

Variable Interest Entity Risks and Governance

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I. INTRODUCTION

A Variable Interest Entity (VIE) is an arms-length entity in which the investor holds a controlling interest not by having majority control of voting rights but through a series of contractual arrangements.¹ The investor's control over the VIE is established and ensured by agreements instead of holding shares.² The future transfer of assets, licenses, and equity interests are also governed by contracts to ensure the holding company's (the foreign-listed company) access to profit.³

The VIE structure provides benefits to both Chinese companies and foreign investors. It has been adopted by Chinese companies to be listed on stock markets overseas.⁴ Foreign

1. Li Guo, *Chinese Style VIEs: Continuing to Sneak Under Smog?*, 47 CORNELL INT'L L.J. 569, 570 (2014).

2. See Xu Ping, *Variable Interest Entity (VIE) Structure for Foreign Investment in the PRC May Face Challenge*, CHINA L. INSIGHT (Oct. 20, 2011), <https://www.chinalawinsight.com/2011/10/articles/foreign-investment/variable-interest-entity-vie-structure-for-foreign-investment-in-the-prc-may-face-challenge/> [<https://perma.cc/YTH6-6M28>] (describing how Chinese companies utilize VIE structures to list their companies overseas to obtain funds and investments from investors abroad while avoiding the restrictive approval requirements implemented by the Chinese government); see also Brandon Whitehill, *Buyer Beware: Chinese Companies and the VIE Structure*, COUNCIL OF INST. INVS. 4–5 (Dec. 2017), https://www.cii.org/files/publications/misc/12_07_17%20Chinese%20Companies%20and%20the%20VIE%20structure.pdf [<https://perma.cc/S6ZA-HX9C>] (explaining VIE structures).

3. Guo, *supra* note 1, at 578–79.

4. Scott Murdoch & Kane Wu, *Explainer: How Chinese Clampdown Will Target Offshore Listings*, REUTERS (July 8, 2021), <https://www.reuters.com/business/how-chinese-clampdown-will-target-offshore-listings-2021-07-08/> [<https://perma.cc/S6ZA-HX9C>].

investors commonly use it to participate in industries that “are explicitly or practically restricted from foreign investment.”⁵

The motivation behind the adoption of VIEs is the strict regulatory scheme for foreign investments in China.⁶ Even after joining the World Trade Organization (WTO), China continued to implement the “Negative List in Foreign Investment” (“Negative List”) as a regulatory approach to foreign investment that prohibits foreign investors from directly investing in some industries.⁷ In accordance with the Negative List, there are several industries in which foreign investors—whether as corporations, entities, or individuals—are prohibited from investing.⁸ As a result, the Chinese domestic companies operating businesses in those industries cannot seek global investment by going public on foreign stock markets.⁹ To overcome this regulatory barrier, the VIE structure is broadly used to circumvent the regulatory effects of the Negative List.¹⁰ Because, in the VIE structure, foreign investors do not hold any shares of the target domestic operating company that runs the business in China, the foreign investment from offshore stock markets would thus not fall under the “prohibited sectors” of the Negative List.¹¹

Although the VIE is broadly adopted in commercial practice, it is inherently defective because there has been no clear and expressed endorsement of the VIE structure by the Chinese government and authorities.¹² Recently, the Chinese government and the U.S. Securities and Exchange Commission (SEC) demonstrated a tendency to implement stricter scrutiny and governance methods towards companies that have been, or seek to be, listed using a VIE structure.¹³ Consequently, the stock prices of Chinese public companies

5. Cari Stinebower, *Understanding China's Variable-Interest Entities*, WINSTON & STRAWN LLP (Sept. 30, 2021), <https://www.winston.com/en/blogs-and-podcasts/notes-from-the-china-desk/understanding-chinas-variable-interest-entities.html> [<https://perma.cc/VV9B-4U7C>].

6. David Schindelheim, Note, *Variable Interest Entity Structures in the People's Republic of China: Is Uncertainty for Foreign Investors Part of China's Economic Development Plan?*, 21 CARDOZO J. INT'L & COMP. L. 195, 205–07 (2012).

7. GULI WAISHANG TOUZI CHANYE MULU (鼓励外商投资产业目录) [THE CATALOGUE FOR ENCOURAGING THE INDUSTRIAL GUIDANCE OF FOREIGN INVESTMENTS] [the National Development and Reform Commission of the People's Republic of China (PRC), and the Ministry of Commerce] (amended 2022).

8. (外商投资准入特别管理措施负面清单), [NEGATIVE LIST FOR FOREIGN INVESTMENT ACCESS] [The National Development and Reform Commission of the PRC, and the Ministry of Commerce] (June 23, 2020).

9. Murdoch & Wu, *supra* note 4.

10. Samuel Farrell Ziegler, Note, *China's Variable Interest Entity Problem: How Americans Have Illegally Invested Billions in China and How to Fix It*, 84 GEO. WASH. L. REV. 539, 541 (2016); Liqian Ren, *Assessing Variable Interest Entity Risk in Your China Portfolio*, MKTS. INSIDER (Aug. 16, 2021), <https://markets.businessinsider.com/news/stocks/assessing-variable-interest-entity-risk-in-your-china-portfolio-1030733951> [<https://perma.cc/ZL28-PMNJ>] (“There are close to 100 Chinese companies listed in the U.S. with a VIE structure and many in Hong Kong. Most well-known Chinese Internet companies, such as Tencent, Alibaba, Pinduoduo, Baidu, JD and NetEase, all operate under a VIE structure.”).

11. See *infra* note 19 and accompanying text. But see Schindelheim, *supra* note 6, at 217–18 (showing that the Chinese government still works to combat contracts by holding them void as contrary to public policy).

12. Xu, *supra* note 2.

13. See Jing Yang, *U.S. and Chinese Regulators Are in a Bind Over a Three-Letter Acronym*, WALL ST. J. (Sept. 30, 2021), <https://www.wsj.com/articles/u-s-and-chinese-regulators-are-in-a-bind-over-a-three-letter-acronym-11632999033> [<https://perma.cc/4AVN-VA7R>] (“Beijing also recently moved to strengthen its supervision of overseas listings by Chinese firms, after Didi went public in New York despite a regulator's suggestion to delay it listing.”); see also Keith Zhai & Jing Yang, *China Targets Firms Listed Overseas After*

that embedded this VIE structure are dropping drastically.¹⁴ The goal of this Note is to contemplate the future governance of VIEs by analyzing the risks VIEs may impose upon the market and investors.

II. BACKGROUND

In VIE structure, the business operation is ultimately controlled by investors, not through holding shares or ownership, but through a series of controlling agreements.¹⁵ To circumvent investment regulations and restrictions, Chinese companies have become deeply involved with the VIE model.¹⁶ It has been broadly used by Chinese companies to seek to obtain investments from overseas capital markets through an offshore public company to support and develop their business operated in the main market in China.¹⁷

Chinese central government has long enforced a three-tiered regulatory scheme on foreign investment through the national Negative List.¹⁸ Under this regulatory scheme, the Chinese market is divided into a tripartite regime: Encouraged Sectors, Restricted Sectors, and Prohibited Sectors.¹⁹ The difference between each category is whether the foreign capital would be encouraged, restricted, or prohibited from investing in companies or programs in a specific industry.²⁰ The Negative List is updated annually and “provides guidance and governs industry sectors in which foreign investment is prohibited or where possible restrictions may apply.”²¹ If the industry sector does not fall within the listed categories in the Negative List, foreign investors are entitled to the same treatment as domestic enterprises.²²

Usually, the VIE structure would be considered the most convenient and effective method when a Chinese domestic operating company intends to seek foreign investment

Launching Didi Probe, WALL ST. J. (July 6, 2021), <https://www.wsj.com/articles/china-to-revise-rules-and-strengthen-supervision-of-overseas-listings-11625572533> [<https://perma.cc/H3NC-8EPU>] (“China said it would tighten rules for companies listed overseas or seeking to sell shares abroad, moves that could hinder attempts by homegrown firms to raise money in the U.S.”).

14. *DiDi Global Inc.*, CNBC, <https://www.cnbc.com/quotes/DIDIY> [<https://perma.cc/SY52-EFKQ>].

15. W. Tyler Perry, *Development and Distrust: A Critique of the Orthodox Path to Economic Prosperity*, 110 NW. U. L. REV. 477, 479 (2016).

16. The term “Variable Interest Entity” was originally used by the United States Accounting Board following the Enron Scandal. *Id.* Sina.com was the first company from the PRC that prominently used VIE to help it be listed on the NASDAQ in 2000. *Id.*

17. Apoorva Kaul, *Chinese Companies Using VIE Structure to Raise Money from Foreign Investors: Report*, REPUBLIC WORLD (Aug. 9, 2021), <https://www.republicworld.com/world-news/china/chinese-companies-using-vie-structure-to-raise-money-from-foreign-investors-report.html> [<https://perma.cc/RS2H-BK9N>].

18. Guoqiang Long, *China’s Policies on FDI: Review and Evaluation*, in DOES FOREIGN DIRECT INVESTMENT PROMOTE DEVELOPMENT? 315, 318–21 (Theodore H. Moran, Edward M. Graham, and Magnus Blomström eds., 2005).

19. See, e.g., Waishang Touzi Chanye Zhidao Mulu (2017) (外商投资产业指导目录) [2017 Update of The Catalogue for the Industrial Guidance of Foreign Investments] (promulgated by PRC National Development and Reform Commission and Ministry of Commerce, amended 2017).

20. *Id.*

21. MULU, *supra* note 7.

22. *Id.*

for their business which falls into the category of the restricted or prohibited sectors.²³ The adoption of the VIE structure enables foreign investors to invest in a restricted or prohibited business market through the foreign listed company.²⁴ It provides foreign investors access to the investment opportunities in those sensitive business markets in China, which were categorized into the restricted or prohibited sectors, such as the internet and media industry.²⁵

Effective use of the VIE is grounded on the contractual and shareholding relationship between the offshore holding company, its subsidiaries (both offshore and onshore), and the onshore company operating the business in the Chinese market.²⁶

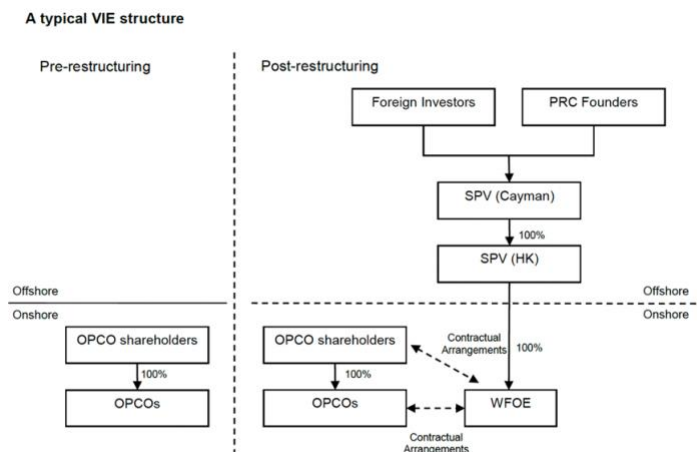
23. Justin Hopkins, Mark H. Lang & Jianxin (Donny) Zhao, *The Rise of US-Listed VIEs from China: Balancing State Control and Access to Foreign Capital* 1 (Darden Bus. Sch., Working Paper No. 3119912, 2018). For example, Didi and Sina both adopted the VIE structure to be listed abroad. Michael Munizinger & Lei Shi, *China Introduces New Negative List 2020 and New FTZ Negative List 2020*, CMS (July 7, 2020), <https://cms.law/en/chn/publication/china-introduces-new-negative-list-2020-and-new-ftz-negative-list-2020> [<https://perma.cc/7PP3-AEZR>]. They both operate in the telecommunications industry. *Id.* In accordance with the Negative List, foreign investments in telecommunications companies are limited to the telecommunication businesses opened according to China's WTO accession commitments. *Id.* Although in the new Negative List 2020 and the Hainan FTP Plan published in 2020, the value-added telecommunications services shall be accessible for foreign investors, and the restrictions on the shareholding ratio of foreign investors shall be gradually lifted, such a lifted restriction would only benefit the companies incorporated in Hainan. *Id.* The restriction on the telecommunication industry would still be a motivation for the companies to create VIE to avoid foreign investment regulation. *Id.*

24. Schindelheim, *supra* note 6, at 209; *see also* Daniel Ren, *Days After Go-Ahead for VIE Structures, Beijing Releases 'Negative List' to Tighten Grip on Overseas IPOs by Strategically Sensitive Firms*, S. CHINA MORNING POST (Dec. 29, 2021), <https://www.scmp.com/business/banking-finance/article/3161307/days-after-go-ahead-vie-structures-beijing-releases> [<https://perma.cc/F7AM-NUNL>].

25. NEGATIVE LIST FOR FOREIGN INVESTMENT ACCESS, *supra* note 8; Paul Edelberg, *Is China Really Opening Its Doors to Foreign Investment?*, CHINA BUS. REV. (Nov. 8, 2017), <https://www.chinabusinessreview.com/is-china-really-opening-its-doors-to-foreign-investment/> [<https://perma.cc/HJ2S-TQXD>].

26. *See* Shen Wei, *Will the Door Open Wider in the Aftermath of Alibaba?—Placing (or Misplacing) Foreign Investment in a Chinese Public Law Frame*, 42 HONG KONG L.J. 561, 565 (2012) (explaining the VIE structure and how it functions).

Figure 1: A typical VIE structure.²⁷



Separating the operation and control is an essential feature of the VIE structure.²⁸ In a VIE structure, an offshore holding company, the public company listed overseas, does not operate the business alone.²⁹ Instead, the offshore holding company would set up a subsidiary in China in the form of a Wholly Foreign Owned Enterprise (WFOE).³⁰ The WFOE would control a Chinese domestic company that operates the actual business—this WFOE is known as the “operating company”³¹ and such a domestic operating company is the VIE of the offshore holding company.³²

In a typical VIE structure, the offshore holding company maintains control of its subsidiary by holding shares.³³ Such a subsidiary would be a Special Purpose Vehicle (SPV) established to facilitate the listing process.³⁴ The SPV obtains and maintains its

27. SULLIVAN & CROMWELL LLP, LISTING VIE STRUCTURE ON THE HONG KONG STOCK EXCHANGE: A BRIEF GUIDE FOR LISTING APPLICANTS USING VIE STRUCTURES 2 (Sept. 10, 2012), https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Listing_VIE_Structures_on_the_Hong_Kong_Stock_Exchange.pdf [<https://perma.cc/J74L-CFWF>].

28. Hopkins, Lang & Zhao, *supra* note 23, at 2.

29. Guo, *supra* note 1, at 577.

30. WFOE is broadly used in mainland China businesses. It is a vehicle used by foreign investors to invest in the mainland China market by incorporating a foreign-owned limited liability company in China. WFOE is the enterprise established by “foreign enterprises, or other economic organization or individual” with “sole foreign investment within Chinese territory.” Article 1, Zhonghua Renmin Gongheguo Waizi Qiye FA (中华人民共和国外资企业法) [Law on Wholly Foreign-Owned Enterprises] (2020).

31. Stinebower, *supra* note 5.

32. Fred Greguras, *China VIE Structure 2020*, INVENTUS LAW (Feb 24, 2020), <https://www.inventuslaw.com/china-variable-interest-entity-structure-2020/> [<https://perma.cc/S6RH-U7J2>].

33. Stinebower, *supra* note 5.

34. A Special Purpose Vehicle (SPV), also called a Special Purpose Entity (SPE), is a subsidiary created by a parent company to isolate financial risk. Its legal status as a separate company makes its obligations secure even if the parent company goes bankrupt. An SPV is usually created with its own balance sheet. The parent company uses the SPV to undertake a risky venture while reducing any negative financial impact on its own financial status and its investors. Sometimes the SPV is used as a holding company for the securitization of debt. Mei Feng, Jeffrey Gramlich & Sanjay Gupta, *Special Purpose Vehicles: Empirical Evidence on Determinants and Earnings Management*, 84 ACCT. REV. 1833, 1834–36 (2009).

control over the WFOE by holding its share fully or partially.³⁵ The WFOE, an onshore company registered in China, maintains control of the business operation by contractual agreements.³⁶ Usually, there are more than two parties involved in such contractual arrangements³⁷ to ensure the WFOE's control over the Chinese operating company and its business from different resources. In a typical VIE structure described in Chart 1,³⁸ the WFOE would enter into contracts with both the business operating company and its shareholders at the same time.³⁹ The operating company often owns all operating licenses to perform the business and participate in the Chinese market.⁴⁰

Although in a VIE structure, investors do not possess the direct ownership state of the VIE (the entity itself), they have a series of contracts to specify rules and percentages of profits.⁴¹ The contractual arrangements usually are designed to confer upon the WFOE, the offshore subsidiary, and its parent company:

- a. the right to all the economic benefits of the operating company, to exercise management control over the actual business operation, and to prevent leakages of assets and values to shareholders of the operating company;⁴²
- b. the right to all intellectual properties through the assignments from the operating company;⁴³
- c. the right to consolidate the financial results of the operating company as if they were wholly owned subsidiaries of the holding company's subsidiary for accounting consideration;⁴⁴
- d. the right to acquire the equity interests in and/or assets of the operating company for a nominal price or a pre-paid amount; and⁴⁵
- e. the priority security interest in the operating company's shares.⁴⁶

In terms of access to the operating company's business profit, the offshore holding company would be able to consolidate the VIE's financials into the group's overall financial statements under applicable accounting standards.⁴⁷ The contractual

35. Ping, *supra* note 2.

36. *Id.*

37. Whitehill, *supra* note 2.

38. *Listing VIE Structure on the Hong Kong Stock Exchange*, *supra* note 27.

39. *Id.*

40. See generally Jesse M. Fried & Ehud Kamar, *Alibaba: A Case Study of Synthetic Control*, 11 HARV. BUS. L. REV. 279 (2021) (using Alibaba as an example and explaining how the founder of the domestic operating company was enabled to control the license under the VIE structures).

41. Guo, *supra* note 1.

42. One such example of a company using such contractual arrangements is the Hong Kong Exchanges and Clearing Limited. See, e.g., H.K. Exchs. & Clearing Ltd., HKEx Listing Decision (HKEX-LD-43-3), at 2, <https://www.hkex.com.hk/-/media/HKEX-Market/Listing/Rules-and-Guidance/Interpretation-and-Guidance-Contingency/Listing-Decisions/2005/LD43-3.pdf?la=en> [<https://perma.cc/HSB7-27SU>] [hereinafter HKEX Listing Decision].

43. *Id.*

44. *Id.*

45. *Id.*

46. *Id.*

47. "A VIE must be consolidated into the financial statements of the primary beneficiary company" Thomas A. Ratcliffe, *To Consolidate or Not*, J. ACCOUNTANCY (Nov. 30, 2005), <https://www.journalofaccountancy.com/issues/2005/dec/toconsolidateornot.html> [<https://perma.cc/9ALM->

arrangements include agreements providing effective control over the VIE and agreements providing for the transfer of substantially all of the economic benefits of the VIE to the WFOE.⁴⁸

The control over the VIE is achieved by a series of agreements instead of ownership.⁴⁹ This trait makes the VIE distinct from other controlling structures and results in a different level of risk for the investor who holds the share or stock of the offshore holding company.⁵⁰ For example, DIDI Global Inc.'s (Didi) IPO fallout⁵¹ definitely reminded the market about the policy risks behind the operation and investment mode of Didi and its affiliated companies.⁵² Didi adopted the VIE approach to become listed overseas.⁵³

After being listed on the New York Stock Exchange (NYSE),⁵⁴ Didi's stock price drastically decreased due to the effect of a regulatory intention expressed by the Chinese Central Government.⁵⁵ Didi, the offshore holding company in the VIE structure, is registered in the Cayman Islands.⁵⁶ It is not the entity practically operating the app-based transportation business in China and worldwide.⁵⁷ Instead, Didi, as the offshore holding company, maintains control over the operating company through a complex contractual

9HK6]. The term "variable interest entity," a U.S. GAAP accounting term, describes an entity consolidated in this way. See DELOITTE, CONSOLIDATION—IDENTIFYING A CONTROLLING FINANCIAL INTEREST 1 (Nov. 2021), <https://www2.deloitte.com/content/dam/Deloitte/us/Documents/audit/ASC/Roadmaps/us-audit-on-the-radar-consolidation-identifying-a-controlling-financial-interest-design-notes-november-2021.pdf> [https://perma.cc/9ALM-9HK6].

48. *O'Melveny & Myers Publishes Paper on VIE Structures in China: What You Need to Know*, O'MELVENY & MYERS LLP (Nov. 1, 2011), <https://www.omm.com/resources/alerts-and-publications/publications/omelveny-myers-publishes-paper-vie-structures-in-china-what-you-need-to-know/> [https://perma.cc/Z93W-49DT].

49. *Id.*

50. When investors purchase stocks in the U.S. stock market, what they are buying is the stock of a shell company (the listed holding company) instead of the real business in China. The holding company does not hold any share of the operating company and therefore does not provide the same level of protection that shareholders normally enjoy. Charles Riley, *The Risky Loophole Chinese Companies Have Been Using for Years*, CNN BUS. (Aug. 8, 2021), <https://www.cnn.com/2021/08/08/investing/stocks-week-ahead/index.html> [https://perma.cc/DNN2-MUMH].

51. A national security investigation was announced by Chinese regulators upon Didi's practice in Chinese transportation market on July 2, 2021, days after Didi's \$4.4 billion initial public offering in New York. After the announcement of an investigation, shares in Didi crashed by 20%. Edward White et al., *China Inc. Braces for Fallout from Didi Data Probe*, FIN. TIMES (Aug. 21, 2021), <https://www.ft.com/content/deac99c5-502e-4432-8450-495fcc6619e2> [https://perma.cc/LK4W-6MLC].

52. Nikkei Staff Writers, *Didi IPO Fallout Reminds Wall Street of China Policy Risk*, NIKKEI (July 14, 2021), <https://asia.nikkei.com/Politics/International-relations/US-China-tensions/Didi-IPO-fallout-reminds-Wall-Street-of-China-policy-risk> [https://perma.cc/LK4W-6MLC].

53. Didi Global, Inc., Registration Statement (Form F-1) (2021) [hereinafter Didi Global Registration].

54. *Id.*

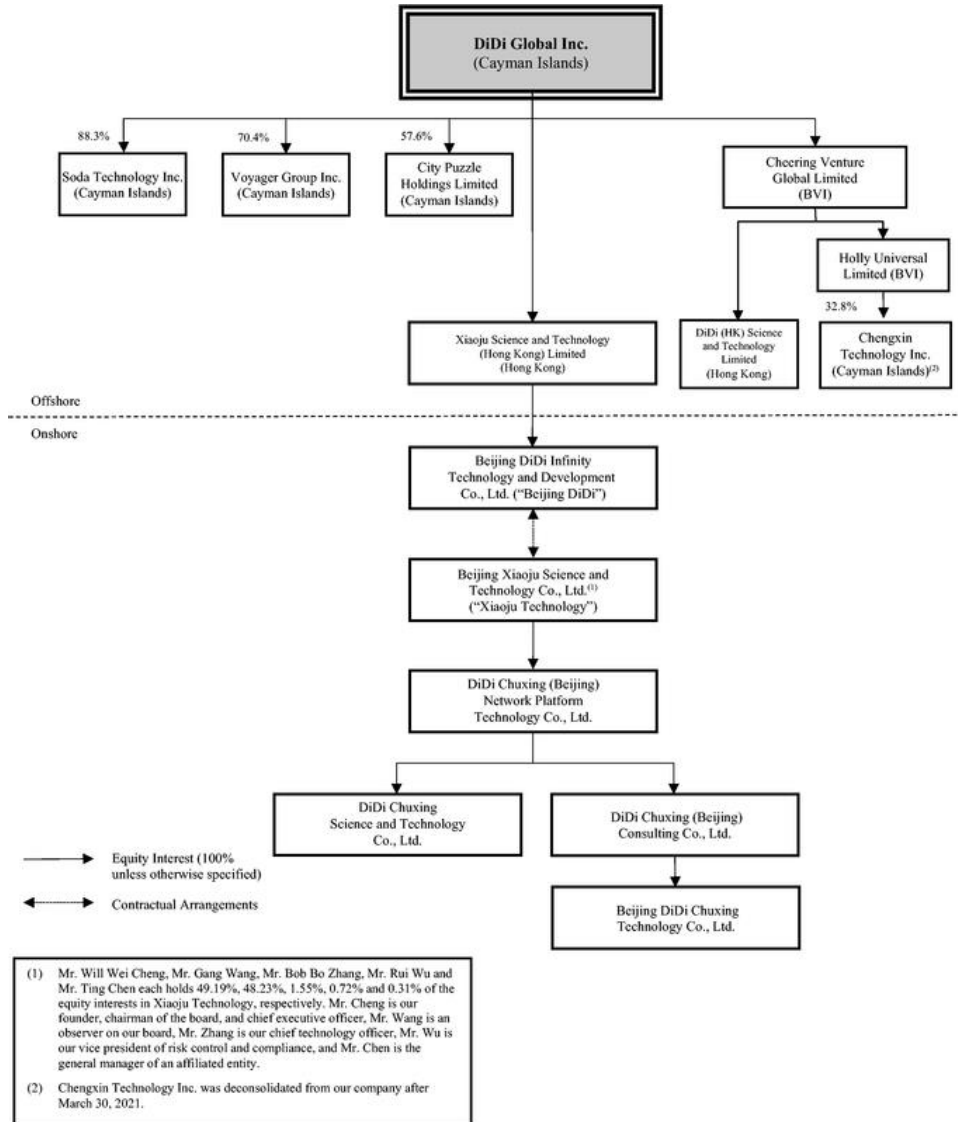
55. Yawen Chen, *China IPO Crackdown Will Cast Chill Over Caymans*, REUTERS (July 7, 2021), <https://www.reuters.com/breakingviews/china-ipo-crackdown-will-cast-chill-over-caymans-2021-07-07/> [https://perma.cc/PAM6-288W].

56. DiDi Global Inc., Registration Statement for American Depository Receipt Shares (Form F-6) (June 24, 2021).

57. Didi Chuxing, a Chinese company registered in Beijing, is the operating company of the app-based transportation business. Emily Feng & David Gura, *A Top Chinese Ride-Hailing Company Delists from the NYSE Just Months After Its IPO*, NPR (Dec. 3, 2021), <https://www.npr.org/2021/12/03/1061219965/a-top-chinese-tech-company-delists-from-the-nyse-just-months-after-its-ipo> [https://perma.cc/C5KV-8EHH].

arrangement.⁵⁸

Figure 2: Shareholding structure of Didi.⁵⁹



Beijing Didi Infinity Technology and Development Co, Ltd. (Beijing Didi) is a WFOE set up by Didi through a Hong Kong incorporated company.⁶⁰ The entity that operates the business for Didi is Beijing Xiaoju Science Technology Co., Ltd. (Beijing Xiaoju), which

58. See Figure 2 (shareholding structure of Didi).

59. Didi Global Registration, *supra* note 53, at 99.

60. Didi Global Registration, *supra* note 53, at 50.

is the VIE in this structure.⁶¹ Beijing Xiaoju is held by five individual shareholders.⁶² There is no shareholding relationship between Didi or Beijing Didi with Beijing Xiaoju.⁶³ However, Beijing Didi controls Beijing Xiaoju's business and economic status.⁶⁴ Such control powers arise from the enforcement of a series of agreements. These agreements allow Beijing Didi to receive economic benefits from the VIE agreements that provide Beijing Didi with effective control over the VIE.⁶⁵ Additionally, there are contractual arrangements that provide Beijing Didi with the option to purchase the equity interest in the VIE.⁶⁶ Through the VIE and controlling agreements, Didi, a foreign-listed public company incorporated in the Cayman Islands, can ultimately avoid the restrictions imposed by the government and invest in value-added telecommunications services through contractual agreements.⁶⁷

III. ANALYSIS

A set of contracts for the purpose of establishing and enforcing VIE structure was held valid as a conditional relevant issue in a breach of contract dispute by the Supreme People's Court of People's Republic of China (Supreme Court).⁶⁸ Adoption of the VIE seems to be a great approach for Chinese domestic companies to introduce foreign capital into the domestic market.⁶⁹ Additionally, it is a convenient vehicle for foreign investors to sidestep the imposed restrictions by the Central Chinese government and access the sensitive markets in China to make more profit.⁷⁰ Despite these advantages, the controlling mode created by the agreements inherently bears unpredictable risks.⁷¹

A. An Overview of Risks Derived from the Contractual Nature of VIE Structure

First, controlling by contractual agreement may result in the listed holding companies

61. *See id.* at 15.

62. According to the filing information captured on China National Enterprise Credit Information Publicity System, Beijing Xiaoju is a private company owned by five shareholders: Wei Cheng (49.19%), Gang Wang (48.225%), Bo Zhang (1.553%), Rui Wu (0.723%), & Ting Chen (0.309%). QiChaCha, <https://www.qcc.com/firm/4659626b1e5e43f1bcad8c268753216e.html> [<https://perma.cc/XUF5-M94Q>].

63. Didi Global Registration, *supra* note 53, at 195.

64. *Id.*

65. Matt Levine, Opinion, *Owning Chinese Companies is Complicated*, BLOOMBERG (July 7, 2021), <https://www.bloomberg.com/opinion/articles/2021-07-07/owning-chinese-companies-is-complicated> [<https://perma.cc/5EQZ-QBVL>].

66. Rey Mashayekhi, *Everything You Need to Know About Chinese Ride-Sharing Giant Didi's IPO*, FORTUNE (June 29, 2021), <https://fortune.com/2021/06/29/didi-ipo-china-ride-sharing-everything-to-know/> [<https://perma.cc/7ZFR-CWBU>].

67. *Id.*

68. ChangSha Xingye Zhiye Fazhan Youxian Gongsu Yu Beijing Shidaanbo Jiaoyu Keji Youxian Zeren Gongsu Hezuohetong Jiufen Shangsu An (长沙亚兴置业发展有限公司与北京师大安博教育科技有限公司合作合同纠纷上诉案) [Changsha Xingye Real Est. Corp. v. Ambow Educ. Holding, Ltd.] (Sup. People's Ct. 2017).

69. KEVIN ROSIER, U.S.-CHINA ECON. & SEC. REV. COMM'N, *THE RISKS OF CHINA'S INTERNET COMPANIES ON U.S. STOCK EXCHANGES 2* (2014).

70. *See* Kaitlyn Johnson, *Variable Interest Entities: Alibaba's Regulatory Work-Around to China's Foreign Investment Restrictions*, 12 LOYOLA UNIV. CHI. INT'L L. REV. 249, 252 (2015) ("VIE is an investment structure used by many Chinese companies and foreign investors to bypass Chinese government restrictions on FDI.").

71. *See id.* at 253.

losing control power over VIEs. The VIE structure establishes the holding company's control over the VIE by contractual agreements instead of ownership.⁷² Investors who contributed capital to the offshore holding company have no direct voting rights.⁷³ Equity investors are at risk, as a group, because they lack the characteristics of a controlling financial interest. Traditionally, shareholders possess a great amount of control by holding ownership of the corporation.⁷⁴ Although they do not control the day-to-day operations, they are enabled to decide the important matters of the corporation by executing voting rights, bringing shareholder proposals, requiring disclosures, and even bringing derivative actions.⁷⁵

The shareholders of the VIE itself hold super-voting shares.⁷⁶ The equity is structured with disproportionate voting rights, and substantially all of the activities are conducted on behalf of an investor with disproportionately few voting rights.⁷⁷

Second, the shareholding structure in the VIE model is normally complex.⁷⁸ By having such a complicated structure, the interests of different entities may conflict with each other. Such conflicts of interest could ultimately pass on to the investors of the holding company and cause huge losses.

Most importantly, policy risks are a concern for the stock market where holding companies are listed. Although the holding company is incorporated abroad and listed on a foreign market, such as the United States, the Chinese Central Government still has powerful and close control over the operation of the VIE.⁷⁹ A single policy change may cause a severe impact on the business performance of the VIE.⁸⁰ This could result because the holding company does not have a direct shareholding relationship with VIE.⁸¹ This kind of loose controlling relationship may diminish the holding company's ability to predict and adjust business operations to prevent or respond to policy risks.

72. *Id.*

73. *Id.* at 255.

74. Julian Velasco, *The Fundamental Rights of the Shareholder*, 40 U.C. DAVIS L. REV. 407, 416 (2006).

75. *See id.* at 417–22 (describing the role of shareholders).

76. *See* Fa Chen, *Variable Interest Entity Structures in China: Are Legal Uncertainties and Risks to Foreign Investors Part of China's Regulatory Policy?*, 29 ASIA PAC. L. REV. 1 (2022) (discussing the influence of VIE shareholders upon business operation and the responsive regulatory reactions).

77. Johnson, *supra* note 70.

78. *See* Whitehill, *supra* note 2, at 2 (discussing the contractual nature of VIEs).

79. *See* Serena Y. Shi, *Dragon's House of Cards: Perils of Investing in Variable Interest Entities Domiciled in the People's Republic of China and Listed in the United States*, 37 FORDHAM INT'L L.J. 1265, 1280–83 (2014) (introducing the scrutiny scheme and policies adopted by the Chinese government in an attempt to regulate and oversee VIEs); *see, e.g.*, Charlie Zhu et al., *China Unveils Sweeping Rules for Foreign IPOs in Didi's Wake*, BLOOMBERG (Dec. 27, 2021), <https://www.bloomberg.com/news/articles/2021-12-27/china-imposes-new-curbs-on-offshore-ipos-from-restricted-sectors> [<https://perma.cc/W2WE-FX3P>].

80. Eva Dou & Pei-Lin Wu, *China Fines Didi \$1.2 Billion for Breaking Data-Security Laws*, WASH. POST (July 21, 2022), <https://www.washingtonpost.com/world/2022/07/21/china-didi-fine-data-security/> [<https://perma.cc/TQJ8-TFH7>].

81. Whitehill, *supra* note 2.

B. Risks Imposed on Holding Companies, Markets, and Investors.

1. Contractual Risk and Control Power Collapse

There are risks of losing control powers between the offshore holding company, its subsidiaries, and the operating company. The control based on shareholding in a typical business structure is simpler and easier to enforce than the contractual arrangement in a VIE.⁸² The shareholder's control is derived directly from holding shares of the company,⁸³ and such control is highly protected from either bylaws or rules under corporate law.⁸⁴ The contractual arrangements are normally carried out in a comprehensive way with detailed agreements for the purpose of maintaining effective control of the business operation.⁸⁵ The inherent deficiency in this contractual relationship is the possibility that parties may breach the contract.⁸⁶

Although the contractual arrangements are usually elaborately designed and cover everything from the business operation to profit making, there is no such concrete protection at the same level as holding shares or stocks, like in a typical business structure.⁸⁷ For investors who contributed capital to the offshore holding company, there are no direct voting rights granted to them to ensure they can get involved in the business operations or the company's decision-making process.⁸⁸ The equity investors are at risk, as a group, because they lack the characteristics of having ownership or controlling financial interest by holding shares of the company.⁸⁹ As a result, it is extremely hard for investors in an offshore stock market to participate in the management or supervision process.⁹⁰

2. Policy Risks

The Chinese government has not expressed an explicit attitude toward the validity of the VIE structure and its practice in offshore listing. There is an inconsistency between the opinions from administrative authorities and decisions from judicial authorities regarding the recognition of the legality of the VIE structure, which creates an unpredictable environment of policy changes that may affect the operating company's business performance and the holding company's stock price. Even in the judicial opinion by the

82. Schindelheim, *supra* note 6, at 211.

83. Velasco, *supra* note 74, 407, 413–26 (2006).

84. *Id.*

85. *Id.*

86. A breach of contract in which the breaching party finds it cheaper to pay damages than to perform under the contract. In other words, a contractual breach that is economically efficient, at least for the breaching party. See generally Robert L. Birmingham, *Breach of Contract, Damage Measures, and Economic Efficiency*, 24 RUTGERS L. REV. 273 (1970).

87. Whitehill, *supra* note 2.

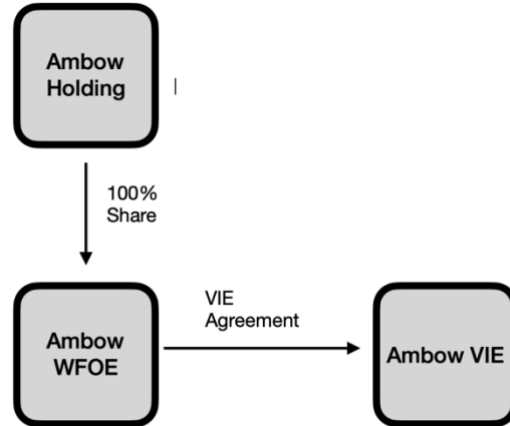
88. See Schindelheim, *supra* note 6, at 207 (“VIEs receive sufficient operating capital through legal agreements with the controlling business entity.”).

89. *FASB Issues Guidance to Improve Financial Reporting for SPEs, Off-Balance Sheet Structures and Similar Entities*, FIN. ACCT. STANDARDS BD. (Jan. 17, 2003), https://www.fasb.org/page/getarticle?uid=fasb_NEWS_RELEASE_01_17_03Body_0228221200 [<https://perma.cc/9LS8-S3Y7>].

90. Whitehill, *supra* note 2.

Supreme Court, which ruled the framework agreements valid, the Supreme Court did not provide any substantial reasoning or ruling over the legal recognition/legality of the VIE structure itself.⁹¹ Instead, the Court heavily relied on contract principles and doctrines and specifically avoided confirming the legitimacy of the VIE structure in the Chinese regulatory scheme.⁹²

In 2014, the Supreme Court decided a case that involved a contractual dispute between



a local property development company and a VIE of a foreign holding company.⁹³ In this case, the Supreme Court held that the VIE contractual agreements were valid and enforceable, based on the contractual doctrine and principle that there was valid manifestation and mutual consent from both parties when they entered into the contract.⁹⁴

Figure 3: VIE Structure of Ambow.

In 2009, Yaxing Properties Development Co., Ltd. (Yaxing) entered into a share transaction with Beijing Normal University Ambow Education Technology Co., Ltd. (Ambow VIE). In this transaction, Yaxing agreed to sell its 70% equity interest in two schools to Ambow VIE.⁹⁵ Later, Yaxing filed an action against Ambow VIE, claiming that the sale and transfer of equity interest were null and void.⁹⁶ Yaxing, the seller, built up its claim upon the fact that Ambow VIE is a VIE of Beijing Ambow Online Software Co, Ltd. (Ambow WFOE), which is solely owned by Ambow Education Holding Ltd. (Ambow Holding), which is a Cayman Islands company listed on the NYSE.⁹⁷ Yaxing, the seller, claimed that under foreign investment regulation in China, foreign investors are prohibited

91. Changsha Xingye Real Est. Corp. v. Ambow Educ. Holding, Ltd. (Sup. People's Ct. 2017) (China).

92. *Id.*; see also Jenny Y. Liu, Carrie Bai, Fiona Li & Julian Zou, *VIE Validity Still Unsure*, PILLSBURY ALERT (March 22, 2017), <https://www.pillsburylaw.com/en/news-and-insights/vie-validity-still-unsure.html> [<https://perma.cc/7MGK-47WX>] (summarizing the Supreme People's Court of China's holding).

93. Changsha Xingye Real Est. Corp. v. Ambow Educ. Holding, Ltd. (Sup. People's Ct. 2017) (China).

94. *Id.*

95. *Id.*

96. *Id.*

97. *Id.*

from investing in the business sector of compulsory education.⁹⁸ The equity interest in the intended equity transfer was in an elementary school, which is within the scope of the compulsory education industry in which foreign investor, here the Ambow WFOE, is prohibited from investing.⁹⁹ Yaxing claimed that since Ambow WFOE is not legally permitted to invest in a Chinese compulsory education institution, using Ambow VIE as a “straw” entity to structure around the statutory prohibitions constitutes “deploying legal form to conceal illegal purposes” under Chinese Contract Law, which is one of the legal bases to null and void a contract.¹⁰⁰

The Supreme Court ruled that Ambow VIE is a domestic company despite the fact that the source of funds for the capital contribution comes from Ambow WFOE.¹⁰¹ Therefore, it is not prohibited from purchasing shares sold by Yaxing of the target schools.¹⁰² Because there is no shareholding relationship between Ambow WFOE and Ambow VIE, even if the shareholders of Ambow VIE granted their voting rights to Ambow WFOE, it does not deprive the shareholders’ legal status.¹⁰³ Ambow WFOE is still an outsider of the shareholding structure and, therefore, does not change the identity of Ambow VIE as a domestic company.¹⁰⁴

It is worth noting that the court did not ground its ruling on recognizing the legality of the VIE structure and contractual arrangement. Instead, the court invoked a contract principle as the legal basis.¹⁰⁵ The court stated that “the validity of the VIE Agreements are not disputed between Yaxing and Ambow and, therefore, will not be decided by this court.”¹⁰⁶ In other words, the court specifically avoided making any decision directly on the legitimacy of the VIE structure. Although lawyers have referred to this case as a strong indication of the judicial attitude confirming the legitimacy of the VIE structure,¹⁰⁷ it is still unclear whether the court will decide the legitimacy issue in favor of VIEs.

The security and commercial administration’s attitude towards VIEs makes the

98. Zhong Hua Gong He Guo Min Ban Jiao Yu Cu Jin Fa Shi Shi Tiao Li (中华人民共和国民办教育促进法实施条例) [Regulations for the Implementation of the Law of the People’s Republic of China on the Promotion of Private Education] (promulgated by the State Council of the People’s Republic of China, Apr. 7, 2021, effective Sept. 1, 2021), http://www.gov.cn/zhengce/content/2021-05/14/content_5606463.htm [<https://perma.cc/P2BS-SPKS>].

99. *Id.*; see also David Wang, April Yan & Klaus Ni, *How Foreign Investors can Legally Invest in the Chinese K12 Education – China Working Group*, INT’L BAR ASS’N (Aug. 1, 2022), <https://www.ibanet.org/article/B1C8C285-AE24-413F-8A99-BA46BAE89903> [<https://perma.cc/2WXV-7TQJ>] (“According to the Regulations for the Implementation of the Law of the People’s Republic of China . . . on Promoting Private Education . . . public organi[z]ations or individuals, other than state authority, are prohibited to establish private profit-making schools providing compulsory education from elementary to junior high school level.”).

100. Changsha Xingye Real Est. Corp. v. Ambow Educ. Holding, Ltd. (Sup. People’s Ct. 2017) (China); Jenny Liu et al., *VIE Validity Still Unsure*, PILLSBURY (Mar. 22, 2017), <https://www.pillsburylaw.com/en/news-and-insights/vie-validity-still-unsure.html> [<https://perma.cc/SPP8-U7DW>].

101. Liu, Bai, Li & Zou, *supra* note 100.

102. *Id.*

103. *Id.*

104. *Id.*

105. Changsha Xingye Real Est. Corp. v. Ambow Educ. Holding, Ltd. (Sup. People’s Ct. 2017) (China); see also Liu et al., *supra* note 100.

106. Liu et al., *supra* note 100.

107. Binbin Sun & Han Wen, *The Insight of VIE’s Legitimacy*, ZHONG LUN PUBLICATIONS (Mar. 21, 2021), <http://www.zhonglun.com/Content/2017/03-21/1818439077.html> [<https://perma.cc/6EZZ-DYR7>].

legitimacy of VIEs more obscure. Early 2021, the China Securities Regulatory Commission (CSRC) announced that it is setting up a team to focus on companies seeking to list offshore using the VIE structure, which the Central Government in China found has led to abuse through using contracts as covers for violation of laws and regulations.¹⁰⁸ The lack of a clear endorsement of the legitimacy of VIE structure creates the risk of policy changes for investors in offshore-listed companies who acquire control and profits through VIE structure in the Chinese market.

The other significant policy risk results from the unpredictable global compliance and national security governance by the Chinese Central Government.¹⁰⁹ With the enactment of China's new Data Security Law, stricter scrutiny will be imposed on large companies that seek to circumvent regulation and compliance by adopting the VIE structure for the purpose of listing in the offshore stock market.¹¹⁰ New rules are expected to be published by Chinese authorities that would ban "companies with large amounts of sensitive consumer data from going public in the U[nited States]."¹¹¹ There are many concerns derived from the enactment of the Data Security Law.¹¹² Under the rules of the Data

108. See Yang, *supra* note 13.

109. See Ji Ma, *National Security Review for Foreign Investment in China: A Transnational Evolution, in REGULATING STATE CAPITALISM: AN INTERDISCIPLINARY AND COMPARATIVE EXAMINATION* (forthcoming 2022) (discussing the development of national security laws and procedures in China); see also 国务院办公厅关于建立外国投资者并购境内企业安全审查制度的通知 [Notice of the General Office of the State Council on the Establishment of the Security Review System for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors], Gen. Off. of the State Council (issued on Feb. 3, 2011, effective on Mar. 3, 2011) (outlining policy to "guide the orderly development of mergers and acquisitions of domestic enterprises by foreign investors and safeguard national security").

110. Ji Ma, *International Investment and National Security Review*, 52 VAND. J. TRANSNAT'L L. 899, 914–15 (2019). China's Data Security Law came into force in the Fall of 2021, dealing with data security that provided more specificity about data localization, data export, and data protection requirements. Ryan D. Junck et al., *China's New Data Security and Personal Information Protection Laws: What They Mean for Multinational Companies*, SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP (Nov. 3, 2021), <https://www.skadden.com/Insights/Publications/2021/11/Chinas-New-Data-Security-and-Personal-Information-Protection-Laws> [https://perma.cc/FF3S-CYSQ]; see also Xiang Wang et al., *China's New Data Security Law: What International Companies Need to Know*, ORRICK (Sept. 23, 2021), <https://www.orrick.com/en/Insights/2021/09/Chinas-New-Data-Security-Law-What-International-Companies-Need-to-Know> [https://perma.cc/7R9Z-QXLL] ("[W]ithout approval from Chinese authorities, no organizations or individuals in China may transfer data stored within China to any foreign judicial or enforcement authorities . . . entities that violate this requirement face fines of up to 1 million yuan (~\$156,000 USD), with additional fines for responsible individuals.").

111. Keith Zhai & Liza Lin, *Chinese Regulators Nudge Didi Toward Hong Kong Listing*, WALL ST. J. (Oct. 21, 2021), <https://www.wsj.com/articles/chinese-regulators-nudge-didi-toward-hong-kong-listing-11634811730> [https://perma.cc/UA4E-L7D9].

112. See, e.g., Bo Qu & Changxu Huo, *Privacy, National Security, and Internet Economy: An Explanation of China's Personal Information Protection Legislation*, 15 FRONTIERS OF L. CHINA 339, 341 (2020) (citing industry development, personal information infringement, and national security as drivers of China's personal information protection legislation); Yi Shao, *Personal Information Protection: China's Path Choice*, 18 U.S.–CHINA L. REV. 227 (2021) (arguing that China should set up special institutions to create criteria for judging facts of damage that are appropriately relaxed to strengthen private law protection of personal property); Yi Bao, *New Chinese Data Privacy Laws Further Complicates SEC Investigations*, COLUM. BUS. L. REV. ONLINE (Nov. 28, 2021), <https://journals.library.columbia.edu/index.php/CBLR/announcement/view/456> [https://perma.cc/N62Q-WU3M] (discussing the collisions that may arise between the SEC's investigative interests and China's data privacy statutes); Matt Haldane, *What China's New Data Laws Are and Their Impact on Big Tech*, S. CHINA

Security Law, all companies in China are required to classify the data they handle into several categories, which governs how such data is stored and transferred to other parties.¹¹³ To facilitate the data categorization process, the Central Government of China is authorized to establish a “hierarchical data categorization system in accordance with the importance of the data to the state’s economy, national security, livelihood of Chinese citizens, and public and private interest.”¹¹⁴ Companies operating businesses nowadays cannot avoid getting involved with collecting data from individual users or the market itself.¹¹⁵ This new detailed regulatory framework is highly likely to cause a broader investigation scope over the companies, especially when the companies are related to foreign-listed holding companies.¹¹⁶ The catastrophe on Didi would be the best example.

The scope of activities subjected to governance is relatively broad, including the collection, storage, use, processing, transmission, provision, and disclosure of data.¹¹⁷ The Data Security Law governs the data processing that occurs both within and outside of China.¹¹⁸ It also applies to the mentioned data processing and management activities occurring outside of China that have the potential to harm China’s national security or public interest or damage the legal interest of any Chinese citizen or organization.¹¹⁹ It remains unclear how this broad regulatory discretion will be enforced, and the extraterritorial effect of the law will likely hinge on treaties and reciprocity agreements between China and other countries.¹²⁰

One example of how the Chinese government’s attitude and policy change would harm the market and investors is Didi’s stock crash.¹²¹ After Didi’s market debut on June 30, 2021, a high-level cybersecurity review was launched immediately.¹²² As a result, the

MORNING POST (Sept. 1, 2021), <https://www.scmp.com/tech/policy/article/3147040/what-chinas-new-data-laws-are-and-their-impact-big-tech> [<https://perma.cc/Y7SR-E2BQ>] (discussing the increased cost for companies storing Chinese user data after passage of the Data Security Law); Lingjie Kong, *Enacting China’s Data Protection Act*, 18 INT’L J.L. & TECH. 197, 198 (2010) (discussing the need for enacting a comprehensive data protection act to establish legal order in data protection).

113. See generally Zhonghua Renmin Gongheguo Shuju Anquan Fa (中华人民共和国数据安全法) [NAT’L DATA SEC. L. OF PRC], ch. 4 (2021) (listing data security protection obligations).

114. See generally NATIONAL DATA SECURITY LAW OF PRC, chs. 2 & 3 (2021); Aravind Swaminathan et al., *China’s New Data Security Law: What International Companies Need to Know*, ORRICK (Sept. 23, 2021), <https://www.orrick.com/en/Insights/2021/09/Chinas-New-Data-Security-Law-What-International-Companies-Need-to-Know> [<https://perma.cc/P6FL-952J>].

115. Swaminathan et al., *supra* note 114.

116. Qu & Huo, *supra* note 112.

117. NATIONAL DATA SECURITY LAW OF PRC, art. 3.

118. NATIONAL DATA SECURITY LAW OF PRC, art. 2.

119. *Id.*

120. See generally Chen Ji, *Cybersecurity and Data Protection: A Study on China’s New Cybersecurity Legal Regime and How It Affects Inbound Investment in China*, 51 INT’L L. 537 (2018) (articulating the enforcement of stricter scrutiny, impact on investors, and penalties may incur); Aynne Kokas, *Platform Patrol: China, the United States, and the Global Battle for Data Security*, 77 J. ASIAN STUD. 923 (2018) (comparing data security practices).

121. Didi’s stock price crashed after Chinese central government’s announcement of national security investigation over Didi and its related entities and government’s intention to de-list its share from NYSE.

122. Coco Feng, *Why Does Ride-Hailing Giant Didi’s Cybersecurity Review Involve So Many Chinese Government Agencies and Who Is Absent?*, S. CHINA MORNING POST (July 19, 2021), <https://www.scmp.com/tech/policy/article/3141649/why-does-ride-hailing-giant-didis-cybersecurity-review-involve-so-many> [<https://perma.cc/U2WF-G969>].

Didi-Rider app was temporarily banned from the market in China.¹²³ Didi's stock price suffered a huge decrease right after the announcement of a cybersecurity review.¹²⁴ The attitude of Chinese regulators always has a huge impact on the market's confidence in Chinese companies.¹²⁵ Eventually, in July 2021, Didi was fined \$1.19 Billion for noncompliance with data security requirements set by regulators in China.¹²⁶ Due to the unpredictability of future regulation and the lack of clarity in the enforcement of these laws and regulations, it is difficult for investors to obtain a clear understanding of what risks they may face in the future.

Foreign investors are not provided enough support in litigation and international legal proceedings.¹²⁷ Under the Data Security Law, without approval from Chinese authorities, no organization or individuals in China may transfer data stored within China to any foreign judicial or enforcement authorities unless there is an international convention or reciprocal agreement between China and the particular foreign jurisdiction.¹²⁸ As a result, there are few ways left for foreign investors to remedy their situation by using such data as evidence. Neither getting approval from Chinese authorities nor taking action in the Chinese judicial system would be an ideal way to resolve the dispute and receive the intended remedy.

C. Governance Approaches—Disclosure Requirement

The stock market in the United States is not the only playground for Chinese-based companies utilizing the VIE structure to obtain capital and investment. In 2018, more than 50 companies were listed on *both* the United States and Hong Kong stock markets.¹²⁹ Forty percent of them are listed on The Stock Exchange of Hong Kong Limited HKEX (HKEX).¹³⁰

HKEX continues its established disclosure-based approach in the reviewing process.¹³¹ It requires the listing applicant (the company and directors) to demonstrate by a clear preponderance of the evidence that all relevant PRC laws and regulations were complied with in fact and in good faith by the applicants.¹³² Additionally, a full disclosure of the contractual agreements shall be provided in the prospectus filed with SEC.¹³³ In practice, the listing applicant's PRC legal advisor will often be required to opine on, among

123. *Id.*

124. Jessica Bursztynsky & Steve Kovach, *Didi Shares Fall After China Announces Cybersecurity Review Just Days After IPO*, CNBC (July 2, 2021), <https://www.cnbc.com/2021/07/02/didi-shares-fall-after-china-announces-cybersecurity-review.html> [<https://perma.cc/F6NB-4TVH>].

125. *Id.*

126. *China Fines Didi \$1.2 Billion After Wrapping Year-Long Probe*, BLOOMBERG (July 21, 2022), <https://www.bloomberg.com/news/articles/2022-07-21/china-fines-didi-1-2-billion-after-wrapping-cybersecurity-probe> [<https://perma.cc/6GJE-APMX>].

127. *Id.*

128. NATIONAL DATA SECURITY LAW OF PRC, art. 36.

129. WU WANG ET AL., GLOB. L. OFF., INVESTMENT IN CHINA: VIE STRUCTURE OVERVIEW IN 2018 7–9 (2019), <http://www.glo.com.cn/UploadFile/Files/2020/6/19/14483720089b08ebf-3.pdf> [<https://perma.cc/LGY2-LBCT>].

130. *Id.* at 9.

131. HKEX Listing Decision, *supra* note 42, at 3.

132. *Id.*

133. *Id.* at 3–4.

other things:

- a. The validity of the Contractual Arrangements (as individual contracts and as a whole) under PRC laws and regulations and that no further approval or confirmation is required for the Contractual Arrangements under PRC laws and regulations; and
- b. the WFOE and the Operating Companies have obtained all necessary approvals and completed all registrations and have the capacity to carry out business operations.¹³⁴

IV. RECOMMENDATION

A. Improve Transparency with a Stricter Regulatory Framework

The most direct and efficient way to avoid risks is by improving the transparency of the companies that adopt the VIE structure. The specific methods include: (1) establishing an alert report mechanism on the SEC portal as well as providing a list of the names of companies who are using the VIE structure so that investors can note the potential risks; (2) requiring a mandatory report by companies who adopt VIE structures to report the important changes in their contractual arrangement with its WFOE and VIE that may affect their performance in the future; and (3) starting a policy-risks-prevention mechanism by requiring periodic domestic policy change reports as an alternative to an SEC investigation.

The impact of VIE structures can be a double-edged sword. On the one hand, the creation and usage of VIE structures enable companies with great potential in a vigorously growing market to access needed capital from stock markets overseas. As a result, the investors in the stock market are provided with plenty of business opportunities and the ability to benefit from the rapid profit growth. On the other hand, this unique structure of control and the volatility of policy risk can expose the investors to higher risks that cannot be strategically predicted or prevented by individual investors in stock markets. It would be unwise and unrealistic to completely abandon the use of the VIE. At the same time, however, the market and investors demand a stricter regulatory scheme to be implemented upon the foreign companies that seek to be listed in the U.S. stock market.¹³⁵ Such a regulatory approach should extend to the whole process of going public and being listed on the stock market. Following the traditional security regulation method,¹³⁶ the listed

134. Fa Chen, *Variable Interest Entity Structures in China: Are Legal Uncertainties and Risks to Foreign Investors Part of China's Regulatory Policy?*, 29 ASIA PAC. L. REV. 1, 3–5 (2021).

135. Erick D. Prohs, Note, *Periodic Financial Reporting – A Relic of the Past?*, 27 J. CORP. L. 481, 486–89 (2002); see generally *The SEC and Corporate Disclosure Program*, 36 BUS. LAW. 119 (1980) (introducing SEC disclosure systems under the 1933 Act and the 1934 Act, including periodic reports as informal disclosures to shareholders). “SEC Chairman Gary Gensler said Friday he has asked agency staff to seek specific disclosures from Chinese firms before signing off on regulatory filings that precede an initial public offering. He also called for additional reviews of filings for companies with significant China-based operations.” Paul Kiernan, *SEC to Set New Disclosure Requirements for Chinese Company IPOs*, WALL ST. J. (July 30, 2021), <https://www.wsj.com/articles/sec-to-set-new-disclosure-requirements-for-chinese-company-ipos-11627651546> [<https://perma.cc/YRC9-2HM2>].

136. *Periodic Reporting Requirements and Disclosure Obligations Toolkit*, THOMSON REUTERS PRAC. L. (2022), [https://content.next.westlaw.com/w-000-4553?_lrTS=20210913085546022&transitionType=Default&contextData=\(sc.Default\)&firstPage=true](https://content.next.westlaw.com/w-000-4553?_lrTS=20210913085546022&transitionType=Default&contextData=(sc.Default)&firstPage=true) [<https://perma.cc/WSF8-CPWM>].

companies who have adopted the VIE structure shall also be required to report on this situation and report the changes over the control structures periodically. Failing to disclose or report the adoption of VIE structure should trigger alerts to SEC so that it can decide whether to issue a letter for further inquiry and demand compliance.

High-quality financial statement disclosure is essential for investors to understand and analyze the market and a company's market performance.¹³⁷ Before making an investment choice, investors are expected to conduct research and decide accordingly. However, that is not always the case. Investors are not always seasoned in the stock market or specific industries. Disclosure would be the most convenient and feasible way for investors to make sound investment decisions. The 2008 financial crisis is evidence of how a lack of transparency and insufficient disclosure can lead to high risks and market collapse.¹³⁸ For unsophisticated investors, without special notice or statement, they may not even realize that the shares they are holding are of a shell company that does not operate the actual business.¹³⁹ For the reasons above, the market and investors demand a stricter and more comprehensive regulatory framework for the companies using the VIE structure to be listed.

Having a strict regulatory system will not only benefit the investors who lack knowledge of the inside information, especially with the complex structure of VIEs, but also will incentivize the listed company to have a more ideal and flawless design of their contractual agreement with the VIE. To fulfill the listing requirements and ongoing disclosure requirements, the listed companies and the VIEs would have to conduct comprehensive legal compliance.¹⁴⁰ Being pressured by the ongoing disclosure requirements, the listed companies would have to enhance the reliability of the control agreement between its WFOE and VIE to ensure control as well as access to information regarding the operating company's business situation. Such improvement would ultimately result in a more concrete control agreement and mitigate the risk of controlling power collapse.

The substantial risks, control stability, and policy risks would be the most important aspects to focus on:

First and foremost, to help investors and potential investors be aware that the target

137. SEC. EXCH. COMM'N, DISCLOSURE CONSIDERATIONS FOR CHINA-BASED ISSUERS (2020), <https://www.sec.gov/corpfin/disclosure-considerations-china-based-issuers> [<https://perma.cc/T355-294F>]. On this point, the SEC stated:

High-quality, reliable disclosure, including financial reporting, is at the core of the Commission's mission to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation. Although China-based Issuers that access the U.S. public capital markets generally have the same disclosure obligations and legal responsibilities as other non-U.S. issuers, the Commission's ability to promote and enforce high-quality disclosure standards for China-based Issuers may be materially limited.

Id.

138. Matthieu Bouvard, Pierre Chaigneau & Adolfo De Motta, *Transparency in the Financial System: Rollover Risk and Crises*, 70 J. FINANCE 1805, 1821–22 (2015).

139. "Many investors didn't understand the risks they were taking with the VIE structure until the SEC statement." Yang, *supra* note 13.

140. Ming Pang, *Standardize the Mergers and Acquisitions of Enterprises with VIE Structure to Ensure the Healthy and Sound Development of the Market*, 21 JINGJI (Dec. 17, 2020), https://m.21jingji.com/article/20201217/herald/28f630918068ec3304edf292cefa2809_zaker.html [<https://perma.cc/W9VG-WDRB>].

company they are interested in is a VIE structure user, a specific category should be created for all the listed companies that adopted VIE structures as a method to conduct major business overseas. It can be provided to the public in the form of a quarterly or annually posted company name list.

Secondly, the SEC should implement a more detailed mandatory report regulatory system for the entities using VIEs for listing purposes. Based on the fact that such information originated from the local market where VIEs conduct business, and it is not always accessible to investors and the SEC,¹⁴¹ a mandatory report requirement should be imposed upon the listed companies with a higher standard of scrutiny compared to other domestic or non-U.S.-based issuers. The report should include, but not be limited to: (1) the changes in their set of contractual agreements which relate or potentially relate to the power to direct and control, and (2) the changes in the shareholding structure of the VIE entity which may affect the shareholder on record's control over the VIE and the operation of business.¹⁴²

An additional method would require issuers who relied on the VIE structure to go public to register their major contractual agreements with the SEC. Putting those important arrangements on record will produce an evidentiary benefit and provide access for the SEC to start closely reviewing those agreements to prevent the risks of control collapse.

B. Establish Policy Risk Alert Mechanism

Policy risks can be a significant concern for both regulators and investors, especially when the VIE entity conducts business in a country with a less-developed legal system which provides low predictability of their policy changes.¹⁴³ As a response to such traits of VIE structures, a self-report procedure shall be implemented to help the SEC and market better assess the investment risks. Combining the different sources of information that are accessible to regulators would make it easier to create more reliable predictions regarding policy risks and changes. The issuer and the VIE entity are better positioned to provide these insights with details. To ensure the information they provide is accurate and verifiable to the best of their knowledge, such self-reporting requirements shall be treated equally with periodic financial reporting requirements.

141. "China has often restricted U.S. regulators' access to information and limited regulators' ability to investigate or pursue remedies with respect to China-based Issuers, generally citing to state secrecy and national security laws, blocking statutes, or other laws or regulations." *Disclosure Considerations for China-Based Issuers*, SEC. EXCH. COMM'N (Nov. 23, 2020), <https://www.sec.gov/corpfin/disclosure-considerations-china-based-issuers> [<https://perma.cc/NCW7-TW97>].

142. New Oriental Education & Tech Group completed a shareholder restructure in July 2012. This adjustment is a response to the departure of ten founders who were no longer shareholders of the company after leaving. After the restructuring, only one person remained an individual shareholder of the VIE company. The reasons behind the adjustment were not disclosed until SEC issued an investigation letter to the issuer/holding company. New Oriental Educ. & Tech. Grp., Annual Report (Form 20-F) (May 31, 2013). Without further disclosure, it is extremely difficult to discern the main reason behind such a drastic adjustment of shareholding structure. Lack of transparency will hurt the confidence of market as an ultimate result. Xiaoyu Li, *Usage of VIE Structure in Offshore Stock Market*, PEKING UNIV. FIN. L. RSCH. CTR. (2013).

143. Divya Chowdhury, *Unpredictable Regulation Dents China's Short-Term Appeal*, *Global Fund Managers Say*, REUTERS (Aug. 12, 2021), <https://www.reuters.com/business/unpredictable-regulation-dents-chinas-short-term-appeal-global-fund-managers-say-2021-08-06/> [<https://perma.cc/5CYP-BQ63>].

V. CONCLUSION

The SEC should reinforce the disclosure requirement for Chinese companies that adopted the VIE structure in their listing process and business operation. The VIE structure should not be completely banned because it is the most convenient way for investors outside of China to enter the Chinese market and profit by investing in Chinese companies. However, undue risks are imposed upon the stock market and investors because of the inherent defect of the VIE structure derived from its contractual nature and the holding company's lack of shareholder control. Such risks can be reduced by implementing a stricter regulatory framework and establishing a policy risk alert mechanism.