

Regulatory Problems and Risk Response Analysis of the Variable Interest Entity (VIE) System

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Abstract: The main reason for adopting the Variable Interest Entity (VIE) structure is that China has strict policies and legal restrictions on the listing of domestic companies. Many domestic companies with VIE structure have successfully listed overseas, and have created remarkable results and gained huge profits, for example, Alibaba, New Oriental, Sina and other enterprises, but the Alipay scandal in 2017 had to make people re-examine the risks of the VIE structure. Therefore, the formulation of laws and policies and regulatory systems applicable to VIE in China plays an important role in the good operation of VIE. This paper will adopt the method of case analysis and take Alibaba as an example to discuss the regulatory problems and risk response existing in VIE itself. The legitimacy of VIE itself is still vague, coupled with the different regulatory systems at home and abroad, the attitude of regulatory authorities and courts towards VIE is not clear, and there is even an inconsistency which makes the operation of VIE structure has certain risks. Therefore, the research and improvement of VIE legal policies and information disclosure systems also play a very important role in the good operation of the domestic capital market.

Keywords: VIE structure, regulatory issues, risk response

1. Introduction

Variable Interest Entity (VIE) is an enterprise with the structure of domestic entity operation and overseas entity listing. The VIE structure was first proposed by Enron company, which is an enterprise with domestic entity operation and overseas listing mode, namely the “agreement control structure”. With the passage of time and the continuous development of China’s economy, the domestic market competition momentum is fierce, China has 250 VIE structure of the companies have successfully achieved overseas listing. The extensive practice of VIE model must have some rationality: first, foreign investors can obtain some economic benefits of the industry that cannot directly control equity in China through agreement control; second, companies subject by domestic policies and laws in China can broaden the financing channels through overseas listing [1]. However, the use of this structure has certain regulatory problems and potential risks. Once the VIE is not handled properly or causes illegal activities, it will face huge economic losses.

2. Literature Review

VIE enterprises are becoming more and more widely listed. This model can not only broaden the financing channels for domestic entities, but also make profits for foreign investors. VIE enterprises to a certain extent, promote the speed of the domestic market industry financing, on the other hand also provides a good source of capital, in addition, in 2011 pay treasure event also will VIE model to the forefront [2]. Therefore, in the VIE enterprise bring domestic profits at the same time, there is also a big crisis, once the legitimacy of the VIE enterprise is denied, will seriously affect the interests of foreign investors. From the perspective of the regulatory authorities, there are no laws and regulations applicable to the VIE structure in China, which leads to a series of regulatory problems. First, there is no unified regulatory department in China, and the legal effect is low, about VIE model legal documents of supervision are usually in the form of notification, and do not form clear legal norms, and the cost of violations is low, resulting in many VIE model enterprises in order to broaden financing channels, obtain capital sources to play the legal “edge” [3]. Second, there are loopholes in the structural tax supervision. VIE company adopts a multi-layer control mode, the core of which is to break the basis of “control equity”. This control mode is very hidden and easy to produce problems such as tax evasion and repeated tax payment [4,5]. In order to reduce tax costs, VIE companies usually choose to list in offshore companies such as the Cayman Islands and the British Virgin Islands, which also provides a channel for companies to illegally evade taxes. Third, the VIE company also has certain risks in its own structure. The first is the policy risks. Take Sina as an example, when it adopted the VIE structure for the first time, the government’s attitude was vague, and it was not clear whether it supported or denied [6]. This vague attitude also leads to the great regulatory and legal risks in the VIE model. Once the VIE structure is deemed illegal, it will seriously damage the interests of foreign investors. Secondly, the transparency of VIE model is not high, and there are certain risks in profit transfer. VIE enterprises need to declare to the country before transferring profits, and then transfer the profits to foreign after passing the audit. Once the national audit fails to pass, it will have a negative impact on the rights and interests of overseas investors [7]. At the same time, the VIE structure has certain governance risk, in front of the interests, VIE structure will inevitably to maintain their own interests to make unilateral tear control agreement move [8]. Because the main purpose of the control agreement only to domestic entities and overseas together, there is no legal protection, and the domestic and foreign regulatory system is not unified, shareholders of management supervision is limited, in the event of financial disputes, foreign investors are likely to be the founder of the team forced [9]. This unreasonable corporate governance structure makes the founder have great power in this paper r over the control of the company. Therefore, the country should strengthen the management of VIE enterprise information disclosure, and study the cross-border supervision system [10,11]. Further strengthen the information transparency of VIE enterprises, establish the foreign investment information reporting system and the international avoidance list, and then strengthen the cooperation of tax supervision of various countries and organizations.

3. The Current Development of VIE

VIE structure, fully known as “variable interest entity”, also known as “agreement control”, its core structure is domestic entity operation and listing of overseas entities. The Alipay incident has attracted the attention and attention of the society, and also has a certain impact on the relevant laws, policies and financing. The VIE structure can be said to greatly provide a significant source of funds for the domestic capital market, as this paper as an important source to stimulate entrepreneurs to continuously innovate and optimize industrial energy. In order to promote the good operation of the VIE model, China should conduct better exchanges and cooperation with overseas countries in terms of market financing and legal policies, and implement reasonable legal policies on the VIE structure, so

as to reduce the occurrence of such incidents as Alipay. According to the study, with the continuous development of China's economy and society, many domestic enterprises in financing aspects of financing, there are many enterprises have been listed overseas, jingdong, alibaba, sina, new Oriental enterprise is a typical example, and these enterprise structure can be collectively referred to as "VIE", but due to the legitimacy of the VIE structure is still in a fuzzy state, its itself is not a perfect architecture design, there are a lot of investment risk, tax risk and legal risk. With the strengthening of VIE regulation in China, the problems existing in VIE are gradually attracting attention. In recent years, many companies with VIE structure in China have achieved great success in listing overseas, with a large amount of financial support. However, the Alipay storm in 2007 once again focused people's attention on the potential problems existing in the VIE structure. The following will talk about the regulatory problems and risk response existing in the VIE structure.

The data of this study mainly comes from the data of the VIE structure of the overseas listing. As the hidden risks of the "VIE" structure adopted by Alibaba are once again pushed to the climax of public opinion, this typical example can be regarded as a nationally representative sample, reflecting the long-standing regulatory problems of the "VIE" structure.

Figure 1 shows the VIE structure of Alibaba, which include Yahoo, SoftBank (foreign investors), Jack Ma and other managers (domestic shareholders), Alibaba Group Holding Co., Ltd.(overseas listed entity), WF OE, Alipay and Zhejiang Alibaba (Alibaba Small and Micro Finance, referred to as "Zhejiang Ali").

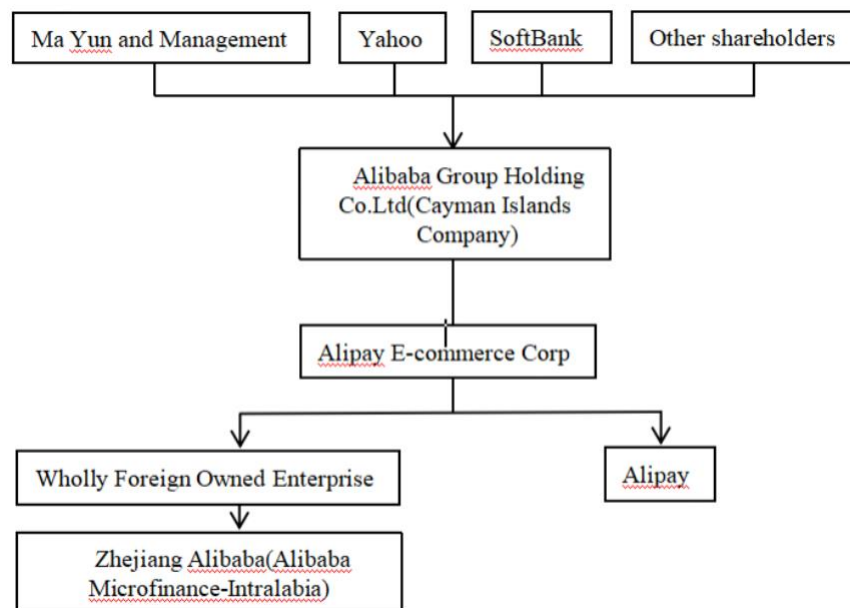


Figure 1: VIE structure of Alibaba.

The essence of Alibaba VIE structure is agreement control. Listed Alibaba Group and Zhejiang Alibaba have the relationship between this paper on agreement constraint and profit transfer. The six agreements include loan agreement, agency agreement, equity mortgage agreement, subscription agreement, and business cooperation agreement in China foreign exchange market. The implementation of the agreement has brought huge profits to Alibaba Group and provided effective control over Zhejiang Alibaba, while Jack Ma and other founding shareholders have control of Zhejiang Alibaba.

4. The Supervision of the VIE Model in China

4.1. Regulatory Policy is Not Clear

There are many factors that promote the development of the VIE model in China, among which there are two main reasons. One is that various strict legal and policy restrictions hinder the VIE model from listing in China. After the reform and opening up in 1978, China began foreign investment. However, in order to protect the lifeline of the national economy and national security, the government has formulated strict legal and policy restrictions, which make many domestic enterprises unable to go public normally. The VIE model can bypass these thresholds, to realize the domestic entity enterprises, overseas listed music, but also to raise a large amount of funds for enterprises. In 2000, Sina successfully used the VIE architecture in the VIE model. After that, the VIE model was gradually widely used. So far, more than 200 domestic enterprises have successfully used the VIE architecture. The second is the operating regulations of overseas listing in 2006, which increase the threshold of overseas listing of enterprises, and the VIE model can bypass this regulation and realize the development of enterprises. Of course, although the VIE model can bypass these thresholds, the enterprise itself still needs to have a more specific situation analysis, and formulate the agreement control system and information disclosure system for its own development, so as to achieve the long-term development of the enterprise. The regulatory risk of VIE in China is latent, and there is no high and unified regulatory system for the VIE structure in China. Most of the laws are mainly in the form of notification, and there are no encouraging or supportive policies for the VIE structure. Due to the low legal constraints on the VIE structure and the unclear regulatory attitude, along with the VIE structure of enterprises in a large amount of financing in the market and achieved rapid development, many enterprises hit a “edge ball”, and even appeared beyond the legal and policy restrictions. However, due to the low cost of punishment and lax national control, many VIE enterprises walk more and more freely in the blank area of the law, taking advantage of the legal loopholes to seek illegitimate interests for themselves. What is more serious is that once the country makes up for the lack of these laws and policies, it will have the greatest impact on the development of VIE structure enterprises, which is undoubtedly a huge loss for investors.

4.2. Cross-border Regulation is Inefficient

So far, 250 domestic enterprises have realized domestic entities and overseas listing for financing. Due to the restrictions of domestic policies, many enterprises cannot gain a foothold in China, so more and more enterprises use the VIE model for overseas listing to achieve a large amount of financing. However, this approach will inevitably lead to the relaxation of regulation, because VIE is a multinational company, and the regulatory system and regulatory standards at home and abroad are not unified. When such transnational regulatory companies do not conform to the policy or legal provisions to some extent, it may lead to the conflict between this paper and the regulatory system of the two countries. Under this conflict, it is unclear that VIE is suitable for which laws and regulations. This phenomenon will inevitably lead to low efficiency of supervision, and even lead to conflicts of interest between this paper and countries. Therefore, the unity of VIE transnational cooperation supervision should be improved.

5. The Existing Risk of VIE Model Enterprises

5.1. Protocol Control Risk Analysis

The special value of the VIE model is the transfer of profits abroad through domestic entities, which is called “agreement control”. The biggest risk of agreement control lies in that when the VIE enterprise has certain problems, the VIE domestic entities will inevitably unilaterally tear up the agreement for their own interests, resulting in breach of contract and damaging the interests of foreign shareholders and investors. Alipay, for example, in 2010, ma to control the third party payment licence and may endanger the national economic security for the reason, when it said immediately suspend the agreement control, stop the financial statements, namely unilaterally tear up agreement and cause default, serious violation of the rights and interests of softbank and yahoo foreign shareholders.

The Alipay incident also reflects from the side that the agreement control of the VIE structure is just a “blank sheet of paper”. Once the interest dispute of the enterprise appears, it will lead to serious default risk. That is to say, under the control of the VIE model, there is no real equity control bet this paper en the domestic operating entities and the overseas listed companies, and the so-called “agreement control” is not guaranteed. After the Alipay incident, although SoftBank and Yahoo have received some economic compensation, this can be said to be the tip of the iceberg relative to the equity appreciation of VIE listing. Therefore, for the VIE model of enterprises, there are huge hidden dangers of default.

5.2. Governance Risk of Management

Due to the particularity of domestic entity operation and overseas listing in the VIE structure, both domestic and foreign management has set up boards of directors, and the two boards of directors have equal rights and status. Therefore, when the board of directors at home and abroad have differences on the decision on the same issue, how to implement the decision may lead to conflicts of interest, which will lead to mutual distrust bet this paper en domestic and foreign management, which is not conducive to the governance of VIE enterprises. And VIE companies need to strictly abide by the overseas listed region information disclosure problems, when the company information disclosure is not timely or imperfect, can lead to distrust bet this paper en shareholders and management, and the board of directors supervision does not reach the designated position, may lead to management for their own interests, thus greatly reduces the cost of management violation of rights and interests, further aggravate the internal conflict, is not conducive to enterprise governance. For example, in the Beijing New Oriental World Incident in 2012 in Beijing, because the board of directors did not play an effective supervisory function, regulatory loopholes appeared. In order to stabilize the VIE structure, Yu Minhong transferred the shareholders’ equity to one person through an “agreement”, which seriously harmed the interests of the shareholders.

To sum up, it is an analysis of the regulatory problems and risk response existing in the VIE structure. There are about 250 successfully listed VIE enterprises in China. Although they have made remarkable achievements, relevant enterprises can try to reduce these risks in practice to avoid losses.

6. Conclusion

This paper takes the structure of alibaba VIE as its research object, and on the regulation of VIE model and risk response is discussed and analysis, and further combined with the domestic research of alibaba VIE structure and legal policy, further improve the VIE mode operation problems and matters needing attention, to further ensure that support the strategic development direction of the enterprise and social best interests, has certain theoretical practical significance and important reference value. In short, the use of VIE structure is more and more extensive, this structure must have

some rationality, the future is also inseparable from the VIE model. This model has made great achievements, which not only encourages entrepreneurs, but also accelerates the docking of domestic and foreign markets and the circulation of funds. Therefore, this paper agrees with the development of the VIE model at this stage. However, in the process of corporate governance, the VIE model often involves the coordination of laws and policies of many countries. This difference makes the VIE enterprises have certain regulatory risks and agreement control risks. Risk of the board of directors and risk of information disclosure, so our country should VIE mode of financing problem to strengthen exchanges and cooperation with overseas regulators, on the one hand is conducive to regulate the reasonable operation of overseas financing enterprises, on the other hand, as the market increasingly internationalization, domestic and foreign regulatory system to strengthen exchanges and cooperation is also conducive to promote the good development of the international market.

In addition, companies with VIE structure will also be subject to the supervision of domestic and foreign supervision mechanism and information disclosure mechanism. China should establish a good communication and cooperation relationship with the overseas market on the market financing issue, which is conducive to solving information asymmetry and other problems through effective communication. The future development of enterprises cannot be separated from the VIE model, so improving the legal and policy problems existing in the VIE model is also conducive to the long-term and excellent development of this model enterprises.

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