

The Benefits and Risks of Chinese VIE Firms

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Abstract: The VIE structure is a unique structure widely used by Chinese companies, especially in industries with restricted foreign investment. Through this structure, Chinese companies can allow foreign investors to indirectly invest money and receive profits through complex contractual agreements without violating domestic and foreign investment restrictions. The operating mechanism of the VIE structure can bring convenience to Chinese companies, provide them with opportunities to enter the international capital market, help them circumvent foreign investment access restrictions, improve company valuations and market liquidity, and simplify the IPO process. However, the structure also faces many risks, including legal uncertainty, regulatory risks, and tax and information security issues. Given that the VIE structure relies on contracts with uncertain enforceability, which are not recognized in the Chinese legal system, foreign investors face greater legal risks when investing in VIE-structured companies. Through an in-depth analysis of Chinese VIE firms, this article aims to provide a reference for investors and policymakers to better understand its advantages and disadvantages and explore its future development direction.

Keywords: VIE, Foreign capital, Internet industry, IPO.

1. Introduction

The VIE (Variable Interest Entity) structure is a special structure which is widely used by Chinese companies, especially those that want to list in overseas capital markets but are subject to Chinese government restrictions on foreign investment. The VIE structure enables foreign investors to indirectly control and obtain the economic benefits of Chinese companies by establishing a series of complex contractual relationships between the actual operating Chinese company and the overseas listed entity. The core of the VIE structure is that through these contracts, overseas investors can enjoy the right to distribute and manage the profits of the Chinese company without directly owning the company's equity [1].

The operation of the VIE structure relies on three main parts: a domestic operating entity, an overseas holding company, and a series of contracts that describe and maintain the economic relationship between the two. First, the domestic operating entity is a company registered in China that is in charge of the actual business operations. Second, the overseas holding company is usually established in an offshore financial center including the British Virgin Islands or the Cayman Islands as the listing entity. Finally, through a series of agreements, such as agreements between business agencies, exclusive technical service agreements equity pledge agreements, and equity pledge agreements, the overseas holding company can control the operating activities of the domestic

operating entity and share its operating profits [1]. The VIE structure can help overseas investors circumvent Chinese legal restrictions on foreign capital entering specific industries, such as the Internet, education, and media industries. Through the VIE structure, Chinese companies can conduct IPOs on international capital markets such as the NASDAQ or New York Stock Exchange (NYSE), thereby obtaining investment support from international capital [2].

Most of China's VIE companies are in industries such as the Internet, education, and media where foreign capital investment is restricted. These industries generally have high growth potential, but because they involve sensitive areas such as national security or culture, the Chinese government has set strict restrictions on foreign investment. For example, Chinese technology giants such as Alibaba, Tencent, and Baidu have all adopted the VIE structure to go public overseas. These companies have successfully obtained financial support from the international capital market through the VIE structure, which has promoted the rapid expansion of their businesses. A typical Chinese VIE structure consists of four layers, including a company registered in the Cayman Islands (as a shell company after listing), a conduit company based in Hong Kong, a wholly foreign-owned enterprise (WFOE) based in China, and a Chinese operating entity. In the VIE structure, the founder of the Chinese company holds shares in the Cayman company and is usually also the sole shareholder of the Chinese operating entity [3]. The VIE structure is widely used by China's most valuable and successful Internet giants, mainly because it brings significant convenience to the company's development, including broadening financing channels, promoting internationalization strategies, and circumventing foreign investment restrictions in specific industries. However, this structure also engenders certain risks, such as challenges in legal compliance, stability of control rights, and tax complexity. This article aims to explore in depth the specific benefits and potential risks that the VIE structure brings to Chinese companies. The VIE structure is commonly used by China's most valuable and successful Internet giants, mainly because it brings significant convenience to the company's development, including broadening financing channels, promoting internationalization strategies, and circumventing foreign investment restrictions in specific industries. However, this structure faces certain risks, such as challenges in legal compliance, stability of control rights, and tax complexity. This article aims to explore in depth the specific benefits and potential risks to Chinese firms under the VIE structure.

2. Advantage of the VIE Structure

In recent years, the VIE (Variable Interest Entity) structure has played a vital role in the internationalization of Chinese companies. Through this structure, many Chinese companies have successfully bypassed domestic restrictions on foreign investment in specific industries and entered the international capital market. This article will explore the four main benefits of the VIE structure: access to global capital markets, circumventing foreign investment restrictions, improving company valuation and market liquidity, and circumventing complex listing processes.

2.1. Financing Convenience

The relatively closed nature of China's capital market along with the strict regulation make it difficult for many Chinese companies to obtain sufficient financial support through domestic channels. When private companies borrow from banks, they face stricter scrutiny than state-owned companies. The VIE structure provides these enterprises with an important way to enter the international capital market. Through the VIE structure, companies can set up overseas holding companies and control domestic operating entities through a series of complex contractual arrangements, thereby achieving international listing and financing. This structure not only helps the company obtain huge financial support from foreign capital but also significantly enhances its global visibility and market influence,

making it easier for the company to conduct overseas business in the future. As of September 2022, 262 Chinese firms were listed in the US stock market, about 2/3 of which are in the form of VIE.

Alibaba Group is a typical case of the successful application of the VIE structure. In 2014, Alibaba was listed on the New York Stock Exchange through a VIE structure and successfully raised US\$25 billion, becoming the world's largest IPO at the time. Alibaba's total market value in 2023 is US\$230.6 billion, while the total market value of all companies on China's Science and Technology Innovation Board is approximately US\$990 billion. The market value of one Alibaba company is equal to 1/4 of the total market value of China's Science and Technology Innovation Board. In 2020, Alibaba's total market value is almost equal to the combined market value of all companies on the China Science and Technology Innovation Board [4]. This listing not only provided Alibaba with huge financial support but also greatly enhanced its influence in the global market and consolidated its position as a global e-commerce giant. This opportunity to enter the international capital market allows Chinese companies to better participate in global competition and promote the rapid expansion of their businesses [5].

2.2. Circumventing Areas where Prohibit Foreign Investment

China has two separate systems for foreign investment: the foreign investment system and the national security review system. The former applies to all foreign investment activities conducted directly or indirectly by foreign investors in China, while the latter applies only to foreign investment that raises national security concerns. In China, foreign investment is divided into four categories: encouraged, permitted, restricted, and prohibited. The Chinese government uses a negative list system to restrain foreign investment in forbidden industries, in which foreign investors are not allowed to participate in. According to the 2021 National Negative List (latest version), foreign investors are prohibited from investing in 21 industries in 10 fields, covering agriculture, information technology, and scientific research, including the Internet industry [6].

For other industries involving national security and cultural communication, the Chinese government has strict regulations on foreign investor's percentage of shareholding or participation. Therefore, the VIE structure offers global investors an approach to indirectly control companies in these intense industries through contractual arrangements, thereby circumventing foreign investment access restrictions [7].

For example, Internet giants such as Tencent and Baidu have successfully listed overseas through the VIE structure. These companies have achieved international financing by establishing holding companies overseas and controlling the actual operating entities in China through contracts. This approach not only enables the company to attract international capital but also promotes the rapid expansion of the company in the international market while complying with Chinese laws.

2.3. Improve Company Valuation and Market Liquidity

Companies listed on international capital markets often command higher valuations. Global investors are usually more willing to buy companies with high growth potential at a premium, which allows companies listed through the VIE structure to obtain higher market values in the global capital market. In addition, the international market is more liquid and has a broader investor base, which makes the trading of company stocks more active and significantly improves market liquidity.

After Pinduoduo was listed on the Nasdaq through a VIE structure, its valuation rose rapidly. Although Pinduoduo has been established for a relatively short period, its innovative business model and strong market performance have attracted the attention of a large number of international investors. PDD segment VIE and its subsidiaries generated 45.7% of total revenue (approximately \$17 billion) in 2023 and cover most of the company's online marketing services, as these services

require a VATS license. The online marketing services segment is set to grow by a staggering 49% in 2023. Other subsidiaries of PDD Holdings, which is wholly owned by PDD, generated 54.3% of total revenue in 2023 and cover most transaction services[8].

2.4. Simplify the Listing Process

China's listing process is relatively complex and time-consuming. Companies must go through multiple regulatory approvals and meet various legal and financial compliance requirements. This can be a huge obstacle for companies that seek funds in the capital market. The VIE structure can be listed directly overseas by setting up a holding company overseas, thus avoiding the complicated domestic approval process.

Xiaomi is a typical example of using the VIE structure to bypass the cumbersome domestic approval process. By listing in Hong Kong, Xiaomi not only successfully avoided domestic approval delays, but also significantly shortened the listing time. This listing brought a large amount of capital injection to Xiaomi, helping the company to rapidly expand its market share in a short period.

3. Risks of VIE Structure

The above points are important reasons why Chinese companies choose the VIE structure. However, the VIE structure may bring potential risks to both foreign investors and the Chinese government due to its lack of direct and comprehensive supervision and review mechanisms and its unique corporate control structure.

3.1. Legal Risks

There are two main ways for Chinese companies to go public overseas. Taking the United States as an example, the first way is direct listing, that is, Chinese companies directly conduct an initial public offering (IPO) in the U.S. stock market. However, this method faces many challenges both at home and abroad. In the United States, the process of direct listing is time-consuming, expensive, and has the risk of failure. In China, companies need to obtain approval from the China Securities Regulatory Commission to conduct direct overseas listings, and this approval is usually difficult. Therefore, not many Chinese business tend to go public directly in the United States

The second way is to go public through the VIE structure. These Chinese firms could bypass the requirement of "needing approval from the China Securities Regulatory Commission" and also circumvent the restrictions in the "negative list plus security review". The VIE structure is legal under the current legal framework of China and successfully avoids the procedural requirements for Chinese companies to go public overseas.

Shell companies established through the VIE structure are listed in the United States, but the listing location is not in China, and the listed entity is not a Chinese legal person. Therefore, it is difficult for the Chinese government to effectively supervise the operating conditions of such companies [9].

The Chinese government has never recognized the legality of the VIE structure, which means that the VIE structure always faces potential legal risks. Central Chinese policies may change at any time, and these changes may affect VIE structures in certain industries or restrict specific aspects of control contracts. The Chinese government has precedents in the past to restrict the electronic gaming and steel industries. If China believes that a major industry is potentially risky, it will not hesitate to restrict foreign participation. Similarly, local governments can restrict the use of VIE structures within their jurisdictions through local regulatory interpretations [10].

3.2. Control Risks

The VIE structure relies on a combination of contractual arrangements that are not enforceable. Foreign investors enjoy the right to reap the returns of their capital but do not have the power to make decisions over the Chinese entity. When the actual controller of the Chinese entity makes a decision that is unfavorable to foreign investors, foreign investors have no way to stop it. For example, when Alibaba split its ownership of Alipay to another company controlled by Jack Ma, its investors Yahoo and Softbank were excluded from the decision. The transfer of Alipay ownership caused Alibaba's stock price to plummet, causing losses to investors [11]. Because the enforceability of these contracts has not yet been legally tested by Chinese courts, foreign investors face increased legal uncertainty. When the Chinese entity defaults, there is unpredictability in the enforcement of these control contracts by Chinese courts, and foreign capital has a relatively weak negotiating position. This legal uncertainty means that once the control contract is breached, the investment value may drop significantly, which is a significant risk for investors.

3.3. Tax Risks

The VIE structure faces multiple risks in terms of tax supervision, especially since many VIE companies are registered in low-tax ranges such as the British Virgin Islands (BVI). These risks are mainly concentrated in the following aspects. First, the tax transparency of offshore regions such as the BVI is low, and companies often register in these regions to take advantage of their relaxed tax policies and confidentiality systems. Although this practice can reduce the tax burden of companies in the short term, it also increases the risk of being identified as tax evasion by Chinese tax authorities. Second, companies using offshore structures must ensure compliance with Chinese tax laws and regulations when conducting cross-border transactions. In recent years, China has strengthened its supervision of cross-border capital flows, especially the enforcement of "anti-tax avoidance" clauses [12]. If companies fail to meet the increasingly stringent supervision of the Chinese government, they may be required to pay additional taxes and face legal sanctions. Third, due to the low tax transparency of the BVI offshore region, investors may not be able to understand the company's true revenue situation, which will affect investment judgment and cause losses.

3.4. Information Security

In addition, China has recently introduced several laws, such as the Data Security Law and the Personal Information Protection Law, to strengthen supervision of the cross-border transfer of certain data and personal information. In the past two months, the Cyberspace Administration of China (CAC) has begun investigating and enforcing the data and information processing practices of some Chinese companies, some of which are related to the cross-border transfer of data or personal information by VIE-structured companies. As stockholders, foreign investors need to have access to VIE business information. Therefore, the interests of investors may conflict with Chinese laws and regulations.

4. Conclusion

Indeed, the VIE structure is an effective way to help Chinese companies obtain more funds and bypass the complex and lengthy regulatory review process. Companies using the VIE structure can more easily improve market valuations and stock liquidity, which is conducive to the development of enterprises. The Chinese government's long-term ambiguous attitude towards the legality of VIE has helped attract foreign investment and promote economic development. However, the VIE structure always faces the risk of insufficient contractual binding and unclear legal validity. With the Chinese government's increasingly strict supervision, continued emphasis on the importance of data security

and privacy, and the expected increasingly tense Sino-US relations, foreign investors should rationally evaluate investment risks.

In the final analysis, the fundamental reason why many companies choose VIE is to facilitate financing and business development. Especially for some restricted industries, when companies cannot raise enough funds domestically and the industries they are in prohibit foreign investment, using the VIE structure is their only way to obtain non-domestic investment. Therefore, the Chinese government should increase its support for enterprises. For non-sensitive industries, it should appropriately increase the openness to foreign capital to attract more investors. For sensitive industries, Hong Kong can play the role of a financing platform for more mainland companies.

In conclusion, the benefits and risks of the VIE structure coexist. Foreign investors need to weigh risks and benefits more carefully when making investment decisions. The Chinese government needs to establish clearer and more effective market supervision, maintain market activity, facilitate corporate financing, and simplify the overly complicated listing process.

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