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

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An investor who buys shares on a stock exchange receives a piece of equity of the listed company. Typically, the listed company is either an operating company or a holding company that owns an equity stake in an operating company or companies. This, however, is not true of half of the businesses domiciled in the People’s Republic of China (“PRC”) that are listed in the United States using the Variable Interest Entity (“VIE”) structure. Under a VIE structure, a US investor purchases shares in an offshore entity, typically a shell company domiciled in the Cayman Islands, which owns neither a revenue-
generating business operation nor equity in an operating company.\textsuperscript{5} The investor derives economic benefits solely from the contractual agreements between the listed entity and the underlying PRC-domiciled business.\textsuperscript{6} As such, a VIE investment is only as good as the validity of its underlying contracts.\textsuperscript{7} The combined market capitalization of US-listed PRC-domiciled VIEs was nearly US$100 billion as of September 2012, and is expected to reach US$300 billion by the end of 2014.\textsuperscript{8}

The VIE structure of PRC-domiciled businesses was created in 2000 to circumvent the PRC government’s restrictions barring non-PRC ownership of PRC companies in certain “sensitive”
industry sectors, such as energy, technology, and value-added telecommunications.\footnote{See McGovern, supra note 9 (“Under Chinese law, certain industries—such as energy, technology and telecommunications—are considered sensitive, and companies are prevented from issuing stock to foreign investors. Some mainland companies operating in these sectors have adopted the VIE structure to gain access to foreign capital.”); Richard Pearson, Looking at Chinese VIE’s, \textit{FORBES} (Oct. 18, 2012), http://www.forbes.com/sites/richardpearson/2012/10/18/looking-at-chinese-vies (“Variable Interest Entity . . . structures were first introduced by Chinese companies listing in the US as far back as the year 2000 when SINA had its initial public offering on the NASDAQ.”).} Notably, almost all of the largest US-listed PRC-domiciled internet companies use the VIE structure.\footnote{See David Barboza, \textit{A Loophole Poses Risks to Investors in Chinese Companies}, \textit{N.Y. TIMES} (Jan. 23, 2012, 5:38 PM), http://dealbook.nytimes.com/2012/01/23/a-loophole-poses-risks-to-investors-in-chinese-companies (pointing out that almost every major Chinese internet company has adopted the VIE structure); Sunny Ye, \textit{The Cash Reserves of China’s Internet Companies}, \textit{TechRICE} (Oct. 2, 2011), http://techrice.com/2011/10/02/chinas-internet-companies-ranked-by-cash-on-hand (listing the twenty-seven largest overseas-listed PRC-domiciled VIEs in the internet business in terms of cash reserves, with US-listed NetEase and Baidu in top spots).} To date, the PRC government has not directly addressed either the legality of the VIE structure or the validity of its underlying contracts.\footnote{See generally Stan Abrams, \textit{The VIE Meta-Narrative: Illegal vs. Invalid}, \textit{China Hearsay Blog} (Oct. 13, 2011), http://www.chinahearsay.com/the-vie-meta-narrative (distinguishing between the risk of a categorical declaration of the illegality of VIE as a financing structure and that of invalidation of the VIE contracts); Schindelheim, supra note 4, at 225 (arguing that the uncertainty is part of the CCP’s deliberate plan).} Nevertheless, recent actions by the PRC’s regulatory bodies have significantly exacerbated concerns over the structure’s fundamental viability.\footnote{See Gillis, supra note 8 (“There is a growing feeling that VIEs are becoming unworkable.”); \textit{An Update on China’s Variable Interest Entities: Navigating Regulations and Mitigating Risks for 2013}, \textit{K&L GATES} (Mar. 8, 2013), http://www.klgates.com/an-update-on-chinas-variable-interest-entities—navigating-regulations-and-mitigating-risks—for-20130308-2013 (suggesting that the PRC government’s recent actions show its intention to crack down on VIEs).} The murky legal and political landscape surrounding VIEs poses unusual challenges to the protection of US investor interests.\footnote{See Steven M. Davidoff, \textit{Alibaba Investors Will Buy a Risky Corporate Structure}, \textit{N.Y. TIMES} (May 6, 2014, 7:46 PM), http://dealbook.nytimes.com/2014/05/06/i-p-o-revives-debate-over-a-chinese-structure (“The structure may be illegal under Chinese law since it conveniently circumvents those prohibitions on foreign investment.”); Dena Aubin, \textit{Investor Risk Lurks in Legal Structure of China IPOs—Lawyers}, \textit{REUTERS} (Nov. 2, 2013), http://www.reuters.com/article/2013/06/25/china-investments-idUSL2N0E MDP20130625 (presenting the possible nightmare scenario, where the listed company loses control of the PRC firm’s assets, essentially wiping out its balance).}
Part I of this Comment discusses the policy background, historical origin, common configuration, and the PRC’s current regulatory regime of the VIE structure. Part I also provides a brief overview of the role of the US Securities and Exchange Commission (“SEC”) in regulating publicly-held VIEs in the United States. Part II examines the inherent legal and regulatory risks of investing in VIE entities and the limited legal recourse afforded to VIE investors. Part III recommends two regulatory actions the SEC may consider taking to better inform the investing public in the nature of VIEs. For the sake of focus and brevity, in this Comment, the term “PRC” refers only to mainland China, and the term “VIE” means only those variable interest entity structures that involve PRC-domiciled businesses publicly traded in the United States.14

I. THE REGULATORY ENVIRONMENT

Part I introduces the historical background that gave rise to the invention and popularity of VIEs and discusses its current regulatory environment. Part IA examines the early days of the PRC’s foreign direct investment (“FDI”) policy, and the emergence of the industry-based investment restriction scheme of the 1970s as a direct result of the PRC’s Open-Door Policy. Part IB investigates the rise and demise of the VIE’s predecessor, the China-China-Foreign (“CCF”) investment structure, and the subsequent rise of the VIE structure since 2000. It also analyzes the typical structure of a VIE arrangement and the motives of its various participants. Part IC reviews the PRC’s recent legislative and regulatory developments as well as the ongoing bilateral treaty negotiation affecting the VIE structure. Part ID briefly addresses the regulatory role of the SEC in the US capital markets, particularly in relation to VIEs.

14. See Mainland China, WIKIPEDIA, http://en.wikipedia.org/wiki/Mainland_China (last visited on Feb. 26, 2014) ("[A] geographical and political term to describe the geographical area under the direct jurisdiction of the People's Republic of China (PRC) [that] generally excludes the PRC Special Administrative Regions of Hong Kong and Macau"); Contra Variable Interest Entity—VIE, INVESTOPEDIA, http://www.investopedia.com/terms/v/variable-interest-entity.asp (last visited on Dec. 19, 2013) (defining VIE as any entity in which the investor has obtained less than a majority interest that is subject to consolidation if certain conditions exist).
A. Long-Held Policy of the People’s Republic of China: Restriction on Foreign Ownership in “Sensitive” Industries

The PRC operates in a self-defined “socialist market economy” under the unitary rule of the Chinese Communist Party (“CCP”). During the Maoist era (1949–78), FDI in the PRC was practically non-existent. Historically, the dominant Confucian ideology had an anti-commercial tradition and assigned low social status to merchants. More recently, in the nineteenth and twentieth centuries, the PRC was colonized and exploited by Western military invasion and forced trade. Consequently, the newly-founded PRC felt intense hostility toward the West and a strong desire to regain autonomy of its trade and commerce. Self-reliance via import substitution was a
resounding theme of the Maoist era. The key turning point in the PRC’s path to modernization occurred after the demise of Mao Zedong and the disastrous Cultural Revolution. In 1978, in an effort to commence a much-needed economic reform, the new CCP leadership under Deng Xiaoping instituted the groundbreaking Open-Door Policy. The new policy advocated the use of “market mechanisms and foreign resources” to spur economic growth. It also marked the first time that the PRC welcomed non-PRC investments into the country. On the
whole, the new leadership welcomed FDI because it attracted the capital and technical expertise necessary for accelerated economic growth. FDI-friendly policies have ranged from preferential tax treatment of overseas investments to special trade zones for economic experimentation. In the 1990s, economic reforms accelerated as the “conventional state planning system” transitioned into “a more market-oriented macro-economic regulation and control” regime. This transition continued into the new millennium with the PRC’s joining the World Trade Organization in 2001.

While the new CCP leaders in the post-Mao era developed substantial and enduring policy changes for economic reform, they did not summarily reverse broad objectives from the previous era. Despite progressive policy changes, protectionism encourage the transfer of advanced technology from abroad and the investment of foreign capital in the PRC.


27. Shen Wei, Dark Past, Grey Present or Bright Future?—Foreign Investors’ Access to China’s Telecommunications Industry and a Political Economy Analysis of Recent Industrial Policy Moves, J. WORLD INV. & TRADE 513, 514–15 (2012) (“The entire 1990s witnessed differential liberalization dominance as well as a departure from the conventional state planning system of the old days to a more market-oriented macro-economic regulation and control.”); see ZHANG ET AL., supra note 17, at 3 (“In 1990s, China has absorbed about half of the FDI inflows into all developing countries.”).

28. See Shen, supra note 27, at 519 (arguing that the PRC’s joining the WTO ushered further liberalization and modernization of its economy); ZHANG ET AL., supra note 17, at 9 (timeline of key developments from 1978 to 2001).

has persisted partly in the form of regulatory restrictions of non-PRC investments in a variety of industries. The disparate treatment of PRC and non-PRC investments has been a longstanding policy of the CCP and is expected to persist in the foreseeable future. Further, some believe that the CCP may be contemplating a return to a more protectionist regime—fueled by growing nationalist pride and a push to keep homegrown companies under the PRC’s control.

Since its promulgation in 1995, the Catalogue for the Guidance of Foreign Investment Industries (the “Catalogue”) has served as the centerpiece of the CCP’s FDI policy. The current version of the Catalogue expressly assigns over four

(observating the deceleration in FDI inflow in the late 1990s and the sentiment among overseas investors of discouragement and determent by the perceived unfavorable FDI environment).


31. See Hui Huang, The Regulation of Foreign Investment in Post-WTO China: a Political Economy Analysis, 23 COLUM. J. ASIAN L. 185, 185 (2009) (suggesting that the dual system of the general company law and the specific laws for foreign investment enterprises is likely to persist in the foreseeable future); DANIEL M. PRICE & MICHAEL J. SMART, PAULSON INSTITUTE, BIT BY BIT—A PATH TO STRENGTHEN US-CHINA ECONOMIC RELATIONS (July 2013), http://www.paulsoninstitute.org/media/102532/bit_by_bit_pricesmart_english_final.pdf (illustrating the incompatibility between the US requirement of providing equal market access to domestic and non-domestic capital and China’s FDI restrictions in the context of the ongoing US-China bilateral investment treaty negotiation).


hundred industry sectors into three categories, designating non-PRC investments as either “encouraged,” “restricted,” or “prohibited,” respectively.\textsuperscript{34} Non-PRC investments in sectors not specifically listed in the Catalogue are considered “permitted.”\textsuperscript{35} Those investments placed in a “restricted” category require government approval, which usually involves a complex and opaque process.\textsuperscript{36} Finally, those in the “prohibited” category are technically forbidden under PRC law.\textsuperscript{37} Notably, the Internet and value-added telecommunications services sectors, where the VIE structure is prevalently used, are categorized as “prohibited,” disallowing non-PRC ownership.\textsuperscript{38}

\begin{footnotesize}
\begin{enumerate}
\item See Jane Bu et al., supra note 34, at 1 (“Projects that are not specified in the Catalogue fall under the ‘permitted’ category by default.”); J. Gray Sasser, China Risk Factor Hiding in Plain View: A Brief Analysis of Variable Interest Entities (VIEs) Under Chinese Law, TENN. CORP. NEWSL. (Nov. 2012), available at http://www.frostbrowntodd.com/resources-1527.html (“Investments in industries not specifically listed in the Catalogue is considered ‘permitted’ . . ..”).
\item See Bath, supra note 15, at 11 (“Despite the substantial amount of material issued by the government in the form of regulations, policies and guidelines, the approval process is still to a large extent non-transparent.”); China Revises Foreign Investment Guidance Catalogue, CONG.-EXEC. COMM’N ON CHINA (Apr. 10, 2012), http://www.cecc.gov/publications/commission-analysis/china-revises-foreign-investment-guidance-catalogue (calling the approval process discretionary and non-transparent, and providing the PRC government the opportunity to “retaliate against foreign investors which have raised the ire of authorities”).
\end{enumerate}
\end{footnotesize}
B. From China-China-Foreign to Variable Interest Entity: The Rise of Variable Interest Entity as the New Workaround

As the Chinese saying goes, “The law is strong, but the outlaws are ten times stronger.” 39 In 1994, China United Network Communications Group Co., Ltd. (“China Unicom”), a state-owned telecommunications operator, invented and utilized what is referred to as the China-China-Foreign (“CCF”) structure to circumvent FDI prohibitions in the sector.40 CCF allowed non-PRC investors to gain equity-like benefits via a joint venture arrangement without outright violation of the PRC’s investment prohibition.41 Within three years, China Unicom raised at least US$1.4 billion, or seventy-two percent of its total funding, through the CCF structure. 42

Unexpectedly, in October 1998, the PRC government issued a report declaring the CCF structure “irregular” and

39. 道高一尺，魔高一丈; see also Wu Zhong, Dark Days for China’s Whistleblowers, ASIA TIMES (Mar. 26, 2009), http://www.atimes.com/atimes/China/KC26Ad01.html (referencing the proverb).

40. See CADWALADER, Understanding the VIE Structure, supra note 6, at 3 (“China Unicom attempted to use the China-China-Foreign structure . . . in 1994 to directly circumvent the Ministry of Information Industry’s . . . prohibition of FDI in the telecom services sector.”); China Legal Developments Bulletin, BAKER & MCKENZIE 9 (Jul.-Sept. 2009), http://www.bakermckenzie.com/files/Uploads/Documents/Supporting%20Your%20Business/Recommended%20Reading/nl_china_legaldevelopmentsbulletin_julsep09.pdf (explaining that the structure is called China-China-Foreign, because it typically involves a Chinese operating company, a Chinese company with the appropriate license, either a wholly owned foreign subsidiary or a joint venture between a Chinese and a foreign company, and a foreign parent company. The foreign company or subsidiary supplies the capital and technology required by the local company); Shen, supra note 27, at 517 (“In the 1990s, foreign investors made great efforts to sneak around the law restricting the involvement of foreign investment in the telecoms industry. . . . China Unicom was the first Chinese entity that used the CCF structure.”).


42. IGI CONSULTING INC., supra note 41, at 57; see Shen, supra note 27, at 517 (“From 1995 to 1999, China Unicom executed around 46 cooperative projects in the form of CCF structure, including projects with French Telecom and Japan’s NTT, and involved planned investments totaling US$1.5 billion and actual investments of US$1 billion.”).
called for its ban.\footnote{43} A dramatic disintegration of the structure ensued.\footnote{44} Although CCF had been utilized by a few dozen telecom businesses for several years without official intervention, the report made clear that the CCF was nevertheless unacceptable under the PRC law.\footnote{45} Many non-PRC investors who had previously interpreted the CCP’s administrative silence as its tacit approval of the investment structure were surprised by this sudden move.\footnote{46} As a result, some of the CCF investors incurred considerable losses on their investment pursuant to the prohibition of the structure.\footnote{47}

For many PRC companies and non-PRC investors, however, the CCF experience did not stop them from looking for other regulatory loopholes and engineering new ways to circumvent...
FDI restrictions. Soon after the CCF structure was invalidated, the Sina Corporation, a major Chinese Internet company, pioneered the VIE structure with its initial public offering (“IPO”) on the NASDAQ. In contrast with CCF’s equity-based joint venture arrangement, the VIE structure simulates the effects of ownership exclusively by contracts, without acquiring an actual equity interest in the PRC business.

The VIE structure, in its most basic format, involves three entities: a US exchange-listed entity domiciled in an offshore financial center, typically the Cayman Islands (“ListCo”), a Wholly Foreign-Owned Entity domiciled in PRC (“WFOE”), and a company with operating business domiciled in the PRC (“OpCo”). US investors purchase equity in the ListCo, which owns one hundred percent of the WFOE. To establish a connection between the ListCo and the OpCo, the WFOE typically executes five essential contracts with the OpCo and its PRC owners. These contracts include: (1) a loan agreement,
which capitalizes the OpCo by channeling the ListCo’s funds through the WFOE; (2) an equity pledge agreement, where the PRC owners of the OpCo pledge their equity to the WFOE as a guarantee of their performance; (3) an options agreement, which allows the WFOE to purchase the PRC owners’ equity in the OpCo at the lowest permissible price under the PRC law; (4) a proxy agreement, in which the OpCo’s owners delegate their shareholder rights to the WFOE’s designee; and (5) a consulting or technical service agreement, which appropriates all of the OpCo’s profits to the WFOE. This web of contracts comprises the VIE structure and allows the ListCo to consolidate the income and assets of the PRC-domiciled OpCo in its financial statements under the Generally Accepted Accounting Principles of the United States (“US GAAP”).

The internet industry was the first to adopt the VIE structure, with other industries quickly following suit. Today, there are more than one hundred PRC-domiciled businesses listed and traded in the United States through the use of VIE structures, including most of the crown jewels of the PRC’s Internet industry, such as Sina, Baidu, Sohu, and Tudou. Like...
its CCF predecessor, VIE has grown more common over the years, presumably as lawyers, bankers, and investors have become increasingly comfortable with the assumption that PRC regulators have tacitly approved VIEs by virtue of their continued non-action.58

Several factors contribute to the popularity of the VIE structure.59 From the PRC companies' perspective, the structure enables them to access the funding that may otherwise be difficult or impossible to obtain in domestic capital markets.60 The structure also proffers a shortcut to overseas investment by eliminating the need to obtain central government approval of cross-border acquisition of Chinese assets and equity.61 Another consideration is the reputational boost a PRC company receives from the prestige of being listed on a US exchange.62 From the

supra note 38, at 1 (noting that “virtually the entire Internet sector” was funded by foreign IPOs).

58. See, e.g., CADWALADER, Understanding the VIE Structure, supra note 6, at 3 (suggesting the widespread acceptance that the Sina/VIE model assumes the tacit approval of the PRC regulators); see also Neil Gough, In China, Concern About a Chill on Foreign Investments, N.Y. TIMES (Jun. 2, 2013, 2:15 PM), http://dealbook.nytimes.com/2013/06/02/in-china-concern-of-a-chill-on-foreign-investments/?_php=true&_type=blogs&_r=0 (musing that the general presumption of tacit approval may be based on the justification that “such investment could help build corporate champions and create jobs”).

59. See, e.g., Barboza, supra note 10, at 2 (“Private companies often chose this route because they had difficulty raising capital in China, where state-run banks tend to favor government-owned companies.”); Clare Baldwin, IPO VIEW-China Web IPO flow to US Threatened by Crackdown, REUTERS (Sept. 23, 2011, 5:08 PM), http://www.reuters.com/article/2011/09/23/markets-stocks-ipos-idUSS1E78M1VA20110923 (“The VIE structure, which has been effective in circumventing foreign investment rules, would not be that easy to replace. . . . So far, investors have been willing to pay rich valuations and put up with VIEs because they have been desperate to tap into Chinese Internet growth.”); supra note 58 and accompanying text (discussing the popular position taken by VIE underwriters and deal lawyers).

60. See Barboza, supra note 10; Csordas, supra note 27, at 382–83 (noting that companies sometimes resort to loansharking as an alternative financing method).

61. See Guanyu Waiguo Touzizhe Binggou Jingnei Qiyede Guiding (关于外国投资者并购境内企业的规定) [Provisions on Mergers & Acquisitions of Domestic Enterprises by Foreign Investors (also known as “Circular 10”)], (promulgated Aug. 8, 2006, effective Sept. 8, 2006) (China) (requiring approvals from MOFCOM and the China Securities Regulatory Commission of cross-border acquisitions of Chinese assets and equity, regardless of industry sector); Heightened Scrutiny to VIE Structures under the New M&A Rules, supra note 56 (“[The] VIE structure [has] been used by PRC nationals to engage in international financing for their businesses to circumvent Circular 10.”).

CCP’s perspective, the substantial economic benefit derived from the cross-border inflow of capital through VIEs incentivizes the CCP to leave this issue in a “legal gray area” for the time being. In the US capital markets, both institutional and retail investors are zealous about high-growth investment projects in the PRC. Absent a better alternative to invest in the PRC’s prohibited sectors, VIE has remained their investment structure of choice.

C. Recent Legislation, Regulation, and Treaty Negotiation by the People’s Republic of China Affecting Variable Interest Entities

In February 2011, the State Council, the PRC’s highest administrative organ, published the Circular by the General their visibility in the US and enhance their prestige at home.”); see also Matthias von Oppen & Joseph Marx, Limited to 300, 27 INT’L FIN. L. REV. 32, 32 (2008) (suggesting that overseas listings provide PRC businesses with domestic prestige).


64. See Shai Oster & Dune Lawrence, Baidu Forced to Add Warnings as Regulators Focus on China Stocks, BLOOMBERG (Dec. 15, 2013), http://www.bloomberg.com/news/2013-12-15/baidu-forced-to-add-warnings-as-regulators-focus-on-china-stocks.html (“‘On the one hand the structure is obviously risky, but on the other hand the best-performing stocks in the world this year have been the Chinese Internet stocks, all of which are VIEs. . . . So if you invest in them you take on more risk than you’d like, but if you don’t invest in them your returns will fall well short of your benchmark. Plus, investors are looking for ways to play the ‘rising Chinese consumer,’ and Internet stocks are really the only way to do it.’” (quoting Arthur Kroeker, Beijing-based managing director of GaveKal Dragonomics)); see also Matthew Mosk et al., US Officials: China Refuses to Help Stop Investment Scams, ABC NEWS (Jan. 9, 2013), http://abcnews.go.com/Blotter/us-investors-lose-billions-alleged-chinese-stock-schemes/story?id=18164787 (assessing that accounting frauds involving Chinese stocks have been fueled by “a burst of interest among US investors in putting money behind the Chinese industrial boom”).

65. See supra note 8 and accompanying text; Heightened Scrutiny to VIE Structures under the New M&A Rules, supra note 56 (noting that VIE has been an investment structure of choice for non-PRC investors to navigate the grey areas of PRC FDI law).
Office of the State Council regarding Institution of the Security Review System for Merger and Acquisition of Domestic Enterprises by Foreign Investors (the “Security Review Circular” or the “Circular”). The Security Review Circular specifically requires government review of those mergers and acquisitions affecting “key technologies” that are susceptible to the “actual control” of a non-PRC investor. Actual control exists when a non-PRC investor becomes either the controlling shareholder or the actual controller of a domestic enterprise through a corporate transaction. Specifically, the Circular emphasizes that a proposed transaction that transfers the actual control of a PRC enterprise’s operational or financial decision-making to a non-PRC investor, is subject to security review.


69. See New Review System for Foreign Investor M&A Deals with Domestic Enterprises, supra note 67; see also Zhang, supra note 68 (“Acquisition of actual control applies to . . . any other circumstance under which the actual control of a domestic enterprise’s operational decisions, financial, personnel, and/or technology is transferred to foreign investors.”).
In September 2011, the PRC’s Ministry of Commerce (“MOFCOM”), an executive agency of the State Council, promulgated Announcement No. 53 pursuant to the Security Review Circular (“M&A Rule”). Of particular relevance to VIE structures, Article 9 of the M&A Rule reads:

With regard to the merger and acquisition of domestic enterprises undertaken by foreign investors, the authorities should judge whether such transaction is subject to the security review based on the essential content and actual impact of the transaction. Foreign investors shall not avoid M&A security review through any means, including but not limited to commissioned shareholdings, trusts, multi-level investments, leases, loans, contractual control, and overseas transactions.

Arguably, to examine a VIE’s “actual impact” would reveal that the structure is contingent upon US investors’ obtaining “actual control” of the PRC business by engaging in “overseas transactions” and exercising “contractual control.” Thus, the M&A Rule may be understood as a clear indication by the CCP that the VIE structure is designed to avoid the PRC’s regulatory scrutiny, and that VIE investors may bear adverse consequences.

70. See Zhang, supra note 68; Shen, supra note 27, at 533–34 (discussing the M&A Rules and calling it “the most influential piece of legislation which had an immediate and widespread effect on the VIE structure”).


72. See Gough, supra note 58 (“While variable interest entities in such cases are technically owned by the Chinese, foreign-owned corporations maintain de facto control through a series of contracts that can involve equity pledges, profit assignments, purchase options and service or consulting agreements.”); see also Russell Flannery, Is It The Twilight Of An Era For Chinese Listings In The US?, FORBES (Oct. 12, 2012, 11:04 AM), http://www.forbes.com/sites/russellflannery/2012/10/12/is-it-the-twilight-of-an-era-for-chinese-listings-in-the-us (“[T]he VIE structure, or variable interest entity, allows foreign investors to achieve de facto control of a Chinese operating business without direct equity ownership . . . accomplished by a web of contracts.”).
for engaging in plainly prohibited investment activities. 73 Accordingly, many experts question how much longer VIE structures can survive under these new regulations, a critical part of which appear to target this particular investment structure.74 The manipulability of the Rules’ loose language, the centralization of the review and approval process, and the lack of clarity as to the ultimate decision-making authority create additional uncertainties to the already precarious legal status of VIE structures. 75 Nevertheless, some experts remain unconvinced that the M&A Rules resolve the ambiguity definitively.76

One other recent development that could shape the future of VIEs is the resumed negotiation of a bilateral investment


74. See, e.g., Dickinson, supra note 38 (“It is now clear that the contractual arrangements on which the various VIEs are based are in clear violation of Chinese law. This renders the contracts unenforceable and makes existing VIE structures essentially meaningless.”); see also Kathrin Hille, Foreign Internet Presence in China to Face Scrutiny, FIN. TIMES (Sept. 1, 2011, 5:23 PM), http://www.ft.com/intl/cms/s/2/7f8645e2-d495-11e0-a42b-00144feab49a.html#axzz1Wb8B6ceg (“[T]he new rules no longer allowed the past assumption of Beijing’s ‘tacit approval’ of such vehicles.”).

75. See, e.g., Hille, supra note 74 (noting that the vague wording of the rules could give regulators greater discretionary powers); Bath, supra note 15 (“The addition of the security review process, which has the potential to reverse the process whereby the ability to approve projects has been consistently delegated to the lower levels of government, is a particularly unconstructive addition to the regulatory process, as it adds time, complexity, and lack of transparency.”); Shaw et al., supra note 57 (citing an unnamed MOFCOM source cautioning that “the lack of consensus on VIE partly reflects ongoing power struggles among various regulatory agencies, which all seek to expand regulatory authority”).

76. See New PRC Rules Establish National Security Review For M&A Transactions Involving Non-Chinese Investors, KAUFMAN & CANOLES, http://www.kaufmanandcanoles.com/news/articles/new_prc_rules_establish_national_security_review_for_m%26a_transactions_involving_non-chinese_investors.htm (last visited Feb. 26, 2014) (contending that the language of the M&A Rule is too ambiguous for one to determine whether the VIE falls within its regulatory scope); Dickinson, supra note 38 (“Many foreign investors contend that existing VIE structures are sound and that VIE arrangements can safely be used in the future.”).
treaty between the United States and the PRC.  This is a promising sign, indicating that the PRC might soon open more sectors to equity investments from the United States.  A successfully negotiated treaty could entirely eliminate the need for the VIE structure and its associated investment uncertainties. Having said that, it is too early to tell whether and when such a treaty will come to fruition. Moreover, even if the two governments eventually reach an agreement, any opening of the restricted sectors will likely occur gradually over time.

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78. See Bourassa, supra note 77 (“This [negotiation] marks an important step in opening China’s economy to U.S. investment by eliminating market barriers, and leveling the playing field for American workers and businesses.”); He Wei, US-China Trade Talks a “Turning Point” in Relations, CHINA DAILY (Oct. 24, 2013), http://usa.chinadaily.com.cn/business/2013-10/24/content_17054413.htm (suggesting that the BIT talk may be the most important trade negotiation since the WTO talks).

79. See Bourassa, supra note 77 (noting that the current negotiation effort “represents the first time that China has agreed to negotiate a BIT that includes all stages of investment and sectors”); Ian Talley & William Mauldin, U.S., China to Pursue Investment Treaty, WALL ST. J. (July 11, 2013, 8:06 PM), http://online.wsj.com/news/articles/SB10001424127887324425204578599913527965812 (suggesting that a deal “could open up more than 100 Chinese industries to investment by US businesses”).

80. See, e.g., Berger, supra note 19, at 21 (arguing that the prospects of a Sino-United States BIT are “rather bleak,” partly because it is doubtful that China would agree to the US demand of market access, and partly because of the growing protectionism pressure in the US); Simon Denyer, Amid Attacks by Chinese Government and Media, Foreign Companies Get Mixed Signals, WASH. POST, Aug. 9, 2013, http://www.washingtonpost.com/world/asia_pacific/amid-attacks-by-chinese-government-and-media-foreign-companies-receive-mixed-signals/2013/08/09/b02eea48-00d6-11e3-8294-0e5b840d_story.html (expecting the negotiations to be “long and tortuous”).

All publicly-held companies in the United States, including VIEs, are subject to the regulation of the SEC. The SEC was created in wake of the Great Depression by the Securities Exchange Act of 1934. Its core mission is “to protect investors,” “maintain fair, orderly, and efficient markets,” and “facilitate capital formation.” One of the SEC’s primary responsibilities is to oversee and improve the quality of corporate disclosure to help the investing public make informed investment decisions.

Public companies are required to disclose all material information in periodic filings with the SEC, and may be subject to securities liabilities for material misrepresentation or omission. Information is considered material if there is “a

Shanghai Pilot Free Trade Zone is expected to be rolled out at a slow and conservative pace).


85. See Frank H. Easterbrook & Daniel R. Fischel, Mandatory Disclosure and the Protection of Investors, 70 VA. L. REV. 669 (1984) (identifying the disclosure requirement as one of the two basic component of the US securities law); see also The Investor’s Advocate, supra note 82, at 1 (explaining that the SEC “requires public companies to disclose meaningful financial and other information to the public” in order to make sure that “all investors, whether large institutions or private individuals, should have access to certain basic facts about an investment prior to buying it, and so long as they hold it”).

86. See 17 C.F.R. § 240.10b–5 (2014) (“It shall be unlawful for any person . . . (b) to make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading . . . .”); Steven M. Davidoff, In Corporate
substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.”87 The materiality of VIE risks seem undisputed, as they are typically disclosed as “risk factors” in the filings.88 It seems, however, that investor awareness of the substantial VIE risks may still be inadequate as a result of this disclosure practice.89

II. ASSESSMENT OF INVESTMENT RISKS

While the VIE structure has been used to evade the PRC’s FDI restrictions for over a decade, it remains “a matter of dubious legality, enforceability and sustainability.”90 Observers


87. See Basic Inc. v. Levinson, 485 U.S. 224, 225 (1988) (expressly adopting the standard of materiality articulated in TSC Industries v. Northway, 426 U.S. 438, 449 (1976)); cf. Davidoff, supra note 86 (characterizing the materiality standard is subjective, which “allows lawyers and others to argue that something is not material because they didn’t think it was certain or important enough to affect the stock price of the company significantly”).

88. See Dickinson, supra note 38 (recognizing that companies clearly describe in their filings details about the VIE structure of their business, such that as a practical matter, it may be difficult to claim that such risks are not disclosed); Paul Gillis, VIE Disclosures are Pathetic, CHINA ACCT. BLOG (Jan. 14, 2012), http://www.chinaaccountingblog.com/weblog/vie-disclosures-are-patheti.html (observing that the current state of VIE risk disclosure does not rise to the standard set by the rules adopted by the Financial Accounting Standard Boards in 2009).

89. See Steve Denning, Big Banks and Derivatives: Why Another Financial Crisis is Inevitable, FORBES (Jan. 8, 2013), http://www.forbes.com/sites/stevedenning/2013/01/08/five-years-after-the-financial-meltdown-the-water-is-still-full-of-big-sharks (“Ever heard of ‘variable interest entities’ aka VIEs? If not, you are not alone.”); Thomas B. Hatch et al., China’s Forbidden Investment: Emerging Legal Risks for Investors Who Deal with Chinese Variable Interest Entity (VIE) Structures, ROBINS, KAPLAN, MILLER & CRESI LLP (Mar. 1, 2012), http://www.rkmc.com/resources/articles/china-s-forbidden-investment (describing the claim in the Orient Paper lawsuit that while the VIE contractual arrangement is disclosed in the Form 10-K filing, the disclosure was so buried that it did not adequately inform the shareholders).

90. Shen, supra note 30, at 570 (“[T]he recent Alipay case reaffirmed that the VIE structure, having an ad hoc character, is a matter of dubious legality, enforceability and sustainability.”); see Ashley Lee, Paul Gillis: VIEs No Longer Viable, INT’L FIN. L. REV. (July 18, 2013), http://www.iflr.com/Article/3292709/Paul-Gillis-VIEs-no-longer-viable.html (discussing the VIE’s increasingly uncertain viability).
have called it “the single biggest ‘time bomb’” and “one of the greatest investment frauds ever perpetrated” in the US market.91

This Part examines the two types of legal risks inherent in the VIE structure and the limited legal recourse available to investors. Part II.A assesses the possibility that the structure be declared illegal or that the underlying contracts be declared unenforceable. Part II.B explores the limited legal recourse available under current law for US investors who lose control over the PRC-domiciled OpCo in a VIE scheme.

A. Uncertain Legal Status

There are essentially two inherent risks in a VIE investment.92 While the VIE arrangement may eventually be declared legal, valid, and enforceable by the PRC government, the presumed validity of this structure could also prove misguided and VIE investments could become worthless.93 Part I.A.1 considers the possibility that the CCP summarily declares the VIE structure illegal.94 Part I.A.2 examines the scenario where the underlying contracts creating the VIE structure are found invalid and unenforceable by the PRC courts.95


93. See Davidoff, supra note 92 (describing two ways VIE structure may collapse).

94. See Davidoff, supra note 92 (“The problem with [VIE] is that it may be illegal under Chinese law and has been criticized by Chinese regulators.”). But see Schindelheim, supra note 4, at 196 (noting that the PRC government has tolerated the VIE structure since birth and not declared it illegal).

95. See Davidoff, supra note 92 (“Even if it is legal, if the Chinese owners decide to go rogue, the United States-listed entity must sue and obtain a judgment from a Chinese court to enforce these dubious contracts. Good luck with that. Such a litigation can take a long time to resolve, if ever.”); Schindelheim, supra note 4, at 220 (“[A]s the
1. Legality of the Structure

Some commentators argue that various political calculations, including pressure from the international capital markets, make it unlikely that the VIE structure would be summarily invalidated.96 Indeed, the PRC government appears to have been hesitant to make a definitive statement on the legality of VIEs, as the Chinese economy continues to benefit from keeping the VIE window open.97 Notwithstanding the lack of clarity on the issue, recent PRC administrative actions on both the local and national levels support the contention that a general nullification of the VIE vehicle is increasingly likely.98

At the local government level, certain provincial authorities have banned the formation of new VIEs.99 In March 2011, Hebei

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97. See Daniel Goodman, Is China Really About To Clamp Down On The Corporate Structure Used For Big American IPOs?, BUS. INSIDER (Sept. 21, 2011), http://www.businessinsider.com/will-china-really-clamp-down-on-vies-2011-9 (“Until recently, the government has largely ignored the use of VIEs because it was either not aware, didn’t care, or found the activity useful at the time.”); Schindelheim, supra note 4, at 197 (“[I]t is likely that the continued uncertainty is a deliberate policy of the Chinese government to selectively facilitate foreign investment in particular industries while limiting foreign equity ownership.”).

98. See, e.g., Tom Shoesmith, The Future of VIEs in China, PILLSBURY WINTHROP SHAW PITTMAN, https://www.pillsburylaw.com/siteFiles/Publications/2012VIEsandtheFutureofInternetRelatedInvestmentinChinav5.pdf (noting that the internet and value-added telecom sectors are closed to foreign investment); Robert Lewis, China Watch: A Foreign Lawyer’s View from the Inside, LAWYER (Oct. 19, 2011), http://www.thelawyer.com/china-watch-a-foreign-lawyers-view-from-the-inside/1009862.article (“The elephant in the room is that the relevant regulators could step back, look at the structure in the entirety, collapse it down to its essentials and declare it to be in violation of the applicable foreign investment restrictions and close it down.”).

99. See CADWALADER, Understanding the VIE Structure, supra note 6, at 9 (noting that Buddha Steel’s withdrawal from its US IPO after certain statements were made by the local authorities has raised concerns among investors); Buddha Steel Inc., Report,
provincial authorities banned Buddha Steel from forming a VIE with a local steel plant, stating that the structure “contravene[d] current Chinese management policies related to foreign-invested enterprises” and was “against public policy.” The announcement prompted Buddha Steel to withdraw from its IPO process on the NASDAQ. Practitioners generally view the incident as limited to this locality, and not necessarily reflective of a definitive trend in national policy. Yet, other observers have suggested that the CCP could take a case-by-case approach and effectuate systemic changes in a piecemeal fashion. In any event, the restrictions on VIE structures imposed by the Hebei province demonstrate the fundamental vulnerability of VIE under the PRC’s regulatory scrutiny.

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101. See supra note 100 and accompanying text (describing Buddha Steel’s withdrawal from IPO after decree by Hebei provincial authority).

102. See, e.g., Shoesmith, supra note 100, at 1 (considering the Buddha Steel incident as “most likely, a ‘one-off’ event driven by local facts and circumstances”); CADWALADER, *Understanding the VIE Structure*, supra note 6, at 9 (“We are inclined to view Buddha Steel’s IPO withdrawal as a case of a local government using China’s legal grey areas surrounding the VIE Structure to further its own self interest.”).

103. See JIANFU CHEN, *CHINESE LAW: TOWARDS AN UNDERSTANDING OF CHINESE LAW, ITS NATURE AND DEVELOPMENT* 43 (1999) (discussing the PRC’s piecemeal approach to lawmaking in order to cater to the fast-changing realities in the context of Deng’s economic reform); Dan Harris, *Buying into a China VIE. What Me Worry?*, CHINA L. BLOG (June 17, 2013), http://www.chinalawblog.com/2013/06/buying-into-a-china-vie-what-me-worry.html (citing that the Chinese government likes to “boil its frogs slowly, not all at once” and that VIEs are on the wrong side of where China wants to be going).

On the national level, the central CCP leadership has also addressed the use of VIE structures in a few instances. The actions by the central government, to the extent that they suggest directions of national policy, may be more alarming than those by provincial authorities. Notably, in a recent pronouncement, the MOFCOM expressly referenced and disapproved of the use of the VIE structure for the first time. In August 2012, the MOFCOM approved the acquisition of a majority stake of Yihaodian, a PRC online retail business, by Walmart, a US multinational retail corporation, with the express condition that Walmart must not engage in Yihaodian’s value-added services through the VIE ownership structure.

2. Validity of the Contracts

Aside from a possible categorical invalidation of the investment structure, US investors could lose their investments if
the contractual foundation of VIEs collapse under manipulation by non-government parties.109

The best-known example of investors’ loss of control over a PRC-domiciled OpCo resulting from its PRC owner’s disregard of VIE agreements is probably the Yahoo-Alibaba dispute in 2011.110 The dispute arose when the founder and then-CEO of the Alibaba Group, the PRC’s e-commerce giant, transferred Alipay, a valuable subsidiary in the online payment business, to a separate PRC company in his name.111 Meanwhile, Yahoo, the US company which held a forty-three percent “ownership” interest in Alibaba through a VIE arrangement, did not approve of the transfer.112 Alibaba argued that the transfer was necessary for Alipay to obtain a requisite payment business permit from the PRC’s Central Bank.113 It was necessary because the PRC law prohibited non-PRC ownership in the payment business, whether such ownership was direct or de facto through a VIE

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109. See supra notes 92–95 and accompanying text (stating the two ways a VIE structure may collapse).


111. See Barboza, supra note 10 (“Jack Ma, the chairman of the Chinese Internet giant Alibaba, surprised investors last May when he acknowledged that he had transferred the assets of the company’s online payment platform to a private company that he controlled.”); Heightened Scrutiny to VIE Structures under the New M&A Rules, supra note 56 (noting that the company receiving Alipay was a purely domestic partnership unrelated to the US-listed entity); Roberts & Hall, supra note 51 (calling Alipay “the crown jewel” of the Alibaba Group).

112. See Shaw et al., supra note 57 (noting that Yahoo’s interest in Alibaba was based on a VIE arrangement); Nabia Damouni & Jennifer Soba, Yahoo, Alibaba Reach Agreement on Alipay, CHINA DAILY (Jun. 2, 2011), http://usa.chinadaily.com.cn/epaper/2011-06/02/content_12629254.htm (describing Alibaba as “43-percent-owned” by Yahoo).

113. See Cadwalader, Understanding the VIE Structure, supra note 6, at 6 (“[Jack Ma] claimed that the spin-off was necessary because of the PBOC’s requirement to disclose the use of a VIE Structure when applying for a Payment Business Permit . . .”); cf. Loretta Chao & Amir Efrati, Yahoo’s China Feud Turns Ugly, Stock Falls, WALL. ST. J. (May 14, 2011, 12:01 AM), http://online.wsj.com/news/articles/SB10001424052748703739804576521630705428022 (“[Alibaba, Yahoo and Softbank] agree the Alipay transfer was done to expedite the company’s application for a necessary regulatory license.”).
structure. Alibaba also asserted that the transfer of Alipay was entirely legal, to which Yahoo did not object. The parties eventually reached a settlement without legal proceeding, on terms that left many Yahoo investors sorely disappointed.

The Yahoo-Alibaba dispute was only one of a series of recent heists that demonstrate the dependency of US investor interests on the managerial fiat or personal affairs of OpCo’s PRC owner-manager. In April 2012, ChinaCast Education Corporation announced that it was unable to resume normal business operations after its ousted chairman and Chief Executive Officer had taken hostage of the company’s corporate seals, business licenses, and accounting records. Its stock was

114. See CADWALADER, Understanding the VIE Structure, supra note 6, at 6 (“[T]he relevant government officials have alleged that they will not issue Payment Business Permits to online payment companies that have foreign ownership, whether directly through equity interests or indirectly through the use of the VIE Structure.”); Julianne Pepitone, Alibaba CEO: Yahoo Should Break Itself Up, CNN (June 1, 2011, 9:57 PM), http://money.cnn.com/2011/06/01/technology/alibaba_d9_yahoo (noting Ma’s frustration with “people who questioned his desire to follow the Chinese regulatory law”).

115. See Gary Epstein, Yahoo-Alibaba Spot Over Alipay: Jack Ma Needs to Say More, FORBES (May 16, 2011), http://www.forbes.com/sites/gadypstein/2011/05/16/yahoo-alibaba-spot-over-alipay-jack-ma-needs-to-say-more (stating that Alibaba’s CEO Ma had no legal obligation to Yahoo); Rusli, supra note 110 (recognizing that the dispute exposed the fact that “Yahoo’s fate in Asia is dictated by the whim of Mr. Ma”).

116. See Michael Liedtke, Yahoo Settles Alibaba Dispute, Stock Still Sinks, YAHOO FINANCE (July 29, 2011), http://finance.yahoo.com/news/Yahoo-settles-Alibaba-dispute-apf-4229132856.html (describing J.P. Morgan’s analyst note “Alipay agreement: better than nothing, but not that great” as summing up the market’s sentiment); Rusli, supra note 110 (noting that David Einhorn, an influential hedge fund manager, “dumped his entire stake in Yahoo, saying in a letter to investors that this ‘wasn’t what we signed up for’”).

117. See Davidoff, supra note 92 (citing examples of ChinaCast, Sino-Forest, GigaMedia in addition to Alibaba); Pilarowski, supra note 38 (citing examples of Shanghai T2 Entertainment, Buddha Steel in addition to Tudou).

suspended from trading on the same day and its market capitalization plummeted from US$200 million to US$5 million as a result of the executive’s misconduct and other related frauds. 119 The ChinaCast episode was reminiscent of the Gigamedia incident in 2010, in which the online gaming company listed on the NASDAQ failed to extract profits from the PRC-domiciled OpCo. 120 There, the ousted chief executive of the OpCo similarly breached the VIE contracts, stopped answering to the WFOE, and refused to give up possession of the OpCo’s corporate seals and other documents necessary for its operation. 121 Even personal affairs of the PRC OpCo’s owner-manager, such as soured marital relationship, could threaten US investments. 122 For example, the messy divorce of Tudou’s founder delayed and almost derailed its IPO, causing the company and its selling shareholders potential monetary loss in the tens of millions of dollars due to declined market condition. 123

119. See Paul Gillis, Another China Heist?, CHINA ACCT. BLOG (Apr. 2, 2012), http://www.chinaaccountingblog.com/weblog/another-chinese-heist.html?utm_source=feedburner&utm_medium=email&utm_campaign=Feed%3A+Chinaaccountingblog+%28China+Accounting+Blog%29 (observing that companies whose stock was suspended from trading like ChinaCast rarely come back from these kinds of problems); SEC Charges China-Based Executives with Fraud and Insider Trading, supra note 114 (noting that ChinaCast’s market capitalization dropped from US$200 million to US$5 million after the misconduct was publicly disclosed).

120. See Gillis, supra note 119 (“We have seen this movie before – Gigamedia.”); Davidoff, supra note 92 (arguing that such fraudulent behaviors are not isolated incidents).

121. See Lawrence, supra note 6 (“When GigaMedia tried to replace its China head last year, he refused to step down or turn over the VIE documents and assets necessary for GigaMedia to run its business in China . . . .”); CADWALADER, Understanding the VIE Structure, supra note 6, at 8 (stating the WFOE’s inability to pay dividends as a result); Davidoff, supra note 92 (“GigaMedia appears to have given up on getting the business back.”).

122. See Pilarowski, supra note 38 (identifying “the founder’s wife” as the newest China risk factor); Owen Fletcher, IPO Filing Exposes Tudou’s Ex-Wife Problem, WALL ST. J. (May 3, 2011, 8:15 PM), http://blogs.wsj.com/chinarealtime/2011/05/03/ipo-filing-exposes-tudou%E2%80%99s-ex-wife-problem (“In the latest tale from the wild west that is China’s Internet sector, a lawsuit between former lovers has complicated business for online video company Tudou Holdings as it aims to list shares in the U.S.”).

123. See Lawrence, supra note 6 (noting that Tudou’s IPO was delayed by a lawsuit in which the ex-wife of founder Gary Wei Wang claimed a share in 76 percent of the VIE’s equity); Pilarowski, supra note 38 (“Normally, a messy divorce for the founder wouldn’t derail an IPO, particularly when he holds only 12.7% of the company’s shares, as was the case for Tudou. But in the world of Chinese internet companies, with byzantine corporate structures designed to evade China’s foreign ownership
Those prior incidences demonstrate the potential consequences of misaligned interests between the PRC owners of the OpCo and US investors in the ListCo. Misalignment of interests can occur when the stock price of the ListCo is persistently depressed, or when the OpCo no longer feels the need for overseas financing or technology know-how.

Furthermore, it is likely that the situations in which OpCo’s PRC owner-manager breaches the VIE agreements, the PRC courts would rule in favor of the PRC individuals at the expense of US investors. In the high-profile Chinachem case in 2013, the PRC’s highest court, the Supreme People’s Court, invalidated VIE-like contracts on the ground that they inherently subverted the Contract Law of the PRC. According to Article 51 of the Contract Law of the PRC, a contract is invalid when restrictions, that is exactly what happened . . . If the company had completed its IPO in December 2010 and received the same revenue multiple as Youku, Tudou would have been valued at $1,026 million, which is over $200 million more than its actual IPO valuation.


125. See Lawrence, supra note 6 (counting low share valuations as one potential reason of misalignment of interests between the ListCo and the OpCo); Wong, supra note 1 (“Problems arise if the Chinese partners decide they don’t want to follow the contracts any longer because, for example, they already have the money and know-how they were seeking, as has happened in several instances.”).

126. See I-Ching Ng, The Dark Cloud Over the Variable Interest Entity, CORP. TREAS. (July 18, 2013), http://www.thecorporate treasurer.com/OpinionEntry/350505/the-dark-cloud-over-the-variable-interest-entity.aspx (“It is likely that Chinese courts will find the terms and conditions typically found in the VIE contracts to be excessively favorable towards foreign investors . . . ”); Leahy & Hirsch, supra note 63 (“In the event of a contract dispute with a PRC national over a VIE deal, investors should ask themselves how confident they can be that the PRC courts will uphold the validity of complex contracts in favor of foreign investors at the expense of PRC nationals?”).

127. See Gough, supra note 58 (“In what appears to be the first time that high-ranking Chinese authorities have weighed in on the issue of foreign control agreements, the court ruled that the contracts . . . were invalid . . . [as they] had clearly been intended to circumvent China’s restrictions on foreign investment, and amounted to ‘concealing illegal intentions with a lawful form.’”); Ng, supra note 126 (“After the decade-long legal battle . . . lawyers quickly sensed China’s supreme court decision to nullify Chinachem’s entrustment contracts has cast a dark cloud over the future of [VIE] structures.”).
“there is an attempt to conceal illegal goals under the disguise of legitimate forms.” 128 This ruling is generally considered a rejection by the PRC's highest judicial authority of the assumption that PRC officials had tacitly approved the popular VIE structure. 129

In sum, given the current legal landscape, investing in VIEs is precarious. 130 The VIE structure stands on a precarious footing in terms of its legality at both the local and national levels of the PRC government. 131 At the same time, the PRC courts are unlikely to uphold the validity of VIE contracts because contracts that effectively circumvent PRC law are unlawful under the PRC contract law. 132 As a result, the value of any VIE investment is ultimately contingent on the integrity and goodwill of the PRC partners and, to a limited extent, external restraints such as reputational concerns. 133


129. See Gough, supra note 59 (“This case shows that contracts used to get around China’s foreign investment restrictions can be struck down by the courts ... Until then, many observers had come to regard the general absence of an official response as a sign of tacit approval.”); Vincent Mu, Thinking Long Term, CHINA L. & PRAC. (Nov./Dec. 2013), http://www.chinalawandpractice.com/Article/3262360/Thinking-long-term.html (suggesting that the ruling signifies “negative attitude of the Supreme People’s Courts towards VIEs ... and should make investors very wary”). But see Charles Comey et al., China VIEs: Recent Developments and Observations, MORRISON & FOERSTER, (Aug. 15, 2013), http://www.mofo.com/files/Uploads/Images/130716-Variable-Interest-Entities-China.pdf (distinguishing the ruling as one that involved entrustment arrangement rather than the typical VIE, therefore any prediction of its implication for VIEs is premature).

130. See supra Part II.A.1–2 (examining the two ways that VIE structures may collapse).

131. See supra Part II.A.1 (noting that the PRC government may outlaw the VIE structure summarily).

132. See supra Part II.A.2 (indicating that VIE contracts may turn out to be unenforceable when breached).

133. See Wong, supra note 1 (arguing that every VIE operates by the grace of its Chinese partner); Don’t Bank on It, WEEK IN CHINA (Jun. 14, 2015), http://www.weekinchina.com/msingle/?mpage=17880 (quoting the Economic Observer which said that most VIE structures are only morally binding and offer investors little legal protection).
B. Investor Rights: Vindication and Enforcement

VIE investors have very limited legal recourse if disputes materialize over their control of the OpCo. However, there are three potential forums where US investors may seek to enforce their “ownership” rights: (1) the PRC jurisdiction where the OpCo and the WFOE are domiciled and presumably under whose law the VIE contracts are governed; (2) the US jurisdiction where the ListCo shares are publically listed and traded; and (3) the intermediary jurisdiction where the ListCo is domiciled. In practice, though, the PRC may be the only jurisdiction for a US investor to sue the OpCo or its owner-manager. It seems that choice of law provisions are inconsequential in VIE agreements, and that these contracts are always governed by PRC law. Finally, even if the contracts stipulate to a non-PRC forum, the choice may provide no better recourse to US investors because judgments by the many non-PRC jurisdictions, including the United States, are not

134. See Dan Harris, Everything You Always Wanted to Know about China VIEs. The Transcript, CHINA LAW BLOG (Nov. 23, 2011), http://www.chinalawblog.com/2011/11/everything_you_always_wanted_to_know_about_china_vies_the_transcript.html (“[E]veryone seemed to agree that Chinese courts will not enforce the contracts on which VIE structures are based.”); Hatch, supra note 89 (“[S]ince most U.S.-listed Chinese companies have little or no assets in the United States, the scope of recovery afforded by lawsuits against these companies is generally limited to these companies’ directors and officers insurance policies.”).

135. See supra note 51 and accompanying text (showing that a typical US-listed PRC-domiciled VIE touches three types of jurisdictions: the PRC, the United States, and the intermediary offshore financial center jurisdiction or jurisdictions).

136. See Hatch, supra note 89 (noting that the scope of recovery in a successful VIE lawsuit in US courts is generally limited to the company’s D&O insurance); Zhang Shouzhi et al., Forum Shopping for Dispute Resolution: Hurdles and Solutions, KING & WOOD MALLESONS (Jan. 2010), http://www.kingandwood.com/article.aspx?id=Forum-Shopping-for-Dispute-Resolution-Hurdles-and-Solutions&language=en (noting that “[m]ost countries with closest economic ties with China, such as US, Great Britain, Canada, Japan and BVI, have not concluded civil and commercial legal assistance treaties with China” that are required for the enforcement of judgment rendered by a non-PRC forum state).

137. See Davidoff, supra note 92 (noting that in the event that VIE contracts are disputed, the US-listed entity must sue and obtain a favorable judgment from a PRC court to enforce them); Hatch, supra note 89 (observing that VIE investors suing in US courts generally seek recovery by alleging false and misleading statements rather than by enforcing the VIE contracts).
enforceable in the PRC. This is certainly true when such judgment contravenes the PRC law or public policy.

Based on the foregoing, it is problematic for US investors to seek enforcement of their contractual rights under a VIE arrangement by way of lawsuit in the PRC. First, if the CCP declares the VIE structure per se illegal, then the contracts that make up the structure would be void. Second, absent a categorical pronouncement by the CCP, US investors may find it practically impossible to convince the PRC courts that the VIE contracts, which are designed to conceal the illegal intention of circumventing the PRC’s FDI prohibitions, should be enforced. Third, the PRC courts are known for their lack of judicial independence. As the PRC central authority continues


139. See Sun Jin & Xue Junge, *The Recognition and Enforcement of Foreign-related Judgment in China*, ZHEJIANG XINMU L. FIRM (June 23, 2013), http://www.xinmulawyer.com/els.asp?id=20 (“According to the provisions of article 267 and 268 in Civil Procedure Law, if foreign court’s judgment want to be recognized and enforced by China’s court, the judgment should satisfy the following conditions: The judgment or written order should be legally effective . . . the judgment doesn’t contradict the basic principle of the law of People’s Republic of China, nor violate State sovereignty, security and social and public interest of the country.”); Lily Chan, *Enforcing U.S. Court Judgments in China*, AM. BAR ASSOC., http://apps.americanbar.org/intlaw/committees/regional_comparative/china/EnforcingUSJudgementsPRC.pdf (last visited on Feb. 26, 2014) (explaining that a non-PRC judgment is not recognized if the PRC court determines that it violates fundamental principles of PRC law, and that PRC courts have wide discretion in evaluating whether to enforce foreign judgments).

140. See supra Part II.A.1–2 (examining the two ways that VIE structures may collapse).

141. See supra Part II.A.1 (suggesting that the PRC government may declare the structure illegal).

142. See Aubin, supra note 13 (“To the extent a VIE contract structure is designed to circumvent the requirements of Chinese law, such contracts are void...not voidable, void. It is as if they did not exist.”); Leahy & Hirsch, supra note 63 (“Should Chinese VIE-owners breach contractual agreements, it is unclear whether Chinese courts would enforce foreign investors’ rights”).

143. See Benedict Sheehy, *Fundamentally Conflicting Views of the Rule of Law in China and the West & Implications for Commercial Disputes*, 26 NW. J. INT’L L. & BUS. 2 (2006), (noting that law is but a tool of the Chinese Communist Party, which alone is the “basis of power and influence as well as the basis of all law”); Megha Rajagopalan & Ben
to tighten control around VIEs by legislative and administrative acts, the likelihood of a judicial ruling that safeguards the VIE structure has substantially declined. As a result, lawyers have almost never sought to enforce VIE contracts in a PRC court.

Instead of bringing a lawsuit, US investors might pursue alternative dispute resolution methods, such as arbitration. Nevertheless, arbitration in the PRC may be unlikely to yield favorable results for non-PRC investors, for the same reasons lawsuits in PRC are expected to fail.

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144. See supra notes 127–129 and accompanying text (explaining the recent judicial ruling that the VIE-like structures contravene public policy and are illegal); supra note 143 (describing the PRC courts’ lack of independence from political influences).

145. See Leahy & Hirsch, supra note 63 (“The common theme to all of these disputes is that none of them was resolved in a conventional litigation strategy, but rather each was negotiated commercially.”); Shen, supra note 30, at 570 (“To date, the VIE structure has never been tested in a PRC court and there is therefore no certainty that the legality of such structure will be recognised or that such a structure will not encounter regulatory scrutiny (or even a crackdown) at a later stage.”); Aubin, supra note 13 (“Lawyers said they do not expect a rash of legal challenges to VIEs. But on the rare occasions when VIEs are challenged, U.S. investors nearly always lose . . . I’ve yet to see a situation where shareholders have gotten their hands on Chinese assets in an adversarial situation.”).


147. See Gough, supra note 58 (“Since 2010, Shanghai’s arbitration board has invalidated two variable interest entities that had been used by foreign companies to control onshore businesses. In one case involving an online game company, the panel applied China’s contract law to reach the same conclusion as the supreme court in the Chinachem case — saying that the variable-interest entities were ‘concealing illegal intentions with a lawful form.’”); Jiang Rongqing & Zhu Biyun, China: Recent Concerns on Foreign Investment in China and VIE, DACHENG L. OFFICES (July 15, 2013), available at
cases arbitrated in Shanghai, the VIE agreements were ruled as void on the ground that they impermissibly circumvented existing PRC law by effectively enabling overseas investments into PRC businesses via contractual means.148 Alternatively, investors may seek arbitration in a non-PRC arbitration tribunal if the VIE agreements have provided so.149 In that case, they run the risk of relief not being enforced if the PRC courts deem the arbitral award a violation of existing law or public policy.150

In sum, if VIE fails, by means of either PRC government decree, managerial rift, or other operational or governance decision, it is exceedingly difficult for US investors to use judicial means to recover their investment losses.151 Accordingly,

148. See supra note 147 and accompanying text (summarizing the rulings of the two arbitration cases).

149. See Thorp & Sun, supra note 138, at 1 (“Although the PRC court system continues to improve, foreign companies dealing with China-related matters often prefer to use arbitration due to their lack of familiarity with the PRC courts and the easier cross-border enforceability of arbitral awards as compared to court judgments.”);


150. See U.N. Convention on the Recognition and Enforcement of Foreign Arbitral Awards, art. V.1, June 10, 1958, 21 U.S.T. 2517, 330 U.N.T.S. 38 [hereinafter New York Convention] (“Recognition and enforcement of the award may be refused . . . [if] said agreement is not valid under the law to which the parties have subjected it . . . .”); Henry L. T. Chen & B. Ted Howes, “Public Policy” and the Enforcement of Foreign Arbitration Awards in China, McDERMOTT WILL & EMERY (Nov. 22, 2010), https://www.lexology.com/library/detail.aspx?g=f96e8738-5cef-4c39-8d1d-7a6fbfbd4c21 (discussing prior cases, including one involving contradiction to the country’s administrative regulations, where the PRC courts applied the public policy exception under the New York Convention). But see Thorp & Sun, supra note 138, at 21 (arguing that refusal to enforce arbitration award on public policy ground rarely occurs).

151. See Aubin, supra note 13 (“In practice, if things go wrong, foreign investors in a VIE may have very few legal rights . . . .”), supra notes 138, 145 and accompanying text (suggesting that it is virtually impossible that the VIE agreements can be enforced).
investors may have no better choice than to settle for inadequate remedy of some sort, as in the Yahoo-Alibaba case.152

III. RECOMMENDATIONS TO THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Part III urges the SEC to carefully scrutinize and regulate publicly traded, PRC-domiciled VIEs to protect US investors.153 Without action targeted at addressing the use of the VIE structure, these entities could lead to severe losses by the US investing public without redress. 154 Specifically, Part III recommends that the SEC take two immediate actions to better inform US investors of the inherent risks of VIEs. Part III.A calls for an investor warning through the Office of Investor Education and Advocacy to explain the legal and regulatory risks of the VIE structure. Part III.B recommends that risk disclosure languages related to the unique VIE risks be more prominently featured in SEC filings.

There are three key reasons for the United States to implement regulatory reform to protect investors from the damaging impact of a VIE collapse.155 First, ex post remedy

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152. See supra note 116 and accompanying text (recalling the disappointment of Yahoo investors in Yahoo’s settlement with Alibaba); Zeng Xianwu & Bai Lihui, Variable Interest Entity Structure in China, KING & WOOD MALLESONS (Feb. 9, 2013), http://www.lexology.com/library/detail.aspx?g=a9d30574427f-ba6b7-84b8-2a3772e6e8d4f (“The result [of PRC individuals or domestic company not performing their obligations under the VIE contracts] is typically difficult, expensive and time-consuming dispute resolution process, which may lead to some kind of settlement or, alternatively, the foreign investor giving up on the PRC domestic company and their presence in China.”).

153. See supra Part II.A–.B (analyzing the inherent risks of VIEs and the limited legal recourse available to investors); Davidoff, supra note 92 (“The Securities and Exchange Commission and Washington seem to be almost as absent... The United States government has also not pressed China to vigorously and quickly enforce its own laws to help American shareholders.”). But see Paul Gillis, VIE Disclosures to Come to Hong Kong, CHINA ACCT. BLOG (Feb. 7, 2014), http://www.chinaaccountingblog.com/weblog/vie-disclosures-to-come-to.html (“The SEC has paid great attention to the disclosures related to VIEs and investors today have considerably more data to evaluate the risks of these structures.”).

154. See supra Part II.B (examining the limited legal recourse available to investors).

creation is expected to produce inadequate results. This is because the PRC courts and arbitrators are unlikely to uphold and enforce VIE agreements, and may not enforce non-PRC judgments or arbitral awards against PRC entities or individuals. Additionally, there is little reason to expect that the PRC would help recoup US investment losses or cooperate with US regulators. Second, the market is unlikely to self-correct in time because there is an inherent conflict of interest. All of the active participants in the VIE scheme have distinct monetary incentives to prolong the appearance of enforceable legality in order to generate transaction fees. Third, the regulatory efforts to date are limited and insufficient.

phenomena that reside in what The Atlantic calls ‘an ever lower circle of financial hell’ than proprietary trading.”; Davidoff, supra note 92 (suggesting that the SEC is yet to take effective action to address the VIE issue).

156. See supra note 145 and accompanying text (noting that merits of VIE agreements have almost never been contested in PRC courts); Zeng & Bai, supra note 150 (suggesting that investors will likely settle or simply give up any claim it may have over the PRC OpCo).

157. See supra Part II.B (concluding that US investors are unlikely to obtain adequate recovery in VIE disputes).

158. See e.g., The SEC Shouldn’t Forget that Beijing Always Wins, CHINA ECON. REV. (Feb. 10, 2014), http://www.chinaeconomicreview.com/china-on-wall-street-sec-csrc-showdown-big-four-auditors (arguing that PRC regulators will not cooperate with the SEC in the heated dispute over the Big Four accounting firms’ China practice, partly because they have never been enthusiastic about US investors buying into mainland companies); Mosk et al., supra note 64 (“The Chinese government snubbed a US request for help in cracking down on a string of alleged investment frauds that have cost Americans billions . . . .”).

159. See Davidoff, supra note 92 (“It is not just a problem of a questionable legal structure, but Wall Street’s apparent willingness to ignore the fact that investors in the United States have tenuous claims when they buy shares in Chinese companies. And underwriters and Chinese issuers have taken advantage of the hunger for Chinese stocks.”); Dan Harris, Buying into a China VIE. What Me Worry?, CHINA L. BLOG (Jun. 17, 2013), http://www.chinalawblog.com/2013/06/buying-into-a-china-vie-what-me-worry.html (“Accountants, lawyers and stock brokers make a ton of money off IPOs so they . . . have every incentive to keep the [VIE] structure going.”).

160. See supra note 159 (noting that the fees generated by VIEs incentivize underwriters, brokers, accounts and lawyers to create more VIEs while they can).

161. See Fu-Tomlinson & Wu, supra note 104 (noting that the New Oriental investigation was the first time the SEC “formally question[s] whether a VIE structure adopted by a China-based company listed in the US provides ‘sufficient basis for consolidation’”); Lawrence, supra note 6 (arguing that the US is still seen as “the paradise for VIEs” due to its lax regulation over the structure).
A. Investor Warning

The popularity of the VIE structure shares several key attributes with the reverse merger wave of PRC-domiciled companies in the 2000s. Both became popular by enabling these businesses to access the US capital markets. Both involve legal structures and financial jargon that are atypical among public companies and confusing to the general public. Both generate handsome profits for the professionals involved in the transactions. Both exist in a near “regulatory vacuum” between the United States and the PRC. Most importantly, both have caused, or have the potential to cause, substantial losses to even sophisticated institutional investors who are

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163. See supra note 60 and accompanying text (noting that companies favor VIE to access overseas financing); Byrnes & Browning, supra note 162 (noting that PRC companies use reverse merger as a short cut to list in the US).


165. See Walter Pavlo, Reverse Mergers – Pushers May Be the Problem, FORBES (Apr. 15, 2011), http://www.forbes.com/sites/walterpavlo/2011/04/15/reverse-mergers-pushers-may-be-the-problem (noting that profit-seeking pushers and dealers are at the center of the troubling reverse merger transactions); supra notes 159, 160 and accompanying text (indicating the disincentives of bankers, lawyers, and accountants to stop VIEs in the tracks).

166. Csordas, supra note 16, at 386 (“Some have described the oversight of ‘foreign private issuers,’ including Chinese companies listed on US securities exchanges, as a ‘regulatory vacuum,’ with neither the United States nor China effectively monitoring those companies.”); supra note 63 and accompanying text (arguing that the PRC government is incentivized to leave VIE in the legal gray area for as long as it deems beneficial).
typically presumed to understand the risks of their investments.\textsuperscript{167}

The SEC should look to past practices and issue a similar warning it used to address the risks related to reverse merger.\textsuperscript{168}

In June 2011, in response to the increasing number of securities fraud scandals involving PRC companies that went public in the United States via reverse merger transactions, the SEC’s Office of Investor Education and Advocacy issued an announcement titled “Investor Bulletin: Reverse Merger,” in which it addressed the common risks of the companies at issue and the typical pattern of frauds.\textsuperscript{169} The announcement prompted immediate discussion and attention in the financial press.\textsuperscript{170}

Similarly, the proposed VIE warning should analyze the legal and regulatory risks of investing in VIEs and include

\textsuperscript{167} See supra Part II.B (analyzing the limited legal recourse available to VIE investors who seek remedy when their investment goes wrong); M. Norman Goldberger & Laura Krabill, \textit{Fraud Prevalent in Reverse Merger Companies with Operations in China}, BALLARD SPAHR LLP (July 8, 2011), http://www.ballardspahr.com/AlertsPublications/Articles/20110708_Fraud_Prevalent_in_Reverse_Merger_Companies_with_Operations_in_China ("There have been enough instances of serious securities fraud in these [reverse merger] companies (and enough instances where sophisticated investors have been damaged with no recourse) that the old adage ‘buyer beware’ is particularly true.").

\textsuperscript{168} See supra notes 162–67 and accompanying text (comparing and identifying the similarities between VIEs and reverse mergers involving US-listed, PRC-based companies); Scott Eden, \textit{SEC Warns on Reverse Merger Stocks}, STREET (Jun. 9, 2011, 5:08 PM), http://www.thestreet.com/story/11148562/1/sec-warns-on-reverse-merger-stocks.html ("The Securities and Exchange Commission put out an investor bulletin Thursday afternoon warning the world of potential fraud among companies that came public in the U.S. through a controversial method called a reverse merger.").


examples of VIE-related risk disclosure language found in the SEC filings.\textsuperscript{171} It should provide a list of incidents where US investors have lost control of the PRC-domiciled VIEs, followed by a brief discussion of each case.\textsuperscript{172} Finally, it should conclude by recommending that investors be particularly cautious and take diligent care in understanding the risks inherent in a VIE’s corporate structure before investing.\textsuperscript{173} Based on prior experience, the SEC may expect the proposed announcement to draw the immediate attention of the media.\textsuperscript{174} Increased media coverage of the issue helps foster wider public discussion, which in turn enhances the general understanding of and alertness to the issue.\textsuperscript{175}

B. Prioritized Risk Disclosure

As a second recommendation, the SEC should enhance the visibility of the risk disclosure related to the unique legal and

\textsuperscript{171} See INVESTOR BULLETIN, supra note 169, at 2–3 (describing in plain English the risks of investing in reverse merger companies and citing examples of risk factor disclosures that reverse merger companies have used in their SEC filings); Stephen E. Fox & Irwin Kishner, SEC Warns Investors about Investing in Reverse Merger Companies, HERRICK FEINSTEIN LLP (Aug. 10, 2011), http://www.lexology.com/library/detail.aspx?g=7faae2bd-5c96-40c1-8f72-b1a04af66c1e (summarizing the potential risks with investing in reverse merger companies that were mentioned in the Bulletin).

\textsuperscript{172} See INVESTOR BULLETIN, supra note 169, at 3–4 (listing recent enforcement actions involving reverse merger companies with brief discussion of each action); Fox & Kishner, supra note 171 (“[The Bulletin] also discusses six reverse merger companies that had their stock suspended from trading by the SEC in recent months, and states that the SEC has recently revoked the securities registration of ‘several’ reverse merger companies.”).

\textsuperscript{173} See INVESTOR BULLETIN, supra note 169, at 4 (“Investors should be careful when considering investing in the stocks of reverse merger companies and should make sure that they have accurate and up-to-date information about a company before investing.”); Fox & Kishner, supra note 171 (summarizing the specific tips for investor due diligence recommended in the Bulletin).

\textsuperscript{174} See supra note 168 (examples of major media reporting on the SEC investor bulletin warning about investing in reverse merger companies). But see Eden, supra note 168 (observing the critique that SEC’s warning had come too little too late).

\textsuperscript{175} See e.g., Anne-Katrin Arnold, Media Effects I: Agenda Setting, WORLD BANK ORG. BLOG (Dec. 22, 2009), https://blogs.worldbank.org/publicsphere/media-effects-i-agenda-setting (suggesting that the more attention media devotes to an issue, the more important the public perceives the issue to be); Dietram A. Scheufele & David Tewskbury, Framing, Agenda Setting, and Priming: The Evolution of Three Media Effects Models, 57 J. COMM. 9, 11 (2007) (noting that the characterization of an issue in the news reports can have an influence on how it is understood by audiences).
regulatory risks of the VIE structure.\textsuperscript{176} While companies already disclose those material risks in technical compliance with relevant SEC rules, the disclosure is often lengthy, difficult to understand, and effectively buried under pages of dense, boilerplate language.\textsuperscript{177} As such, the current disclosure requirement inadequately serves the SEC’s main regulatory objective—to protect investors by ensuring that disclosures are truly informative.\textsuperscript{178} While addressing the general inadequacies of risk disclosure practice is an ongoing effort that requires far more reflection and discussion, the SEC should not hesitate from embracing effective piecemeal measures to promote understanding of the VIE-specific risks in the interim.\textsuperscript{179}

The SEC must prioritize the disclosure of VIE-specific risks over that of generic economy or industry-wide risks through two new reporting requirements for VIEs.\textsuperscript{180} First, the SEC should
require that risk disclosure language relating to the legal instability and unpredictability of the VIE structure be in boldface and italicized fonts to signal the critical importance of the issue.181 Second, such language should be placed at the beginning of the risk disclosure section to reduce the likelihood that it is overlooked by investors.182

In sum, Part III advises the SEC to institute precautionary regulatory measures with respect to VIEs and recommends two such measures that may be implemented in the near future.183 While US regulatory attention may cause disruptive dislocation in the international capital markets, causing immediate diminution of the share prices of affected entities, it ultimately leads to a more efficient and transparent system, which in turn promotes investor confidence in the integrity of the US capital markets.184
CONCLUSION

PRC-domiciled VIEs are contract-based investment structures engineered to enable non-PRC investors’ de facto control over PRC businesses in contravention of Chinese FDI restrictions. Contracts made to circumvent existing PRC law are not enforceable, and the VIE structure has yet to be explicitly approved by the CCP. Further, typical shareholder safeguards do not protect the rights of US investors in a VIE arrangement. By not directly addressing the legality of VIE or the validity of its underlying contracts, the PRC government reserves for itself the right to declare its position at a later date, creating substantial unpredictability for US investors. The SEC is encouraged to take immediate precautionary actions to protect US investors from the unique and under-appreciated legal risks of investing in PRC-domiciled VIEs.