

Comparative Study on the Structure of China and US VIE Structure

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Abstract: VIE, originally called as Sina-model structure, refers to the structure of agreement-based control that Sina adopted in 2000 when it was indirectly got listed overseas. Back then, such a structure was not called as VIE. Later, due to the Enron scandal, to regulate listed companies from leveraging SPV to transfer debts or loss, the US issued the rules on the consolidation of VIE accounting statements in 2004, which then get through the information of income and risks as the financial statements of the VIE operated domestically and the shell company listed overseas were consolidated. Since then, such a model with agreement-based control has been referred as VIE. The original intention to establish VIE structure may vary for enterprises in the US and in China, but in real practice, they have applied this model. In this paper, the fundamental features, the financial evaluation and the judicial supervision of VIE in both China and abroad have been introduced and compared. In the meantime, some advice has been provided to improve the VIE structure to cope with the trend that multinational companies would get listed in major global trading markets in the future.

Keywords: VIE structure, Red-chip model, listed companies, SEC

1. Introduction

After Sina successfully got listed in the United States through the VIE, the VIE structure has inevitably become the almost one and only way for China's prosperous internet enterprises to get listed overseas.

Subsequent paragraphs, however, are indented. Under the background that internet technology is developing rapidly, the VIE agreement introduced a great deal of capital, technology and management experience from foreign countries into China and brings China its own internet industry, thus promoting the fast transformation of various fields in China. It is not overrated at all to say that VIE has created a multi-win situation for the government, industries, the domestic and overseas capitals, entrepreneurs, and ordinary people.

Because of this, Chinese government's attitude towards the VIE structure has been blurred. On the one hand, it won't give up the authorities or regulating power to legalize the VIE structure, but on the other hand, the government is benefiting from the good aspects brought by the VIE structure, for example, the rapid development of the internet industry, the progress of the society, as well as other positive impact on employment, tax, etc. Therefore, the government won't define VIE structure as illegal because the benefits and profits would be gone and there might be potential social unrest [1]. However, the gray areas never last long. The regulation of government and law may be lagged behind

when the society is developing fast, but it will finally come. This paper mainly discusses the fundamental features of VIE structure, the practical application in current stage, and potential government regulations in the future, so as to provide reference for the benign development of VIE structure in the future [2].

2. Brief Introduction on VIE Structure Inside and Outside China

2.1. Basic Concepts of VIE Structure

Variable Interest Entities (“VIE Structure”), also known as an agreement control structure, refers to a structure where listed entities registered overseas are separated from domestic business entities, which are controlled by overseas listed entities. This model is first created by Sina, so it is also known as the “Sina Model”. This structure is usually used in certain industries where the Chinese government restricts or prohibits foreign investment, such as education, Internet, etc. [3].

2.2. Typical VIE Structure

The founder of a domestic enterprise may set up a wholly foreign-owned enterprise (“WFOE”) in China through the special purpose vehicle (“SPV”) founded overseas and sign various agreements with domestic entities through the WFOE to control the operation of the domestic enterprise and enjoy its profits, while the offshore SPV will absorb foreign capital as the subject of future listing or financing. Different from traditional equity control, under the VIE structure, the entity operated domestically only has a contractual control relationship with the company listed overseas, so it is called agreement control. In domestic practice, a BVI company is usually set up in the British Virgin Islands for capital operation, and then the BVI company will set up a company in the Cayman Islands (usually), which will be the subject of absorbing investment or listing [4]. Subsequently, the Cayman company, for the purpose of tax avoidance, will set up a shell company in Hong Kong, which will set up a WFOE in mainland China as the subject of agreement control over the entity operated domestically.

VIE Structure. Entities listed overseas usually arrange the WOFEs with their stock controlled to sign a series of agreements with the entities operated domestically and their shareholders to gain control over them and transfer business profits [5]. Generally speaking, the series of agreements will include the following types:

Loan Agreement. The shareholders of the entities operated domestically introduce the funds borrowed from the WOFE to the enterprise for business development.

Equity Pledge Agreement. The shareholders of the entities operated domestically pledge their equity in the operating entity to the WOFE completely.

Exclusive Consultancy Service Agreement. The agreement stipulates that the WOFE provides the operating entity with exclusive intellectual property and technical consulting services to transfer profits, as the entity pays the net profit of the whole year to the WOFE.

Asset Operation Control Agreement. This agreement allows the WOFE to control the assets and operations of the operating entity in substance.

Stock Option Agreement. When legal policies allow foreign capital to enter the entity’s field, the WOFE can propose to acquire the equity of the entity company and become the legal controlling shareholder.

Voting Agreement. This agreement allows the WOFE to substantially control the decision-making of the operating entity’s board of directors or dispatch members to the board of directors directly.

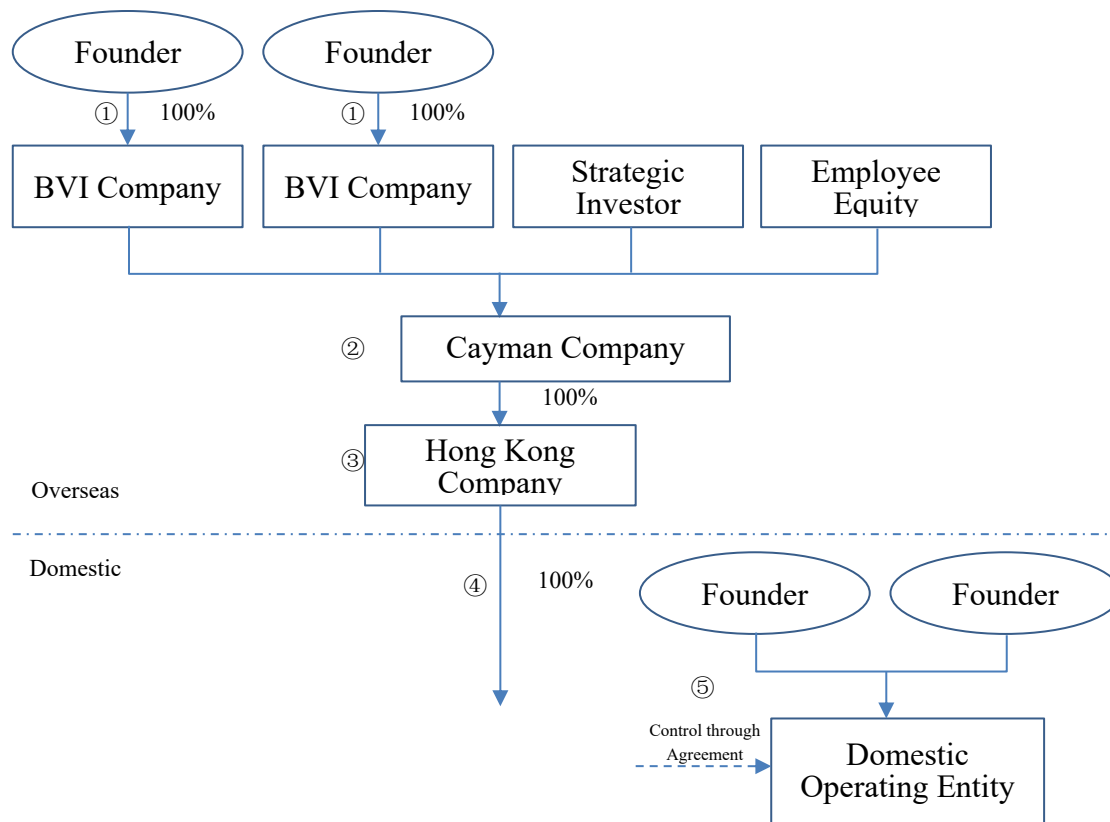


Figure 1: Typical VIE structure (only refers to a typical example and the form may vary in real practice).

2.3. Features of VIE Structure

VIE Structure. In China, the legal risks of the VIE structure have been widely discussed. Indeed, the primary purpose of the VIE institutions is to circumvent the existing regulations on foreign investment, which is suspected of “covering unlawful purposes by legal forms” [6]. According to the Contract Law, concealing illegitimate purposes in a legal form or violating the mandatory provisions of laws and administrative regulations will invalidate the contract. In practice, however, the VIE structure promotes the rapid development of China’s industries such as Internet, education, etc. The VIE structure has been in a gray area as the regulators and the courts hold an ambiguous attitude to the VIE structure. In 2012, CIETAC Shanghai directly ruled in two cases that the VIE agreement arrangement was invalid for “covering unlawful purposes by legal forms” and “violating the mandatory provisions of national administrative regulations”, which made the validity of VIE at the judicial level more uncertain. To sum up, there are no specific legal and financial/accounting regulations for the VIE structure in China.

VIE Structure in the US. Most of the VIE-structure companies were founded by Chinese companies for listing in the United States. To strengthen supervision, the US Accounting Standards pointed out that there are clear regulations on the standards for identifying variable interest entities (VIE structures), namely, the United States has clear regulations on the VIE structure. A VIE structure must have at least one of the following characteristics: The VIE structure’s risk-bearing equity investment is insufficient to meet its operating needs without additional financial support, namely, its equity is equal to or less than the entity’s expected losses. The holders of the equity do not make direct or indirect decisions on the entity’s operational activities through voting rights or similar rights

as a whole. Voting rights are not distributed among holders in proportion to their expected losses or expected residual income. In fact, all of the entity's business activities represent the interests of a small percentage of investors with fewer voting rights. The holders of the rights and interests do not bear the expected losses and receive the expected residual benefits as a whole.

3. VIE Structure's Advantages and Risks

3.1. VIE Structure's Major Advantages

Avoiding investment risks. Since the laws and policies of many overseas registration places for investment are quite different from those in China, investing through overseas companies can avoid legal risks incurred in China [7].

Enjoying tax incentives. Preferential tax rates on dividends and property transfers are available in countries and territories with tax treaties with the investor's home country [8]. Registering overseas companies helps with reasonable tax planning, as overseas companies tend to embrace simple tax systems and low tax rates.

Facilitating the flow of capital funds. In view of the financing difficulties encountered by enterprises in development, having overseas structures allow enterprises to enjoy premium overseas financing funds for better development and to open up capital channels for a free flow of capital within the legal scope and quickly respond to the market.

3.2. Risks of VIE in Practice

The legal risks incurred by the loopholes in the supervision of policies, which mainly resulted from changes in Chinese laws, namely, the government's supervision policies. All the industries involved in overseas indirect listings under the contract control pattern restrict and prohibit foreign investment in accordance with Chinese laws. The legality of the VIE structure as a workaround depends entirely on the stance and attitude of the Chinese government. Companies with the VIE structure are subject to the impact of concerning regulations issued by the state ministries and commissions.

Foreign exchange control risks in the process of foreign investment. For example, in the case of the overseas listing of Jiayuan.com in 2009, its two major subsidiaries with physical operations in China failed to obtain the foreign exchange registration certificate approved by the State Administration of Foreign Exchange as scheduled, resulting in the invalidation of the foreign-invested enterprise approval certificate. It cast a cloud over the company's development for causing uncertainty about investors' investment in Jiayuan.com.

Tax risks. The dividend distribution of VIE-structure companies is subject to potential tax risks due to a large number of related party transactions and anti-tax avoidance issues concerned. The dividends distributed by VIEs to their agreement controllers and domestic companies are the only source of cash, as the listed shell companies do not have any business in mainland China.

4. Supervision Practice of VIE Structure in China and US and Suggestions for Improvement

4.1. Current SEC Leaning Towards a Disclosure-based System

According to incomplete statistics, at least 220 of the 285 Chinese concept stocks listed on Nasdaq and the New York Stock Exchange have set up a VIE structure. In addition, all MSCI China constituent stocks currently listed in the US have adopted the VIE structure, dominated by the Internet sector and consumption sector.

In September 2021, the SEC's Office of Investor Education and Advocacy, in conjunction with the Office of the Chief Accountant and the Division of Corporate Finance, issued this Investor Notice to warn individual investors against the risks associated with investing in certain companies that engage in business in China. The VIE-structure model has become a major target of US regulators. For the United States, the legal status of this type of corporate structure in China is not clear and its legality is questionable. In view of the prohibition by regulatory policies, there are plenty of hidden risks in this type of structure.

As long as companies listed in the US have controlling financial interests in Chinese VIEs as defined by U.S. GAAP, the information disclosures and financial statements published by the companies listed in the US will include the financial results of the Chinese VIE as a subsidiary. This consolidation treats all entities (those VIE companies and subsidiaries controlled through equity) controlled by companies listed in the US as one accounting reporting entity. VIE companies emerge in a great variety of business environments. This investor announcement only discusses Chinese VIE structures that seek investment from American investors through companies listed in the US.

The VIE model is often used in certain sectors in China where the Chinese government restricts foreign ownership of companies, such as education or telecommunications. By contracting with companies listed in the US that sell shares to American investors, Chinese companies indirectly raise capital from American investors without allocating their ownership to the investors.

A US-listed company and its Chinese VIE may appear to be the same company because they are presented in a consolidated manner, but they are not. US-listed companies' control over Chinese companies is entirely based on contracts rather than equity ownership [9]. If the Chinese company (or its officers, directors, or Chinese equity owners) breaches the contract with the shell company listed in the US, or changes in Chinese law affect the enforceability of those arrangements, or the contracts are unenforceable under Chinese law, the American investors will suffer significant losses with little recourse.

4.2. Improvement of the VIE Structure to Achieve Win-win

Therefore, the SEC is working to require more for these VIE agencies to disclose more information, aiming to provide investors with the information they need to make an informed decision. For example, the SEC requires US-listed companies to disclose all VIE structures in their filings, but it directly causes a major conflict between China and the United States over the VIE structure: on the one hand, the American securities regulator has always advocated independent law enforcement in accordance with its domestic laws and inspection of Chinese accounting firms, while China, out of considerations for sovereign security, has advocated that the United States needs to rely on Chinese securities regulators for supervision and enforcement, or to conduct joint inspections through negotiation; on the other hand, the SEC and PCAOB also advocate direct access to the audit working papers of Chinese concept stock companies. However, China rejected the advocacy because submitting audit papers goes against China's interests, as some audit working papers contain sensitive information about the country, according to the concerning strict provisions made by Chinese law.

In fact, a serious conflict between China and the United States over the supervision of companies listed through the VIE structure has already emerged. In the future, if the conflicts between China and the United States over supervision cannot be resolved substantially, on the one hand, the United States is likely to further curb Chinese companies' financing in the United States by means of regulatory tools. On the other hand, since China has not decided whether to clarify the legitimacy of the VIE structure and the opening of the service sectors such as the Internet and telecommunications has always been restricted, the VIE structure has always been in a gray area without being clearly protected and regulated by the law.

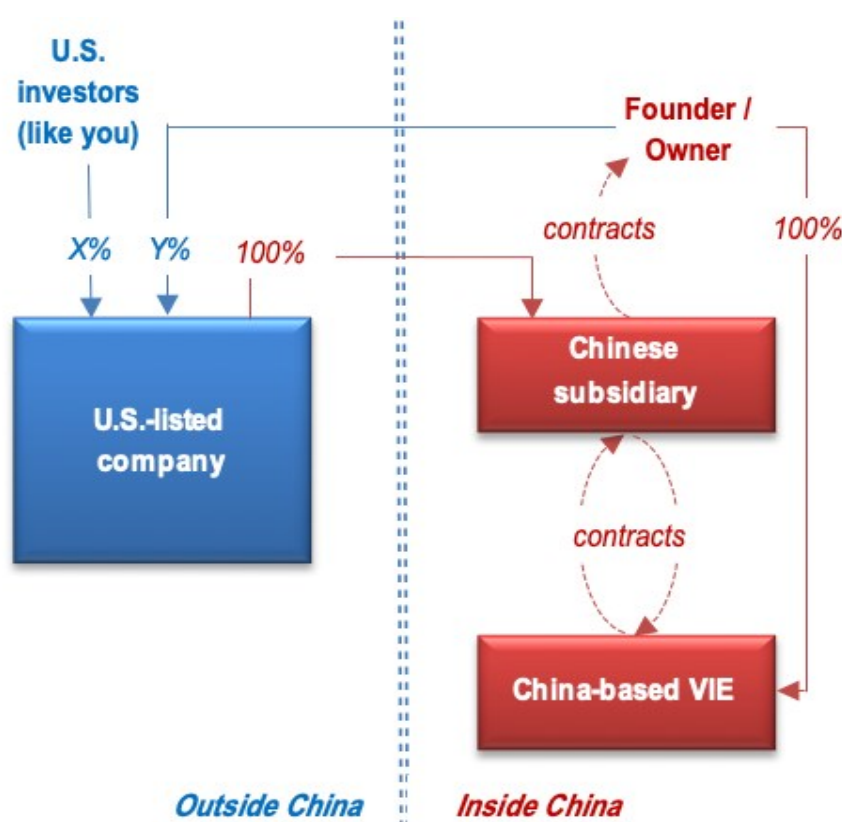


Figure 2: General structure of US listed companies and China VIE companies (simple version).

4.3. Advice on Improving VIE Structure

Promoting the international standards of financial systems on the basis of protecting national interests. In China, the standards for enterprises to get listed are high (for example, the requirements on earnings and profits are set relatively high), but if a Chinese company wants to get listed overseas with direct control over the stocks, there may be restrictions on the industry, the audit on related M&A, and limitations on the WFOE capital settlement and equity investment. VIE structure, to some extent, can help avoid the restrictions of domestic laws and regulations on the thresholds of foreign-owned enterprises in some industries. Specifically speaking, the internet companies which previously needed ICP and SP certificates adopted the VIE structure because of such reasons.

The causes behind the significant differences between the laws and regulations as well as the supervision policies of different countries can be attributed to various aspects. For example: the industrial development stages may vary in different countries; the maturity of the financial system was not the same; the strength of the economy was different; etc. However, nowadays, countries around the world are having closer relationship with each other in terms of industries, trading, and financing, and economic globalization has become an inevitable trend. Chinese companies need to get listed in the US, and in the future, some US companies may want to get listed through the A-share. The connected and mutual benefits in company structure are the basis for economic entities to rely on each other. Therefore, countries should narrow the differences, promote the international standards of the financial system on the basis of mutual benefits, and get rid of the obstacles for getting companies listed in different countries. If that succeeds, the VIE structure may eventually disappear one day and remain something special left by the history.

Narrowing the differences between major economies through unilateral or bilateral agreement and the judicial interpretations. One of the key reasons for companies to adopt the VIE

structure is that the region where the listed entity is located may have more flexible legal regulations. For example, corporate laws under the Anglo-American system are more flexible than relevant Chinese laws and customized needs in terms of company governance and shareholder's rights and interests can be satisfied. According to the Company Law of China, only those limited liability companies that have not been listed can adopt the equity structure that allows weighted voting rights, and this is only permitted conditionally for companies listed on NEEQ and STAR Market [10]. In other cases, companies are not allowed to set rules for the rights of shareholders through agreement or other forms. To keep the control rights over the company while keeping the financing to the largest degree, many listed companies in China (especially internet companies) decided to get listed in the US market through the VIE structure, mostly because that the American Company Law basically permits the possibility that weighted voting rights could be given to shareholders with same shares. Some examples include: JD, Kingsoft Cloud, Mi, and other well-known internet enterprises in China, all of which finally decided to get listed in the US.

The Hong Kong Stock Exchange started to allow companies to adopt weighted voting rights after it revised the listing rules in April 2018. It can be seen that the reform in mainland China is a little bit lagged behind compared with that in Hong Kong, Macau, Taiwan and foreign countries. The reason that Chinese government hasn't agreed on the weighted voting rights is that the financial investors in China are still not professional enough, and they have the concern that the controlling shareholder or the major shareholder may leverage their rights to damage the rights and interests of other investors, especially those medium and small investors. However, China's capital market, after developing for three decades, has shown strong and positive growth and resilience despite of many problems out of immaturity. China can take some effort to actively integrate with the international legal systems and make weighted voting rights more common, so that the Chinese listed companies can directly enter the A-share market with suitable equity structure.

Strengthen the supervision and cooperation between countries. Most companies with VIE structure chose to get listed in the US. From this perspective, the cooperation between different countries, especially between China and the US, is the key to promote the healthy development of VIE structure. The Chinese and the US can cooperate and establish a framework and mechanism, for example: communication and coordination works should be properly in advance when either party needed to check and audit the accounting offices of the other party, and the US party may check the audit drafts and other documents with the help of China's regulating institutions. As for the sensitive information involved during the process of audit and supervision, specific agreement should be reached, and special procedures should be designed for data such as personal information. These should follow the principles of equality, fairness, and responsibility. It can be considered a pioneering mechanism, which provides feasible method for the two parties to perform their legal supervision responsibilities and to ensure the security of relevant information.

The pragmatic cooperation between the countries in terms of supervision is a positive act to maintain market order and protect the legitimate rights and interests of investors, and it is also a smooth path for supervision cooperation in the capital market. With sincerity and patience in problem-solving, methods are always more than difficulties. Positive cooperation results are believed to be available by mutual supervision within the cooperation framework and pragmatic cooperation to enhance mutual trust.

5. Conclusion

VIE structure, since its emergence, has been created opportunities and conditions for multinational groups, especially Chinese companies which get listed in the US, and established the fundamental framework for China's high-technology enterprises against the backdrop of fast-developing internet era and rapid globalization. However, there have been some legal and policy-related loops at the very

beginning when VIE structure came into being. Therefore, as the financial supervision became increasingly strict, the advantages and disadvantages of VIE structure may lead to some serious dispute. In this case, as long as there are differences in the financial systems, laws, regulations, policies and rules in different countries, the capital flow across countries will inevitably lead to the adoption of VIE structure or some new form, since the enterprises are seeking for development. Therefore, it is not necessary to just categorize VIE as illegal or set extremely strict rules on it. Instead, countries around the world should cooperate with each other and establish a supervision and negotiation mechanism to maximize the benefits and minimize the shortcomings. In this way, the VIE structure, as a legal and appropriate form, can better connect the finance across different countries.

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