the domestic company and U.S. investors have taken risks with the VIE structure. Recently U.S. and China introduced some policies to deal with the problems. Those policies might threaten the VIE structure's survival but also provide other safer and more efficient options to Chinese companies and U.S. investors.

Keywords: Variable interest entity, foreign investment, regulatory policy, financial market; listing.

1. Introduction

Foreign direct investment (FDI) is essential for both an economy and a company: the economy gets a higher Gross Domestic Product (GDP) by gaining more investment, and a company gains multiple sources of finance. However, it takes work for a company to access foreign investment in China. Usually, there are many requirements and regulations for this investment process from both the company and the investor side. For example, to guarantee national security, the Chinese government prohibits foreign investors from investing in news agencies or some special ore mining industries; also, investors are not allowed to have too many shares in one Chinese company. For the companies, the benefit they gain through foreign investment is attractive; however, it is hard to get enough foreign investment as they want. To avoid being restricted, some Chinese companies began to find a solution. This situation was common in the Internet market at the beginning of the reform and opening-up since foreign investment could benefit Internet businesses from policy help and new technology while foreign firms could not be set in the Internet market. In this case, the variable interest entity (VIE) structure was invited and applied in many Internet companies such as Alibaba and Tencent. Chen Fa states, "A typical Chinese style VIE structure contains tiers. Including a Cayman-incorporated company that serves as the listed shell upon flotation, a conduit company domiciled in Hong Kong, a wholly foreign-owned enterprise (WFOE) based in China, and a Chinese operating entity [1]. With this special structure, many Chinese companies gained enough capital, technology support, and investment from foreign investment, mainly from the American stock market, and eventually grew into vast and successful companies.

However, since the VIE structure is the reply to Chinese restrictions on foreign investors, the laws do not strongly support it, and the risks of VIE on both the domestic and foreign aspects lead to restrictions on this special financial structure. In other words, the American government wants to mitigate the risks American investors take, while the Chinese government aims to reduce the safety hazard that the VIE structure brings to the country. Eventually, these policies that aim to protect countries' interests might negatively affect the VIE structure and the companies using this structure. This paper will figure out the positive and negative influences those policies made on VIE structure and analyze whether companies should use VIE structure as the primary financial resource in the future.

Many researchers have studied the VIE structure in China and the risks of using this structure. In most cases, investors are those taking the most risks; the VIE structure also has some negative effects on society. For investors, the problems mainly come from the validity of contracts and lack of legal protection, while VIE-based companies can avoid tax payments through the VIE structure. For

example, Samuel Farrell Ziegler stated that the VIE structure would threaten American investors by stealing assets with impunity since the VIE structure was not admitted or protected by the Chinese government. Also, there was a possibility that the Chinese government could easily crack this structure. In this case, American investors' interest would be damaged [1].

Li Guo also mentioned the same legal hazard, saying that the contract between a domestic company and a listed company was less reliable, and investors' interests could not be protected under the conflicts between owners and managers. Guo Li gave an example of Alibaba and Yahoo! and pointed out that even though Yahoo! Was the principal shareholder of Alibaba Group, Alibaba still transferred ownership of Alipay without Yahoo!'s agreement [2]. MacKensie Larson gave a more specific analysis of Alibaba's VIE structure, focusing on the application of base-erosion and profit shifting (BEPS) in Alibaba. According to his paper, Chinese VIEs used BEPS to avoid high tax rates in OECD countries, transferring their profits into tax havens such as the Cayman Islands, and this harmful practice could lead to damage to the global tax system [3].

2. VIE structure

Chen Fa states, "A typical Chinese style VIE structure contains four tiers, including a Cayman-incorporated company that serves as the listed shell upon flotation, a conduit company domiciled in Hong Kong, a wholly foreign-owned enterprise (WFOE) based in China, and a Chinese operating entity [4]." It could be simply demonstrated as the figure shows (Fig. 1).

In the VIE structure, the WFOE acts as a connection between foreign investors and the domestic company, and the core of the VIE structure is the contract between the WFOE and the Chinese operating entity, which ensures the control force of the operating company. According to the contract, the operating company has full control of the WFOE, and WFOE should provide interest-free loans and technology to the operating company in order to get the profits and benefits they served. In this case, the operating company could transfer all the investment in WFOE into an investment of its own. Since this kind of investment is not considered a foreign direct investment, it does not need to pass the regulatory requirements or restrictions.

It is common for Internet companies to use the VIE structure to gain foreign investment and technology, as FDI was prohibited in this field. However, Internet companies needed large-scale investment and technology to help with their development. Then, to cope with this FDI difficulty, Sina first used the VIE structure in 2000 and was listed on the NASDAQ successfully. After Sina's success, more and more companies, such as Tencent, Alibaba, and so on, found the benefits of the VIE structure and started to use it. In the next twenty years, more than 300 companies in the Internet market chose to list overseas through the VIE structure.

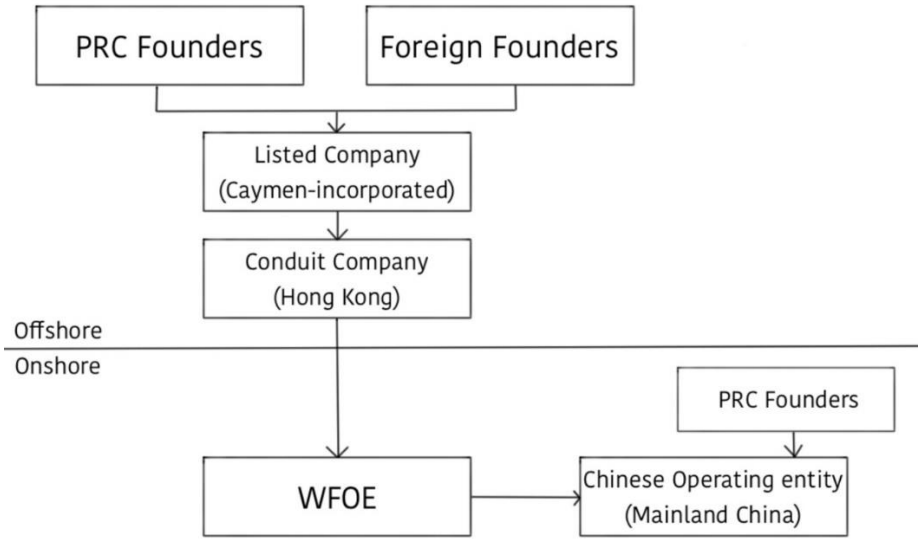


Fig. 1 The VIE structure

3. Issues of VIE Structure

Since the VIE structure is a coping strategy to the strict restrictions on foreign investment set by the Chinese government, it also brings risks to investors, and most of those risks are caused by the separation between operation and ownership. According to Paul Gillis and Michelle Lowry (2014), those risks can be classified into three categories: regulatory risks, agency risks, and operational risks [5]. This paper focuses on the agency risks the most since it best shows the conflicts between the owners and controllers. In common situations, owners always have a significant impact on a company's decision-making or even operation – the board of directors has the right to choose the CEO and can influence the important decisions the company makes. However, the VIE structure cannot provide as many rights as traditional companies since the actual control is in the original Chinese company, not the investors. In other words, those investors do not gain a deserved return for their input. The conflicts between owners and managers can be more severe than in other companies. Also, there is a legal hazard to the VIE structure. Since the original company wrote the contract and lacked legal protection, the owners' rights could be damaged once the original company changed the contract without the investors' agreement. Take Alibaba as an example: to fit Chinese laws, Alibaba separated Alipay, the main asset in Alibaba's VIE structure, out of its VIE structure, leading to a huge loss for U.S. investors since the profit of Alipay was no longer accounted for in the VIE company. However, there was no law to protect U.S. investors' interest in either the U.S. or China, and the strongest guarantee the U.S. investors had was in the contract between the operating company and the WFOE, which could be revised by the operating company.

When a company wants to go public, it must first go Initial public offering (IPO). IPO is the first time a company sells its share to the public. In order to attract investors and show capacity and reliability, companies always need to public some basic information. However, most VIE companies are in a sensitive field, and some of the information and data they hold would not be able to be shown to foreigners, according to the Chinese government. For example, DiDi, a company that provides booking taxis in China like Uber, which has a typical VIE structure, was questioned leaking precise map information of China towards America in its IPO. Also, the VIE structure helps Chinese companies avoid being checked and refused by the regulatory commission. Thus, the cost of going listed can be more manageable. But for the Chinese government, it is hard to audit and censor the VIE companies, because those listed companies are based in America, not in China. So, under the present situation, the China Securities Regulatory Commission (CSRC) is not able to audit the public process effectively.

4. Policies in the U.S.

4.1. Holding Foreign Companies Accountable Act (HFCAA)

To cope with the risks that VIE structures bring to U.S. investors, in December 2020, the Holding Foreign Companies Accountable Act (HFCAA) was signed. HFCAA is the law that restricts US-listed, China-based companies by forcing all of them to accept audits by the Public Company Accounting Oversight Board (PCAOB) in order to protect the interest of U.S. investors. According to HFCAA, Foreign Issuers, those issuers that are controlled by foreign governments, would face trading prohibition or even delisting. For the Chinese companies, once they are considered as Commission-Identified Issuer, they need to "submit documentation and make certain disclosures related to their ties to the Chinese government and the Chinese Communist Party [6]". This means additional costs for those companies since the document needs to contain a lot of details, and they still have a high risk of being labelled as Commission-Identified Issuer.

For U.S. investors, the companies they invested in might be prohibited from trading or delisted, according to the HFCAA, though it is profitable. If those Chinese companies are considered Commission-Identified Issuers, they might go private or even relist in another market, such as Hongkong or Mainland China, which could be bad for U.S. investors since they lose the chance to

earn profits. The biggest problem is that U.S. investors are even not able to guarantee their interest and assets because the domestic companies are located in China, where the U.S. courts can not intervene [6]. According to the United States Securities and Exchange Commission (SEC) (2023), there were 174 companies were listed on the conclusive list of issuers identified under the HFCAA, including Weibo corporation, iQIYI, Baidu and many other Internet companies [7] (Table. 1).

Table 1. Part of the conclusive list of issuer

Issuer Name	CIK	Date conclusively identified
Weibo Corporation	1595761	April 14, 2022
iQIYI, Inc.	1722608	April 21, 2022
Baidu, Inc.	1329099	April 21, 2022
Sohu.com Limited	1734107	May 4, 2022
Zhihu Inc.	1835724	May 13, 2022
Bilibili Inc.	1723690	May 26, 2022
360 DigiTech, Inc.	1741530	May 26, 2022
NetEase, Inc.	1110646	May 26, 2022
Pinduoduo Inc	1737806	May 26, 2022

Source: U.S. Securities and Exchange Commission

4.2. Special Purpose Acquisition Companies (SPAC)

At the same time, some substitutions for the VIE structure can be used. One of these is special purpose acquisition companies (SPAC), a method for private companies to gain financial support from the public by IPO. However, it is different from the traditional IPO since the SPAC company is actually a shell company with no assets, and then the SPAC company will acquire or merge with another private company to achieve the transactions. [8].

Different from the VIE structure, SPAC is admitted and protected by the laws, which means that it is safer for both the U.S. investors who are afraid of lack of control since the SPAC company will finally merge with the actual private company and the Chinese companies since they are not restricted by the HFCAA and have fewer risks to be prohibited. In this case, SPAC could be a good choice for those companies that were forced to delist but still want to come back to the market.

5. Policies in China

5.1. Special Administrative Masure

Chinese government actually have admitted VIE structure in a secret way: in the Special Administrative Measures (Negative List) for the Access of Foreign Investment, it is called “the merger or acquisition of an affiliated domestic company by a domestic company, enterprise, or natural person through an overseas company [9]”. Also, VIE companies should follow the same regulations as common foreign-invested companies do, which means the VIE structure is limited or banned in some fields, such as news organisations, publishing, rare earth and so on. With clearly defined and stricter laws, companies in that field cannot avoid restrictions by using a VIE structure. Thus, their financial resource and technology are limited.

However, this change does have some benefits: now that the VIE structure has been admitted by the Chinese government, U.S. investors do not need to worry that the VIE company will be banned by the Chinese government. Also, this is a signal showing that the Chinese government is encouraging FDI and expanding the permitted fields, so in the future, companies might be able to gain more FDI to support their operation.

5.2. Encourage in FDI

Though VIE is now restricted by the Chinese government, the items on the negative list have been reduced during these years. In the recent four years, Special Administrative Measures (Negative List) for the Access of Foreign Investment has been revised many times, and the Chinese government has decreased the limited field of foreign investment to 33; in the high-tech field, the foreign investment has increased for 20.9%, and service sector was the main increasing point of foreign investment [10].

It is undeniable that FDI is essential to an economy, and in the future, the Chinese government may expand the fields for FDI. For example, the restrictions on the manufacturing market have now been moved thoroughly, and the Chinese government is mitigating the restrictions on high-tech fields. In this case, the Chinese VIE companies, especially those high-tech or e-commerce companies, might have a chance to gain financial support through FDI rather than being listed in the U.S. Also, the cost will be less since they do not need to do another IPO in the foreign market.

6. Conclusion

Both the policies introduced by the U.S. government and the Chinese government aim to protect and guarantee their interests, so the VIE structure is restricted for its negative impact on investors and society. It is true that the VIE structure is not perfect, and it is just a coping strategy against the tight, strict foreign investment policy in China in the early years. Now, China is loosening its foreign investment policies and regulations and trying to get more FDI; in this case, even though the VIE structure gained massive damage from the HFCAA, those Chinese companies can also list and gain foreign investment inside China. However, this paper didn't analyze how the existing VIE companies changed their structure into safer and admitted ones. In future studies, the details of the VIE structure change should be researched more. Also, none of the policies entirely prohibited the VIE structure, and the policies might change as the international environment and the relationship between the U.S. and China change.

Reference

[1] Ziegler S. China's Variable Interest Entity Problem: How Americans Have Illegally Invested Billions in China and How to Fix It. The George Washington Law Review, 2016, 84(2): 539-562.

[2] Guo Li. Chinese Style VIEs: Continuing to Sneak under Smog. Cornell International Law Journal, 2014, 47(3): 569-606.

[3] Larson M. Alibaba's VIE Structure and Erosion of BEPS Goals in China's E-commerce Industry. Temp. Int'l & Comp. LJ., 2018, 33: 201-243.

[4] Chen Fa. Variable interest entity structures in China: are legal uncertainties and risks to foreign investors part of China's regulatory policy?. Asia Pacific Law Review, 2021, 29(1): 1-24.

[5] Gillis P., Lowry M. Son of Enron: Investors Weigh the Risks of Chinese Variable Interest Entities. Journal of Applied Corporate Finance, 2014, 26(3): 61-66.

[6] Fried J., Ozery T. The Holding Foreign Companies Accountable (HFCA) Act: A Critique. The Harvard John M. Olin Discussion Paper Series, 2023.

[7] Holding Foreign Companies Accountable Act. SEC.gov | Holding Foreign Companies Accountable Act, U.S. Securities and Exchange Commission, 2023.

[8] Newman N., Trautman L. Special Purpose Acquisition Companies (SPACS) and The SEC. U. Pa. J. Bus. L., 2021, 24:639-699.

[9] Special Administrative Measures for Access of Foreign Investments (Negative List) (2021 Edition). National Development and Reform Commission of the People's Republic of China, 2021.

[10] 14th Five-Year Plan: Introducing Foreign Investment Project. National Development and Reform Commission of the People's Republic of China, 2023.