Council of Institutional Investors®
The voice of corporate governance

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BUYER BEWARE: CHINESE COMPANIES AND THE VIE STRUCTURE

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Foreword

Over the last 18 years, an increasing number of Chinese companies have listed on U.S. exchanges relying heavily on a corporate structure called a variable interest entity (VIE). A VIE is an entity controlled by a company by means other than a majority of voting rights.[1]

Through December 7, a total of 20 Chinese companies using VIE structures conducted or filed for initial public offerings (IPOs) on U.S. exchanges in 2017, a resurgence compared with the previous two years. This total includes 15 IPOs since just September. Moreover, some companies that went public earlier with VIE structures, notably Sina, Alibaba, and Baidu, have reached enormous valuations, with Alibaba racing neck and neck with Amazon to achieve a $500 billion market capitalization.[2]

These marketplace developments make it appropriate to revisit and highlight the riskiness of VIEs. While some Chinese companies list on U.S. exchanges without VIE structures and others with VIEs list on exchanges outside the United States, this study focuses particularly on Chinese companies using VIE structures with primary listings on U.S. exchanges.

The VIE structure is common among Chinese companies seeking foreign investment, including internet giants like Sina—which in 2000 became the first U.S.-listed Chinese company using a VIE—and Alibaba, which in 2014 made the largest IPO in history. But VIEs are fraught with complexity and risk for investors, including vulnerability to Chinese government pressures and management conflicts of interest. The VIE structure could be deemed to contravene Chinese laws that restrict foreign investment in strategically sensitive industries. VIEs operate using contractual arrangements rather than direct ownership, leaving foreign investors without the rights to residual profits or control over the company's management that they would otherwise enjoy through equity ownership.

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[1] Financial Accounting Standards Board (FASB) FIN 46R provides guidance on consolidation of VIEs. FIN 46 is an interpretation of US GAAP that was designed to make it difficult to remove assets and liabilities from a company's balance sheet if the company has economic exposure to the assets and liabilities, notwithstanding lack of majority voting control. The use by Enron of special purpose entities to hide certain liabilities was an important factor prompting development of the FASB interpretation. *See* http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1175801627792&acceptedDisclaimer=true

[2] Deirdre Bosa, "Alibaba vs Amazon: The Race to $500 billion," *CNBC*, September 1, 2017, https://www.cnbc.com/2017/09/01/alibaba-vs-amazon-the-race-to-500-billion.html.

While VIEs have established themselves as common practice among U.S.-listed Chinese companies and have won some validation from market actors[3], the structure puts public shareholders in a perilous position. VIEs depend heavily on executives who are Chinese nationals and own the underlying business licenses to operate in China, introducing unusually significant "key person" succession risk. Aside from dual-class structures with limited shareholder rights in the Cayman Islands and other jurisdictions in which these companies are often incorporated, the VIE structures themselves create significant management conflicts of interest, complicating, if not foreclosing, the ability of outside shareholders to challenge executives for poor decisionmaking, weak management, or equity-eroding actions. VIEs lead foreign investors to believe that they can meaningfully participate in China's emerging companies, but such participation is precarious and may ultimately prove illusory.

VIE Function and Form

The Emergence of VIEs

As a socialist economy striving for market economy status, China faces a tension between the goals of maintaining control over domestic industry and cultivating the benefits of foreign capital. The country's market-oriented reforms in 1979 launched decades of double-digit growth. Freed from outright state control, new private-sector companies found China's underdeveloped capital markets inadequate to fuel their growth and turned instead to foreign investors.[4]

Lingering from China's centrally-planned past, however, is the Ministry of Commerce (MOFCOM) Catalogue of Industries for Guiding Foreign Investment. Last revised in June 2017, the Catalogue trifurcates industries into those encouraged, restricted, or prohibited from receiving foreign investment.[5] Restricted and prohibited industries include those that the Chinese government regards as strategically sensitive, such as internet platforms, financial services, telecommunications, energy, agriculture, transportation, and education.[6]

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[3] *See* Lina Choi, et al., "Baidu and Tencent Can Manage Risks from VIE Structure," *Moody's,* May 27, 2014, https://www.moodys.com/research/Moodys-Baidu-and-Tencent-can-manage-risk-of-VIE-structure--PR_300293.

[4] *See* Justin Yifu Lin, et al., *The China Miracle: Development Strategy and Economic Reform,* (Hong Kong: The Chinese University Press, 2003).

[5] "Catalogue of Industries for Guiding Foreign Investment (Revision 2017)," Ministry of Commerce People's Republic of China, June 28, 2017, http://www.fdi.gov.cn/1800000121_39_4851_0_7.html.

[6] Other countries maintain varying levels of restrictions on inward foreign investment as well. In the U.S., the Committee on Foreign Investment in the United States (CFIUS) screens covered M&A transactions for threats to national security on a case-by-case basis. In bilateral investment treaties (BITs), the U.S. and

To operate legally in a restricted or prohibited industry, a company must receive a business license from MOFCOM. Before issuing the license, MOFCOM ensures that the company is owned and controlled by Chinese owners. Because MOFCOM's regulatory responsibilities also include screening inbound foreign direct investment, companies find it challenging to hide foreign capital in their coffers.[7] Companies seeking foreign investment consequently adapted by obscuring their foreign capital through the construction of a complex network of contractually connected entities. The desire of Chinese companies to sidestep MOFCOM restrictions, combined with the willingness of foreign investors to fund China's emerging enterprises through equity-type investment without equity ownership rights, provided the basis for the potentially unlawful VIE corporate structure. CII analysis finds that 62% of Chinese companies currently listed on U.S. exchanges use VIEs, and more than 80% of those that IPO'd within the past three years employ this structure.

The Structure of VIEs

The VIE structure consists of at least three core entities: a Chinese company with legitimate operations (referred to as the VIE or OpCo); a wholly foreign-owned enterprise (WFOE) established as an intermediary in China; and an offshore shell company that lists on a U.S. or other foreign exchange (ListCo).

To secure a MOFCOM business license, ownership of the VIE must remain in Chinese hands, often with the company's founder. The owner and VIE then establish an intermediary, the WFOE, with which they enter into a series of contractual arrangements. These contracts model control without granting direct equity ownership. Since the WFOE neither directly owns the VIE nor owns any assets that are restricted from foreign investment, it does not require a MOFCOM license and may receive foreign investment.

Next, a shell company incorporated in a management-friendly jurisdiction like the Cayman Islands or British Virgin Islands (BVI) conducts an IPO on a foreign exchange, frequently the New York Stock Exchange (NYSE) or Nasdaq. This ListCo owns the WFOE and funnels capital from foreign investors into China. Compounding the structure's complexity, the ListCo is generally a holding company that bears the same

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other countries establish a "negative list" of sectors in which foreign investment is restricted, prohibited, or based on reciprocity. *See* "Summary of US negative Lists in BITs," *The US-China Business Council,* 2014, https://www.uschina.org/sites/default/files/Negative%20list%20summary.pdf.

[7] Samuel Farrell Ziegler, "China's Variable Interest Entity Problem: How Americans Have Illegally Invested Billions in China and How to Fix It," *The George Washington University Law Review*, Vol. 84, No. 2, March 2016, 539-561, http://www.gwlr.org/wp-content/uploads/2016/03/84-Geo.-Was.-L.-Rev.-539.pdf.

name as the Chinese VIE, obscuring the reality that investors purchase depositary shares of a shell company with a third-tier relationship to the lucrative VIE.[8] (See Figure 1 below.)

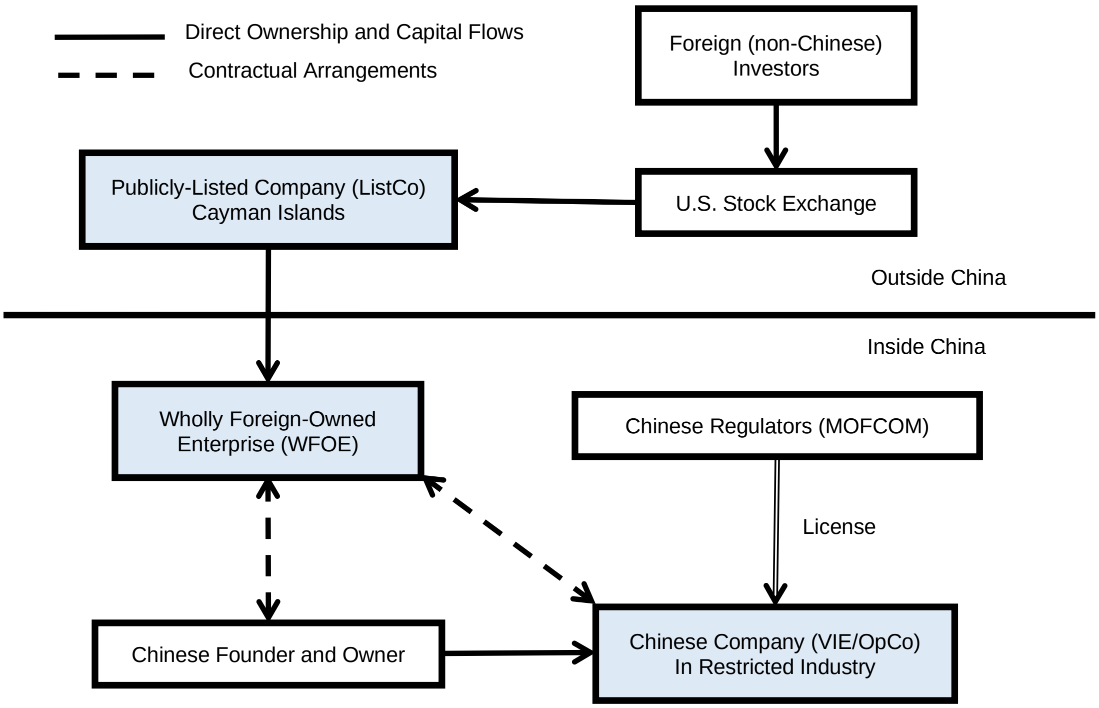

Figure 1. The VIE Structure and Ownership Scheme.

[8] As an example of this VIE-WFOE-ListCo structure applied to a real company, consider ZTO Express, the largest IPO on a U.S. exchange in 2016. The ListCo is ZTO Express (Cayman) Inc., which along with other subsidiaries is connected to China-based Shanghai Zhongtongji Network Technology Co., Ltd., the WFOE, which is contractually connected to the VIE/OpCo ZTO Express Co., Ltd. *See* https://www.sec.gov/Archives/edgar/data/1677250/000104746916016357/a2230086z424b4.htm.

The contractual arrangements that connect the ListCo and its WFOE to the Chinese VIE and its owner play a central role in facilitating the flow of foreign capital into the restricted industry. The contracts imitate ownership in function and form without granting investors direct equity ownership of the Chinese VIE. The contracts generally include the following characteristics:

- A **loan agreement** and **equity pledge agreement** whereby the WFOE provides an interest-free loan to the VIE's owner to capitalize the VIE. In exchange, the VIE serves as collateral for the loan as the owner pledges all of its assets and liabilities to the WFOE.
- A **call option agreement** between the VIE and WFOE that provides the latter a right to purchase the VIE at a pre-determined price, usually the amount of the loan agreement.
- The VIE's founders give the WFOE **power of attorney**, granting it shareholder rights such as voting, attending shareholder meetings and submitting shareholder proposals.
- A **technical services agreement** designates the WFOE as the exclusive provider of services like consulting and fulfillment to the VIE. This justifies the equity pledge agreement that entitles the WFOE to the VIE's earnings. The entities may also sign an **asset licensing agreement** whereby the VIE pays the WFOE royalties for assets like intellectual property licensing.[9]

Together, these contracts theoretically provide the WFOE rights over the VIE that a traditional parent company would have over its subsidiary through ownership. Because the WFOE assumes both the economic costs and benefits of the VIE and the ListCo directly owns the WFOE, U.S. accounting rules may require the ListCo to consolidate the VIE on its financial statements despite the absence of equity ownership.[10] These consolidated financial statements, along with the contractual arrangements, supply the glue that holds the VIE structure together. They enable the ListCo, a shell company with no meaningful operations of its own, to attract foreign investors who provide capital to what they might think is an emerging Chinese company.

[9] Paul Gillis, "Accounting Matters: Variable Interest Entities in China," *Forensic Asia*, September 18, 2012, http://www.chinaaccountingblog.com/vie-2012septaccountingmatte.pdf.

[10] FASB Interpretation No. 46R provides that "An enterprise that consolidates a VIE is the primary beneficiary of the VIE. The primary beneficiary of a VIE is the party that absorbs a majority of the entity's expected losses, receives a majority of its expected residual returns, or both, as a result of holding variable interests, which are the ownership, contractual, or other pecuniary interests…" *See* note 1.

VIE Risks

Substantial legal uncertainties surround these contractual arrangements since their purpose is to circumvent Chinese law. A threshold concern is whether they are enforceable at all should a dispute arise between the WFOE, its investors, and the VIE. Chinese contract law dims the prospects for their enforceability as it invalidates any contract that conceals an illegal purpose under the guise of legitimate acts.[11]

Moreover, each individual contract could theoretically violate Chinese law. First, the WFOE can only legally provide a loan to the VIE's owner if loans are within the WFOE's MOFCOM-sanctioned business scope. Second, since the VIE operates in a restricted industry, the WFOE—being foreign-owned—cannot exercise the call option without transferring it to a Chinese-owned entity. Finally, a services agreement for which the VIE pays 100% of its earnings to another company could raise regulators' eyebrows and incur tax penalties.

The VIE structure consequently deprives foreign investors of vital legal protections they would otherwise enjoy through equity ownership. Three risks arise as a result: government enforcement, owner expropriation, and punitive taxation. Although foreign investors have not experienced a fully confiscatory action, they have suffered devaluation of their investments as a result of the VIE structure in a number of cases.

Government Enforcement

Sina, the owner of China's version of Twitter, pioneered the VIE structure with its IPO in 2000. Since then, more than 150 Chinese companies of various sizes and industries using VIEs went public on U.S. exchanges.[12] By retaining a Chinese owner, these companies assure regulators that they remain under Chinese ownership and control while simultaneously telling foreign investors the exact opposite through their publicly traded ListCo.[13] Despite this contradiction and the questionable legality of the VIE structure, MOFCOM has largely tolerated their existence by declining to enforce its own restrictions. U.S.-listed VIEs essentially operate on a precarious assumption that MOFCOM will continue to allow the VIE structure to funnel foreign capital into restricted industries.

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[11] *See* Contract Law of the People's Republic of China, Chapter III, Article 52(3), http://www.npc.gov.cn/englishnpc/Law/2007-12/11/content_1383564.htm.

[12] This figure is current as of this writing and includes companies that went public and have since delisted.

[13] Gillis, "Accounting Matters."

Exceptions to the Chinese government's tacit approval exist. In 1998, the government abruptly prohibited a corporate structure similar to VIEs that it had previously tolerated. Companies used this structure, called China-China-Foreign (CCF), "to facilitate foreign investment in violation of MOFCOM's Catalogue prohibitions—just as VIEs do today."[14] The telecommunications companies that predominantly employed this structure were forced to unwind their holdings at a substantial loss to shareholders. The government separately interfered again in 2011, when provincial authorities advised Baosheng Steel that its control agreements "contravene current Chinese management policies related to foreign-invested enterprises and, as a result, are against public policy." Baosheng Steel was a Chinese VIE planning to go public on the Nasdaq through Buddha Steel, its Cayman Islands ListCo. In response to the adverse advisory, Buddha Steel withdrew its proposed IPO, transferred all payments and assets to the VIE, terminated its contractual arrangements with Baosheng, and became a shell company.[15]

These precedents underscore the risk of the Chinese government at any time enforcing MOFCOM's Catalogue and ordering Chinese companies to terminate their contracts with the WFOE. Short of dismantling VIEs, however, the government could also use the threat of enforcement to compel companies to take actions favorable to Beijing at the expense of shareholders. In 2015, MOFCOM stoked fears by issuing a draft Foreign Investment Law that includes "the ability to exercise decisive influence over a company by way of contractual arrangements" in the definition of control for designating foreign investment enterprises.[16] Since issuing the draft for public comment, MOFCOM has not made any progress in advancing the law. If implemented, however, this policy change could proscribe the VIE structure that nearly 100 publicly traded Chinese companies employ.

Owner Expropriation

In addition to the risk of adverse government action, the Chinese owner of the VIE could decide to breach the contractual arrangements and expropriate the company's earnings. Investors own shares of the Cayman Islands ListCo while the company's real assets reside in the Chinese VIE where courts are unlikely to enforce the contracts. Because the value of the ListCo derives from its ability to consolidate the Chinese VIE on its financial

[14] Ziegler, "China's VIE Problem," at 552: "Like the VIEs of today, the CCF was technically illegal, but (at least initially) tacitly permitted by authorities."

[15] *See* Buddha Steel Form 8-K, March 28, 2011, https://www.sec.gov/Archives/edgar/data/1367777/000114420411017680/v216334_8k.htm.

[16] "Foreign Investment Law of the People's Republic of China (Draft for Comments)," Jones Day, (Unofficial English Translation), https://www.uschina.org/sites/default/files/2015%20Draft%20Foreign%20Investment%20Law%20of%20the%20People%27s%20Republic%20of%20China_JonesDay_0.pdf.

statements, losing the VIE as a result of breached contracts (or government enforcement) would significantly devalue shareholders' investments.

Before Alibaba went public in 2014, it constructed a VIE structure to court foreign investment from Softbank and Yahoo, which purchased a 43% stake. Under the structure, Alibaba's WFOE contained the operations for Alipay, a leading online payment platform in China. After failing to secure a license for Alipay from the Chinese government because of its foreign ownership, founder Jack Ma abruptly spun off Alipay from Alibaba in 2011, taking control himself allegedly without consulting shareholders. Yahoo, no longer able to include Alipay's profits on its own financial statements, ultimately brokered a deal with Ma that entitled Alibaba to up to $6 billion from the proceeds of any future Alipay IPO or sale.[17] That figure, however, represents a 62.5% devaluation of Yahoo's stake in Alipay had it remained fully under Alibaba's control.

A year before the Alibaba drama, Nasdaq-listed GigaMedia, a diversified ListCo with multiple VIEs in China, lost control of one of its VIEs, T2CN. A T2CN executive seized the company's business license and financial documents upon discovering that the ListCo's shareholders wanted to remove him.[18] Since these financial "chops" facilitate the contractual arrangements, this maneuver paralyzed the VIE structure and dispossessed Gigamedia of its right to control and profit from T2CN. Since T2CN was one of GigaMedia's several VIEs, its loss represented a 20% devaluation of GigaMedia's revenues rather than a full 100%. Gigamedia never regained control, ultimately selling its ownership of T2CN's WFOE and settling with the rogue executive.[19]

While no publicly traded company with a VIE has entirely collapsed due to government enforcement or owner expropriation, the CCF, Buddha Steel, Alibaba, and GigaMedia cases illustrate that significant investment devaluation in VIEs is a palpable risk.

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[17] Liana Baker, "Yahoo gets short end of stick in Alibaba deal," *Reuters*, July 29, 2011, https://www.reuters.com/article/us-yahoo-alibaba/yahoo-gets-short-end-of-stick-in-alibaba-deal-idUSTRE76S2QN20110729.

[18] In China, these financial documents—including the company seals, business registration certificates, financial data, and licensing arrangements—are known as the company's "chops" and are indispensable to operating a business in China. *See* Ziegler, "China's VIE Problem," at 549.

[19] "GigaMedia Announces Sale of T2CN, All T2CN Litigation Resolved," December 14, 2011, https://www.sec.gov/Archives/edgar/data/1105101/000119312511343031/d272014dex991.htm; *see* Ziegler, "China's VIE Problem," at 500: "[I]t is telling that the company would rather settle with a manager who effectively took the company assets hostage than take the chance of having a court declare the entire operation illegal."

Punitive Taxation

The invalidation of the contractual arrangements in cases of enforcement or expropriation is not the only source of investment devaluation. Vulnerability to punitive taxation also is a concern. Even if the contracts function as intended, the potential for punitive tax treatment in China raises questions about the ListCo's consolidated financial statements. In theory, the VIE should pay all of its earnings to the WFOE under the terms of the services contract in order to model direct ownership. The ListCo could in turn extract the profits from China since it directly owns the WFOE. Chinese companies conducting IPOs in the United States generally advertise this arrangement in their Securities and Exchange Commission (SEC) filings to justify their consolidated financial statements and attract foreign investors.[20]

Accounting firms rely on this arrangement, substantiated by a legal opinion that Chinese law firms issue affirming the functionality and enforceability of the contracts, when preparing the ListCo's financial statements. Regardless of when or how the VIE pays its earnings to the WFOE, the financial statements should reflect the service payment as an expense of the VIE and income to the WFOE. The receivables and payables between the various entities are eliminated in consolidation, but the financial statements should arguably reflect—or at least disclose—the potential taxation applicable to the payments.

In China, the VIE's earnings are subject to an average 8.5% value added tax (VAT) from the outset.[21] The VIE should then pay the remaining 91.5% of its earnings to the WFOE. Due to the VIE structure's questionable legality, tax treatment after the VAT is less clear and determined by the Chinese State Administration of Taxation. In a hypothetical but potentially realistic scenario, Paul Gillis, editor of the China Accounting Blog, argues that the administration could consider the VIE payment a dividend to the VIE's Chinese owner who then transfers it to the WFOE. [22] This formulation would subject the VIE owner to a 20% individual income tax and the WFOE to a 25% corporate income tax. When the WFOE pays the rest to the ListCo, extracting the profits from China, the

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[20] Common language from SEC filings states, "We entered into a series of contractual arrangements with [our VIE] and its shareholders, which enable us to receive substantially all of the economic benefits from our consolidated affiliates," *See* RISE Education (Cayman) Ltd. Form F-1, October 18, 2017, https://www.sec.gov/Archives/edgar/data/1712178/000119312517312619/d414107df1a.htm.

[21] China's VAT was implemented in 2016 and uses multiple rates. For example, many services including financial services are taxed at 6% and construction and real estate are taxed at 11%. *See* "China's new VAT rates and rules," KPMG China Tax Alert, March 2016, https://assets.kpmg.com/content/dam/kpmg/pdf/2016/03/china-tax-alert-09-vat-implementation-rules.pdf.

[22] Paul Gillis, "Accounting for VIE Taxes," *China Accounting Blog*, December 8, 2013, http://www.chinaaccountingblog.com/weblog/accounting-for-vie-taxes.html.

administration would apply an additional 10% withholding tax.[23] Table 1 below shows the potential tax liability of a hypothetical company with a VIE that has pre-tax earnings of $500 million.[24]

Pre-Tax Earnings	$500,000,000
8.5% Average VAT (on VIE)	$42,500,000
Profit Remaining	$457,500,000
20% Income Tax (on VIE owner)	$91,500,000
Profit Remaining	$366,000,000
25% Corporate Tax (on WFOE)	$91,500,000
Profit Remaining	$274,500,000
10% Withholding Tax (on WFOE)	$27,450,000
Profit Remaining Offshore	$247,050,000
Total Taxes Collected	$252,950,000
Effective Tax Rate	**50.6%**

102.4% Higher

Table 1. Hypothetical Tax Liabilities of VIE Earnings

Although it is difficult to follow the actual cash flow of companies using VIEs, the payments stipulated under the contractual arrangements between entities could incur the taxation outlined above. Most ListCos indirectly confirm the potential for this panoply of taxes in their SEC filings, citing the corporate tax as a reason not to extract earnings from the VIE and the withholding tax as a reason not to pay dividends. While some companies provide a precise estimate of their deferred tax liability[25]—even if hypothetical—many more avoid providing such figures by claiming the calculation is impracticable,[26] citing a reinvestment exemption,[27] or suggesting the existence of tax-free means of moving their

[23] *Ibid.;* Paul Gillis, "Deferred Taxes and VIEs," *China Accounting Blog*, December 12, 2013, http://www.chinaaccountingblog.com/weblog/deferred-taxes-and-vies.html.

[24] For other hypothetical formulations of tax liability, *see* Quintus Dienst, "Tax Issues and Legal Obstacles Chinese Companies Face When Seeking to Capitalize Overseas Using a VIE Structure," Friedrichshafen Zeppelin Universitƒt, 2012, https://www.zu.de/info-wAssets/forschung/dokumente/zuwuerfe/2012-09-20_CME_BA_Dienst.pdf.

[25] "The deferred tax liabilities arising from the aggregate undistributed earnings of the PRC Domestic Entities and… the WOFEs amounted to US$33,508 and US$29,297 as of December 31, 2015 and 2016, respectively." *See* Fang Holdings Ltd. Form 20-F, May 12, 2017, https://www.sec.gov/Archives/edgar/data/1294404/000114420417026955/v464444_20f.htm.

[26] "Determination of the amount of unrecognized deferred tax liability related to these earnings is not practicable." *See* Baidu, Inc. Form 20-F, March 31, 2017, https://www.sec.gov/Archives/edgar/data/1329099/000119312517105041/d277810d20f.htm.

[27] "We have not recognized any deferred tax liability for the undistributed earnings of the PRC-resident enterprise as of December 31, 2014, 2015 and 2016, as we plan to permanently reinvest these earnings in the PRC." *See* GDS Holdings, Ltd. Form 20-F, April 19, 2017, https://www.sec.gov/Archives/edgar/data/1526125/000110465917024311/a17-6886_120f.htm.

money.[28] The result of these divergent approaches—as some companies account for deferred tax liabilities and others grasp for any reason to avoid them—is inconsistent financial reporting across companies with VIEs, to the confusion of investors.[29]

In reality, most VIEs appear not to pay their cash flow to the WFOE. Standard language in ListCo SEC filings notes, "We may rely on dividends from our subsidiaries in China for our cash requirements, including any payment of dividends to our shareholders. PRC regulations may restrict the ability of our PRC subsidiaries to pay dividends to us [the ListCo]." Since most of these companies reinvest their earnings in China, they add: "We do not have any present plan to pay any cash dividends on our ordinary shares in the foreseeable future after this offering. We currently intend to retain most, if not all, of our available funds and any future earnings to operate and expand our business."[30] CII analysis has found that less than one fifth of U.S.-listed Chinese VIEs currently pay or intend to pay dividends to shareholders. While not uncommon in start-ups, indefinite reinvestment for at least some of these VIE-dependent companies appears more related to Chinese restrictions on moving money from the VIE to the WFOE and ListCo. In short, all the money made in China stays in China. This arrangement potentially leaves investors to rely solely on the appreciation of the company's stock price for a return on their investment.

By creating a ListCo that bears the same recognizable name as a Chinese VIE and giving every appearance that the publicly traded ListCo controls the VIE's profits, these Chinese companies may mislead unsophisticated foreign investors on the extent of their participation in China's emerging industries. MOFCOM designs its regulations to preclude their participation, and the VIE structure—while sidestepping those restrictions—nonetheless seems to ensure one-way capital flows into China. The unholy trinity of potential risks—government enforcement, owner expropriation, and punitive

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[28] "A deferred tax liability should be recorded … However, recognition is not required in situations where the tax law provides a means by which the reported amount of that investment can be recovered tax-free and the enterprise expects that it will ultimately use that means." *See* Yirendai Ltd. Form 20-F, April 24, 2017, https://www.sec.gov/Archives/edgar/data/1631761/000110465917025460/a16-23489_120f.htm. About this point, Professor Gillis writes, "Arguing that the profits can be taken tax free from the VIE requires an assumption that Chinese tax authorities are daft," *See* Gillis, "Deferred Taxes."

[29] US GAAP requires the deferred taxes for each jurisdiction to be presented as a net noncurrent liability on the balance sheet. *See* Brett Cohen and Kyle Quigley, "FASB Simplifies Balance Sheet Classification of Deferred Taxes," *PwC,* November 23, 2015, https://www.pwc.com/us/en/cfodirect/assets/pdf/in-brief/us-2015-37-fasb-simplifies-balance-sheet-classification-deferred-taxes.pdf.

[30] *See* ZTO Express (Cayman) Inc. Form 424B4, October 28, 2016, https://www.sec.gov/Archives/edgar/data/1677250/000104746916016357/a2230086z424b4.htm.

taxation—threatens to devalue shareholders' investments and leaves them with limited legal recourse.

VIE Trends and Corporate Governance

Despite the risk these companies using VIE structures pose to investors and capital markets, U.S. exchanges are experiencing a sharp increase in Chinese VIE IPOs. According to CII analysis, 20 companies using VIEs have conducted or filed for IPOs so far in 2017, including 15 just since September. That compares with six VIE IPOs in all of 2016 and seven in 2015. As Table 2 shows below, 2017 is the most active year ever for VIEs as measured by number of IPOs (although the amount raised was higher in 2014).

Year	2000	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Chinese VIE IPOs	5	1	1	4	3	1	4	2	4	13	4	2	2	9	7	6	20
Dual Class	20%	0%	0%	0%	33%	0%	0%	0%	25%	15%	100%	50%	0%	78%	14%	83%	55%
Cayman/BVI Incorporation	60%	0%	100%	75%	100%	100%	100%	100%	50%	69%	100%	100%	50%	100%	100%	67%	90%

Table 2. Characteristics of Chinese VIE IPOs

Some Chinese companies using VIEs have conducted among the largest IPOs in the United States by amount raised. Alibaba shattered records in 2014 and remains the largest IPO ever conducted at $25 billion raised.[31] ZTO Express, raising $1.4 billion, was the largest U.S. IPO in 2016.[32] Even as more U.S.-based companies IPO'd in 2017, Chinese companies with VIEs conducted two of the top 10 largest IPOs this year, with Tencent-backed Sogou raising $585 million and Alibaba-backed Best, Inc. raising $450 million.[33] While the majority of VIE IPOs raise smaller sums, these headline-grabbing companies contribute to the narrative that Chinese IPOs offer investors a secure, high-growth investment opportunity.

[31] Ryan Mac, "Alibaba Claims Title for Largest Global IPO Ever With Extra Share Sales," *Forbes*, September 22, 2014, https://www.forbes.com/sites/ryanmac/2014/09/22/alibaba-claims-title-for-largest-global-ipo-ever-with-extra-share-sales/#65819c448dcc.

[32] Jethro Mullen, "This year's biggest U.S. IPO is by a Chinese delivery firm," *CNN Money,* October 27, 2016, http://money.cnn.com/2016/10/27/investing/zto-express-biggest-ipo-china-new-york/index.html.

[33] Brian Deagon, "Sogou Rises in Debut After China Search Engine IPO Prices High," *Investor's Business Daily,* November 9, 2017, https://www.investors.com/news/technology/sogou-ipo-prices-high-as-china-search-engine-firm-set-to-begin-trading/; "Alibaba-backed Best Inc raises $450 million in IPO after slashing terms," *Reuters,* September 19, 2017, https://www.reuters.com/article/us-best-ipo/alibaba-backed-best-inc-raises-450-million-in-ipo-after-slashing-terms-idUSKCN1BU1UX.

Compounding the risk surrounding these companies using VIEs, however, is the poor corporate governance practices they often employ. MOFCOM's restrictions on foreign investment and the resulting VIE arrangements seek to preserve Chinese control over companies operating in strategic industries. Although VIEs finesse the letter of the law by funneling foreign capital into restricted industries, many uphold the spirit of the law by creating controlled companies. These companies employ a dual-class structure with one class of shares containing anywhere from three to 30 times more voting power per share than the other class. Chinese insiders then invest in the ListCo and hold the superior-voting class of shares while outside investors purchase the inferior-voting class of shares.

Although the contracts are designed to transfer all ownership rights from the VIE's owners to the ListCo's shareholders, these dual-class arrangements guarantee Chinese insiders the vast majority of voting power over the entire structure despite their lack of proportionate economic interest in the publicly listed company. Like Chinese IPOs overall, the combined VIE and dual-class structure is increasingly prevalent on U.S. exchanges.

The complexity of the VIE structure and the management-friendly jurisdiction of incorporation free these companies to pursue actions that investors would generally regard as unacceptable for U.S.-domiciled companies. For example, Cayman Islands and BVI law neither requires companies to hold annual meetings nor provides shareholders a right to submit proposals. While the majority of Chinese companies with VIE structures do hold annual meetings, a notable exception is Baidu, the Chinese equivalent of Google with an $82 billion market capitalization. Baidu has not held an annual meeting since 2008. JD.com, an online retailer with a $58 billion market cap, has not hosted any shareholder meetings since its IPO in 2014.

Cayman Islands and BVI laws also exempt companies from maintaining a majority-independent board of directors or fully-independent compensation and nominating and corporate governance committees. CII analysis finds that 56% of U.S.-listed Chinese companies with VIEs rely on these legal exemptions, leaving shareholders with severely subpar protections. These companies go to great lengths to ensure that the board remains composed of insiders. Alibaba's structure includes a 28-member partnership of founder Jack Ma's associates that has the power to nominate a majority of the board. Sina recently won a proxy fight against a U.S. hedge fund and subsequently invoked a "blank check preferred stock" provision to issue its founder a class of shares with 10,000 votes each and no economic rights.[34] The maneuver gave the founder control of the firm, with no premium attached for other shareholders.

Investors could at least make informed decisions if they read SEC filings assuming that companies fully disclosed these details. But disclosure varies significantly across VIEs, as some detail the manifold risks of the contractual arrangements and inferior corporate governance practices while others fail to clearly indicate in their prospectuses or annual reports that they employ a VIE structure at all. As in the case of failing to account for deferred tax liability, some companies creatively avoid disclosure through euphemism or legal exemption. Borqs Technologies, for example, makes passing reference to its "alternative structures to comply with regulations in certain Chinese industries," and Kingold Jewelry omits the entire risk factors section of its filings.[35] Neither company is a foreign private issuer (FPI), an SEC designation that grants certain disclosure exemptions, making their obfuscation all the more concerning.[36] Between 2012 and 2017, the NYSE and Nasdaq delisted 12 Chinese companies with VIEs for failing to file annual or quarterly reports with the SEC, according to CII analysis. This lack of transparency helps obscure these companies' poor corporate governance practices and the overarching risks of the VIE structure.

Recommendations

Enshrined in CII policy is the principle that companies should take no action with the intent of reducing accountability to shareholders.[37] The entire VIE structure, in function and form, exists to serve a fundamentally contradictory purpose. Companies claim to MOFCOM that the VIE remains under Chinese control while simultaneously signing legally dubious contracts that promise shareholders the opposite. Despite the hundreds of billions of dollars raised and record-breaking success of Chinese VIEs in U.S. capital markets, they expose foreign investors to substantial risk. All the while, these predominantly Cayman Islands-based companies pursue corporate governance practices

[34] Amie Tsang, "Sina Doubles Down to Ward Off Activists After Proxy Fight," *The New York Times*, November 7, 2017, https://www.nytimes.com/2017/11/07/business/dealbook/sina-proxy-activists.html.

[35] *See* Borqs Technologies, Inc. Form 10-K, August 17, 2017, https://www.sec.gov/Archives/edgar/data/1650575/000121390017008855/f10k2017_pacificspecial.htm; "As a smaller reporting company, we are not required to provide the information otherwise required by this Item," Kingold Jewelry, Inc. Form 10-K, April 17, 2017, https://www.sec.gov/Archives/edgar/data/1089531/000114420417020749/v464032_10k.htm#a_003.

[36] Foreign private issuers are exempt from producing quarterly reports and proxy statements, for example. 82% of Chinese VIEs are FPIs.

[37] *See* Policies on Corporate Governance, section 1.4, Council of Institutional Investors, http://www.cii.org/corp_gov_policies.

devoted to reducing accountability and transparency to foreign investors. As shareholders without equity ownership, foreign investors possess no meaningful right to participate in the profits or control over the operating company.

The enforceability of the contractual arrangements in China is at the crux of the consolidation of VIEs. In view of its investor protection mandate, the SEC should consider probing VIEs and ensuring greater transparency by:

1. Requiring Chinese companies using VIE structures to disclose in their 20-F filings the full legal opinion regarding the contracts on which they rely as the basis for consolidating the VIE;
2. Requiring separate, unconsolidated financial statements for each entity—the VIE, the WFOE, and the ListCo—so investors can understand where the company's operations exist and the cash flow between the entities;
3. Promoting higher quality implementation of the accounting for deferred tax liabilities, including disclosing the potentially applicable tax rates of moving cash flow through the VIE structure;
4. Requiring Chinese companies with VIEs to disclose a succession plan that details the arrangement and procedures that will ensue should the VIE's Chinese owners depart; and
5. Strengthening disclosure requirements for FPIs, given that 82% of U.S.-listed Chinese companies with VIEs are FPIs, to include a certification of compliance with Chinese regulations and the enforceability of any contractual arrangements that underpin the business model.

Addressing the 19th Party Congress in Beijing in mid-October, Chinese President Xi Jinping pledged to "protect the legitimate rights and interests of foreign investors" as the country moves to open its markets.[38] But this rhetoric does not match reality in the world's second-largest economy as emerging Chinese companies construct this convoluted structure while the government looks the other way. Until China liberalizes its foreign investment restrictions and until the SEC achieves greater transparency for foreign investors, Chinese VIEs remain in the "buyer beware" corner of global capital markets.

[38] Tay Hwee Peng, "19th Party Congress: 7 key themes from President Xi Jinping's work report," *The Straits Times*, October 18, 2017, http://www.straitstimes.com/asia/east-asia/19th-party-congress-7-key-themes-from-president-xi-jinpings-work-report.

Table 3. Chinese VIEs Currently Listed on U.S. Exchanges

Ticker	Company	Market Cap ($ millions)	Sector	Incorporation	IPO Year	Exchange
BSPM	Biostar Pharmaceuticals, Inc.	$5.19	Health Care	Maryland	2000	NASDAQ
NTES	NetEase, Inc.	$39,660.62	Miscellaneous	Cayman Islands	2000	NASDAQ
SINA	Sina Corporation	$7,591.28	Technology	Cayman Islands	2000	NASDAQ
SOHU	Sohu.com Inc.	$2,129.92	Technology	Delaware	2000	NASDAQ
UTSI	UTStarcom Holdings Corp	$115.58	Consumer Durables	Cayman Islands	2000	NASDAQ
ONP	Orient Paper, Inc.	$28.74	Consumer Durables	Nevada	2002	NYSE
CTRP	Ctrip.com International, Ltd.	$23,860.68	Miscellaneous	Cayman Islands	2003	NASDAQ
JOBS	51job, Inc.	$3,866.42	Technology	Cayman Islands	2004	NASDAQ
JRJC	China Finance Online Co. Limited	$50.78	Finance	Hong Kong	2004	NASDAQ
SEED	Origin Agritech Limited	$32.36	Consumer Non-Durables	British Virgin Islands	2004	NASDAQ
NCTY	The9 Limited	$17.93	Miscellaneous	Cayman Islands	2004	NASDAQ
BIDU	Baidu, Inc.	$82,448.61	Technology	Cayman Islands	2005	NASDAQ
CNTF	China TechFaith Wireless Communication Tech Ltd.	$24.35	Technology	Cayman Islands	2005	NASDAQ
HOLI	Hollysys Automation Technologies, Ltd.	$1,416.83	Energy	British Virgin Islands	2005	NASDAQ
EDU	New Oriental Education & Technology Group, Inc.	$13,337.20	Consumer Services	Cayman Islands	2006	NYSE
ATV	Acorn International, Inc.	$46.12	Consumer Services	Cayman Islands	2007	NYSE
AMCN	AirMedia Group Inc	$127.51	Technology	Cayman Islands	2007	NASDAQ
FANH	Fanhua Inc.	$1,095.35	Finance	Cayman Islands	2007	NASDAQ
XIN	Xinyuan Real Estate Co Ltd	$378.85	Basic Industries	Cayman Islands	2007	NYSE
ATAI	ATA Inc.	$108.12	Consumer Services	Cayman Islands	2008	NASDAQ
DL	China Distance Education Holdings Limited	$265.36	Consumer Services	Cayman Islands	2008	NYSE
CYOU	Changyou.com Limited	$1,941.57	Technology	Cayman Islands	2009	NASDAQ
CADC	China Advanced Construction Materials Group, Inc.	$5.49	Basic Industries	Delaware	2009	NASDAQ
CLNT	Cleantech Solutions International, Inc.	$7.81	Technology	Delaware	2009	NASDAQ
RCON	Recon Technology, Ltd.	$13.96	Energy	Cayman Islands	2009	NASDAQ
BITA	Bitauto Holdings Limited	$3,435.16	Technology	Cayman Islands	2010	NYSE
HGSH	China HGS Real Estate, Inc.	$63.52	Finance	Florida	2010	NASDAQ
CNIT	China Information Technology, Inc.	$67.99	Technology	Nevada	2010	NADSAQ
CJJD	China Jo-Jo Drugstores, Inc.	$39.33	Consumer Durables	Nevada	2010	NASDAQ

CCIH	ChinaCache International Holdings Ltd.	$31.01	Technology	Cayman Islands	2010	NASDAQ
CNET	ChinaNet Online Holdings, Inc.	$15.18	Technology	British Virgin Islands	2010	NASDAQ
DQ	DAQO New Energy Corp.	$422.55	Technology	Cayman Islands	2010	NYSE
SFUN	Fang Holdings Limited	$2,027.37	Technology	Cayman Islands	2010	NYSE
KGJI	Kingold Jewelry Inc.	$147.22	Miscellaneous	Delaware	2010	NASDAQ
KONE	Kingtone Wirelessinfo Solution Holding Ltd	$5.05	Technology	British Virgin Islands	2010	NASDAQ
MOXC	Moxian, Inc.	$183.60	Technology	Nevada	2010	NASDAQ
NOAH	Noah Holdings Ltd.	$2,189.62	Finance	Cayman Islands	2010	NYSE
TAL	TAL Education Group	$14,595.51	Consumer Services	Cayman Islands	2010	NYSE
VNET	21Vianet Group, Inc.	$817.88	Technology	Cayman Islands	2011	NASDAQ
NQ	NQ Mobile Inc.	$420.19	Technology	Cayman Islands	2011	NYSE
FENG	Phoenix New Media Limited	$384.14	Consumer Services	Cayman Islands	2011	NYSE
RENN	Renren Inc.	$698.39	Technology	Cayman Islands	2011	NYSE
VIPS	Vipshop Holdings Limited	$4,856.47	Consumer Services	Cayman Islands	2012	NYSE
YY	YY Inc.	$5,078.58	Technology	Cayman Islands	2012	NASDAQ
CCCR	China Commercial Credit, Inc.	$57.94	Finance	Delaware	2013	NASDAQ
LITB	LightInTheBox Holding Co., Ltd.	$129.47	Consumer Services	Cayman Islands	2013	NYSE
BABA	Alibaba Group Holding Limited	$472,422.40	Miscellaneous	Cayman Islands	2014	NYSE
EHIC	eHi Car Services Limited	$753.33	Consumer Services	Cayman Islands	2014	NYSE
KANG	iKang Healthcare Group, Inc.	$999.41	Health Care	Cayman Islands	2014	NASDAQ
JD	JD.com, Inc.	$58,852.81	Consumer Services	Cayman Islands	2014	NASDAQ
MOMO	Momo Inc.	$5,914.65	Technology	Cayman Islands	2014	NASDAQ
TEDU	Tarena International, Inc.	$842.77	Consumer Services	Cayman Islands	2014	NASDAQ
TOUR	Tuniu Corporation	$927.17	Consumer Services	Cayman Islands	2014	NASDAQ
WB	Weibo Corporation	$23,741.91	Technology	Cayman Islands	2014	NASDAQ
XNET	Xunlei Limited	$810.27	Technology	Cayman Islands	2014	NASDAQ
BZUN	Baozun Inc.	$1,879.28	Consumer Services	Cayman Islands	2015	NASDAQ
BRQS	Borqs Technologies, Inc.	$146.32	Finance	British Virgin Islands	2015	NASDAQ
CCRC	China Customer Relations Centers, Inc.	$254.05	Miscellaneous	British Virgin Islands	2015	NASDAQ
FORK	Fuling Global Inc.	$77.99	Consumer Non-Durables	Cayman Islands	2015	NASDAQ
HLG	Hailiang Education Group Inc.	$1,006.43	Consumer Services	Cayman Islands	2015	NASDAQ
JMU	JMU Limited	$91.82	Technology	Cayman Islands	2015	NASDAQ
YRD	Yirendai Ltd.	$2,500.79	Finance	Cayman Islands	2015	NYSE
COE	China Online Education Group	$257.11	Consumer Services	Cayman Islands	2016	NYSE
GDS	GDS Holdings Limited	$1,864.10	Technology	Cayman Islands	2016	NASDAQ

GSUM	Gridsum Holding Inc.	$261.60	Technology	Cayman Islands	2016	NASDAQ
TYHT	Shineco, Inc.	$78.25	Consumer Non-Durables	Delaware	2016	NASDAQ
SPI	SPI Energy Co., Ltd.	$81.21	Technology	California	2016	NYSE
ZTO	ZTO Express (Cayman) Inc.	$12,147.56	Transportation	Cayman Islands	2016	NASDAQ
BSTI	Best, Inc.	$3,874.50	Consumer Services	Cayman Islands	2017	NYSE
BCAC	Bison Capital Acquisition Corp.	$78.59	Finance	British Virgin Islands	2017	NASDAQ
BEDU	Bright Scholar Education Holdings Limited	$2,530.00	Consumer Services	Cayman Islands	2017	NYSE
CIFS	China Internet Nationwide Financial Services Inc.	$1,118.26	Consumer Services	British Virgin Islands	2017	NASDAQ
LYL	Dragon Victory International Limited	$71.87	Finance	Cayman Islands	2017	NASDAQ
FEDU	Four Seasons Education	$476.40	Consumer Services	Cayman Islands	2017	NYSE
HX	Hexindai Inc.	$601.42	Finance	Cayman Islands	2017	NASDAQ
JT	Jianpu Technology	$1,566.80	Technology	Cayman Islands	2017	NYSE
PPDF	PPDAI Group	$2,930.00	Finance	Cayman Islands	2017	NYSE
QD	Qudian Inc.	$8,987.28	Finance	Cayman Islands	2017	NYSE
REDU	RISE Education Cayman Ltd	$1,188.00	Consumer Services	Cayman Islands	2017	NASDAQ
RYB	RYB Education	$401.70	Consumer Services	Cayman Islands	2017	NYSE
SECO	Secoo Holding Limited	$228.60	Consumer Services	Cayman Islands	2017	NASDAQ
SOGO	Sogou	$5,089.80	Technology	Cayman Islands	2017	NYSE
YECO	Yulong Eco-Materials Limited	$8.39	Capital Goods	Cayman Islands	2017	NASDAQ
ZKIN	ZK International Group Co., Ltd	$99.90	Capital Goods	British Virgin Islands	2017	NASDAQ
FAMI	Farmmi, Inc.	(No Data)	Consumer Non-Durables	Cayman Islands	Filed	NASDAQ
LX	LexinFintech Holdings, Ltd.	(No Data)	Technology	Cayman Islands	Filed	NASDAQ
AIHS	Senmiao Technology	(No Data)	Technology	Nevada	Filed	NASDAQ
SSLJ	SSLJ.COM Ltd.	(No Data)	Technology	Cayman Islands	Filed	NASDAQ

Source: Nasdaq, CII analysis.