Feature

China companies' VIE structure

Lyndsey Zhang reviews the history of Chinese companies' VIE structure, the structure's potential risks as seen in the case of Alibaba and the Chinese Government's approach to fix the VIE loophole.

In the past three decades, Variable Interest Entity (VIE) structure has become a widely used business structure for Chinese companies accessing overseas capital. I remember that when I worked in Hong Kong between 2015 and 2017 establishing VIE structure was one of the 'must have' steps Chinese companies took when setting up subsidiaries in Hong Kong. In the global market, VIE is still an unsolved mystery. But because its impact on the market is not as visible as other hot Chinese business topics like related-party transactions and auditor independence, it remains as powerful as it is hidden.

What is VIE structure?

VIE structure is a unique business structure in which investors do not have direct ownership but have controlling interest of the entity through special contracts. The contracts specify the services and purpose of the agreements, and the percentage of profits allocated to each party, but do not provide direct voting rights to the controlling party. VIE structure comprises the following (see Figure 1):

VIE: In the case of overseas-listed Chinese companies, a VIE refers to a company that is incorporated in China and owned by individuals who are Chinese citizens (usually the founders).

OLOE and WFOE: The Overseas Listed Offshore Entity (OLOE) is typically a shell company domiciled in the Cayman Islands. OLOE often incorporates a Wholly Foreign Owned Enterprise (WFOE) in China that holds material assets and conducts operations on behalf of the overseas-listed company. An OLOE generates revenue mainly through its ownership of WFOE. And the WFOE captures profits of the VIE through a series of contracts between the WFOE and the VIE. The contracts (loan agreements, technical services agreements) give WFOE the rights to VIE's residual profit. Additionally, the VIE and its owners will sign a power of attorney or proxy agreement to grant WFOE voting rights at VIE shareholder meetings.

Technically, OLOE shareholders don't own the VIE, but have contractual rights to the VIE's profit and will be able to conduct voting rights through its WFOE. An OLOE can operate its business through more than one VIE. We often refer to the entire set of relationships as a 'VIE structure'.

Brief history of VIE structure

VIE structure emerged in China primarily for two reasons. First, the Chinese Government has forbidden foreign investments in certain sectors, though regulators have increased the number of acceptable foreign investments over the years. Investments in industries like telecommunications, e-commerce, education and media were still restricted as of June 2019. Second, Chinese authorities have complicated the approval process for overseas fundraising, making it extremely hard for private companies to access offshore capital.

VIE structure was designed in the 1990s to avoid the approval process and bypass the foreign investment restrictions. In 1993, Ping An Insurance in Shenzhen used a VIE structure to simplify its government approval process in order to obtain strategic investment from Morgan Stanley. After China's leading online media company (also with a VIE structure) Sina.com's successful Nasdaq IPO in April 2000, hundreds of State-owned and private Chinese companies followed. As of October 2018, 92% of Nasdaq-listed and 64% of NYSE-listed Chinese companies took advantage of the VIE structure. Out of the 11 Chinese IPOs in the US between November 2019 and January 2020, six were structured as VIEs due to China's foreign investment restrictions and two were structured as VIEs for other reasons.

VIE structure itself has evolved in the past two decades. VIEs have been consolidated into OLOE's financials since the SEC started requiring off-balance controlling entities to consolidate their balance sheets in early 2000s (after the Enron scandal).

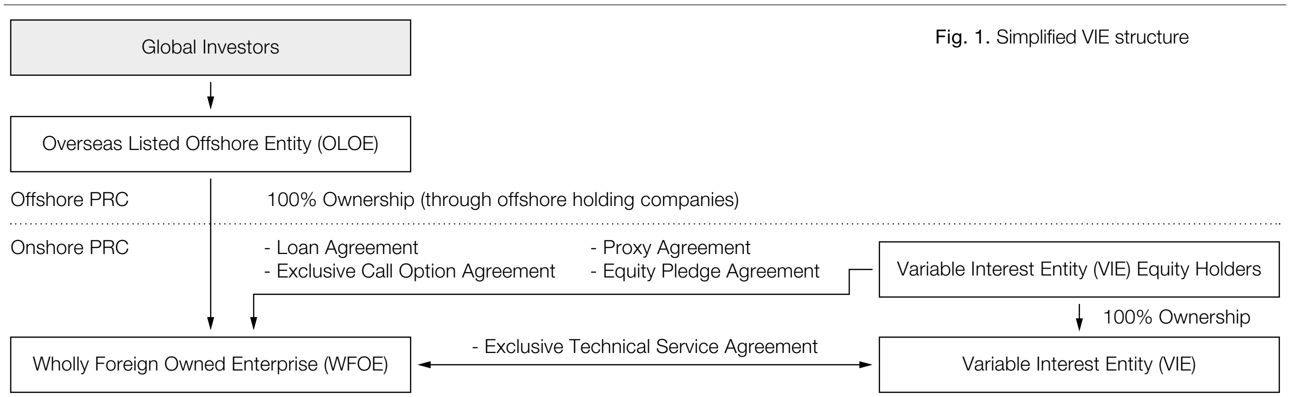

Fig. 1. Simplified VIE structure

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Since VIEs naturally favour founders, in order to protect investors' interests, some VIE agreements include conditions that even factor in the risks associated with a founder's marital status.

VIE structure risks

When companies use a VIE structure to evade China's regulations, they enter a gray area in Chinese contract law. And the complicated relationship between different entities under a VIE structure exposes VIEs to the following risks:

- *Legal uncertainty:* The question over whether VIE agreements are legal is their biggest vulnerability. According to current Chinese law, a contract written to avoid regulation requirements is void and the courts will not enforce it. The special contracts enabling global investors' controlling interest of VIEs are technically not valid. In addition, Chinese authorities can choose to close the loophole at any time by banning or restricting VIE structures, which could leave global investors in limbo.
- *Investors' fragile ownership:* The fact that global VIE investors are only shareholders of the shell company leaves investors out of decision-making processes unless agreed otherwise. The most severe example is the Alipay spin-off controversy between Alibaba and its partners Yahoo and Softbank in 2011. When the Chinese Government tightened regulations for online payment businesses, Alibaba decided to transfer ownership of its online payment platform, Alipay, to a private company owned by founder Jack Ma. As Alibaba's strategic partners, Yahoo and Softbank were not part of the decision because of Alibaba's VIE structure. Yahoo and Softbank's dispute became a warning to global investors.
- *Founders' risk:* the VIE structure also jeopardises founders' interests. According to MSCI's September 2017 *Corporate Governance in China* report, Alibaba was one of the five lowest Chinese companies on the MSCI China Index Corporate Governance Score ranking list due to its VIE structure. Alibaba's stock price rose four times from USD68 per share upon its 2014 IPO to USD290 per share in September 2020. Compared with its eight-fold increase in revenue from USD9bn 2014 to USD72bn 2020, it's clear that Alibaba's VIE structure has had a significant, adverse impact on its stock price due to investors' lack of confidence. Alibaba's founders' group was not able to profit fairly from the disproportionate correlation between stock price and company performance.

China's regulation development and its impact on the VIE structure

Like many other unique events during China's economic reform in the past three decades, the VIE structure was formed at a time when China's economic growth exploded, its desire and demand for global expansion accelerated rapidly and regulation development lagged behind. Sophisticated companies like Alibaba learned to communicate their VIE risk with investors by disclosing the significant uncertainty and addressing potential financial consequences in SEC reports since 2018. But it is widely accepted that VIE, as a transitional structure, needs a regulatory solution to close the loophole. In this new decade, it's worth asking: 'What has been done so far and what solutions are Chinese regulators considering now?'

2015 Draft Foreign Investment Law (FIL): The 2015 Draft Foreign Investment Law initiative was the first regulation to clearly state that the VIE structure cannot be used to circumvent foreign investment law, with the exception of foreign companies ultimately controlled by Chinese citizens. The exception accommodated companies like Alibaba and Baidu that were founded and are owned by Chinese citizens. But companies like Tencent were excluded despite their Chinese founding, because Tencent's shares are not controlled by its founders. The 2015 version was later withdrawn.

2019 new FIL: Global investors were disappointed and surprised when the most recent FIL (effective 1 January 2020) did not address the VIE structure. As a result, S&P Global Ratings concluded that China would back off efforts to restrict VIEs and updated its risk assessment for VIE structured Chinese companies; the Hong Kong Stock Exchange revised its guidance to continue to permit VIE structures.

Negative lists: Since July 2017, the Chinese Government has implemented a nationwide negative list approach with annual updates. The negative list defines prohibited and restricted industries for foreign investors. The list gets shorter each year, opening up more areas for foreign investment and lifting caps for foreign ownership in certain industries. The trend of shortening the negative list will attract more foreign investment. At the same time, by prohibiting fewer industries, China will help reduce the necessity of VIE structures.

It's highly unlikely that China will suddenly ban VIEs without notice or justification. Most well-known Chinese multinational companies today are structured as VIEs. These VIEs are major contributors to China's GDP growth, job opportunities, tax revenues and global expansion. Harming VIEs would cause financial chaos and economic disruption to China.

China has been taking a gradualist approach to economic reform and corporate governance development in the past 30 years. The approach has proved successful in comparison with the Russian 'rush approach,' for example. According to Jing Leng's *Corporate Governance and Financial Reform in China's Transition Economy* (2009), with a gradualist strategy, countries tend to lack well-functioning or out-of-date regulations, which means regulation development always lags behind. It appears that Chinese regulators are taking the same strategy to fix VIEs as they steadily and continuously relax foreign investment restrictions.

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China's 2019 FIL still needs work, but it establishes the principles necessary to create a more equal environment for foreign investors, to simplify the approval process for foreign investments entering and exiting China's market, and to better protect foreign investors' interests. Most reforms of current FIL still need detailed provisions for practical implementation and these reforms are foundational to fixing VIEs. Therefore, leaving the VIE structure as a grey area could be a practical decision which indicates that the Chinese Government is still working to improve these foundations and is unlikely to prohibit or restrict VIE structure in the near future.

Conclusion

The VIE structure has provided a workaround structure or shortcut for Chinese companies to access foreign capital over the past 30 years. However, Chinese companies need to understand the risks of the VIE structure and disclose the risk properly for the awareness of investors. Those companies not on the negative list need to re-evaluate the risk and benefits before choosing VIE structures. The VIE structure will not remain a regulation grey area forever. When Chinese regulators are ready to close the VIE loophole, companies on sound legal footing will be more resilient regardless of the regulatory change.

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