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Article 1

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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COMMENT

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

Serena Y. Shi *

“Some are calling it ‘bigger than Enron’ and ‘a bit of a Ponzi scheme.’” —New York Times¹

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1. Sue-Lin Wong, *China Court Ruling Could Threaten Foreign Investments in Country*, N.Y. TIMES (June 17, 2013, 3:09 AM), <http://rendezvous.blogs.nytimes.com/2013/06/17/china-court-ruling-could-threaten-some-foreign-invested-companies>.

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INTRODUCTION

An investor who buys shares on a stock exchange receives a piece of equity of the listed company.² Typically, the listed company is either an operating company or a holding company that owns an equity stake in an operating company or companies.³ 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.⁴ 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-

2. See, e.g., *Stock Market Definition*, MERRIAM-WEBSTER.COM, <http://www.merriam-webster.com/dictionary/stock%20exchange> (last visited Dec. 19, 2013) (“A system or place where shares of various companies are bought and sold”); *Equity Market Definition*, INVESTOPEDIA, <http://www.investopedia.com/terms/e/equitymarket.asp> (last visited Dec. 19, 2013) (defining the stock market as giving companies capital and investors a slice of ownership in a company).

3. See, e.g., *Holding Company Definition*, BLACK’S LAW DICTIONARY 257 (9th ed. 2009) (characterizing a holding company as a company formed to control other companies and confines its role to owning stock and supervising management without participating in making day-to-day business decisions); HERVÉ STOLOWY & MICHEL LEBAS, *FINANCIAL ACCOUNTING AND REPORTING, A GLOBAL PERSPECTIVE* 454 (2006) (noting that a pure holding company’s sole purpose is to hold and manage its subsidiaries and does not directly engage in business operations).

4. See Wong, *supra* note 1 (suggesting that more than half of the 200 Chinese companies listed on the New York Stock Exchange (“NYSE”) and the NASDAQ Stock Market (“NASDAQ”) use a Variable Interest Entity (“VIE”) structure); Paul Gillis, *Statistics on VIE Usage*, CHINA ACCT. BLOG (Apr. 11, 2011, 7:20 PM), <http://www.chinaaccountingblog.com/weblog/statistics-on-vie-usage.html> (noting that about forty-seven percent and sixty-five percent of the Chinese businesses that went public on the NYSE and NASDAQ, respectively, used the VIE structure); David Schindelheim, Note, *Variable Interest Entity Structures in the People’s Republic of China: Is Uncertainty for Foreign Investors Part of China’s Economic Development Plan?*, 21 *CARDOZO J. INT’L & COMP. L.* 195, 196 (2012) (explaining that foreign control is established over a PRC entity through contractual arrangement rather than equity ownership).

generating business operation nor equity in an operating company.⁵ The investor derives economic benefits solely from the contractual agreements between the listed entity and the underlying PRC-domiciled business.⁶ As such, a VIE investment is only as good as the validity of its underlying contracts.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 2014.⁸

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"

5. See, e.g., NetEase Inc., Annual Report (Form 20-F) (Apr. 22, 2013) (documenting the places of incorporation to be in the Cayman Islands and principle executive offices in the PRC); RenRen Inc., Annual Report (Form 20-F) (Apr. 23, 2013); Sina Corp., Annual Report (Form 20-F) (Apr. 22, 2013). *But see* Chen Ke, "Rule by Law" and Its Impact on Cross-Border Transactions Affecting Chinese Interests, 34 T. JEFFERSON L. REV. 161, 166 (2011) (acknowledging the British Virgin Islands to be the other common destination for VIE shell companies).

6. See *Understanding the VIE Structure: Necessary Elements for Success, and the Legal Risks Involved*, CADWALADER, WICKERSHAM & TAFT 2 (Aug. 10, 2011), <http://www.cadwalader.com/uploads/cfmemos/a6415b15f2ab1795be964c203f513215.pdf> [hereinafter CADWALADER, *Understanding the VIE Structure*] ("The key concept that underpins a VIE Structure is control over the Domestic Licensed Co through various service agreements . . . rather than through share ownership."); Dune Lawrence, *China Companies Evading Owner Rule with US Listings Frustrate Regulators*, BLOOMBERG L. (Oct. 9, 2011), <http://about.bloomberglaw.com/legal-news/china-companies-evading> ("Under U.S. accounting rules, the company in China is considered a 'variable interest entity' in which the U.S.- listed firm's interest derives from the contractual relationship, not voting rights.").

7. See Dan Harris, *Crouching Tiger, Hidden Fraud. Clear Speaking On VIEs.*, CHINA L. BLOG (July 16, 2011), http://www.chinalawblog.com/2011/07/crouching_tiger_hidden_fraud_clear_speaking_on_vies.html ("[T]he contractual arrangements providing for control by the public company are only as strong as the enforcement mechanisms that can be effectively used – generally Chinese law and Chinese courts."); William McGovern, *SEC Probe Raises Uncertainty Over VIE Structures*, S. CHINA MORNING POST (Jan. 23, 2013, 12:00 AM), <http://www.scmp.com/business/china-business/article/1133845/sec-probe-raises-uncertainty-over-vie-structures> (cautioning about the enforceability of the VIE agreements connecting the foreign-owned offshore entity and the onshore operating VIE owned by PRC nationals).

8. See Paul Gillis, *Accounting Matters: Variable Interest Entities in China*, FORENSIC ASIA GUEST SERIES (Sept. 18, 2011) (listing over one hundred US-listed PRC-domiciled companies in descending order of market capitalization as of September 2011); Vindu Goel, Michael J. de la Merced & Neil Gough, *Chinese Giant Alibaba Will Go Public, Listing in U.S.*, N.Y. TIMES (May 6, 2014, 4:48 PM), <http://dealbook.nytimes.com/2014/05/06/alibaba-files-to-go-public-in-the-u-s> (confirming that PRC's "e-commerce behemoth" Alibaba Group has filed with the SEC for its IPO in New York and is expected by the market to be valued at roughly US\$200 billion).

industry sectors, such as energy, technology, and value-added telecommunications.⁹ Notably, almost all of the largest US-listed PRC-domiciled internet companies use the VIE structure.¹⁰ To date, the PRC government has not directly addressed either the legality of the VIE structure or the validity of its underlying contracts.¹¹ Nevertheless, recent actions by the PRC's regulatory bodies have significantly exacerbated concerns over the structure's fundamental viability.¹² The murky legal and political landscape surrounding VIEs poses unusual challenges to the protection of US investor interests.¹³

9. 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*, 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.”).

10. See David Barboza, *A Loophole Poses Risks to Investors in Chinese Companies*, 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, *The Cash Reserves of China's Internet Companies*, 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).

11. See generally Stan Abrams, *The VIE Meta-Narrative: Illegal vs. Invalid*, 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).

12. See Gillis, *supra* note 8 (“There is a growing feeling that VIEs are becoming unworkable.”); *An Update on China's Variable Interest Entities: Navigating Regulations and Mitigating Risks for 2013*, K&L GATES, (Mar. 8, 2013), <http://www.klgates.com/an-update-on-chinas-variable-interest-entities—navigating-regulations-and-mitigating-risks-for-2013-03-08-2013> (suggesting that the PRC government's recent actions show its intention to crack down on VIEs).

13. See Steven M. Davidoff, *Alibaba Investors Will Buy a Risky Corporate Structure*, 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, *Investor Risk Lurks in Legal Structure of China IPOs—Lawyers*, REUTERS (Nov. 2, 2013), <http://www.reuters.com/article/2013/06/23/china-investments-idUSL2N0E MPD20130623> (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 I.A 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 I.B 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 I.C reviews the PRC's recent legislative and regulatory developments as well as the ongoing bilateral treaty negotiation affecting the VIE structure. Part I.D 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”).¹⁵ During the Maoist era (1949–78), FDI in the PRC was practically non-existent.¹⁶ Historically, the dominant Confucian ideology had an anti-commercial tradition and assigned low social status to merchants.¹⁷ More recently, in the nineteenth and twentieth centuries, the PRC was colonized and exploited by Western military invasion and forced trade.¹⁸ Consequently, the newly-founded PRC felt intense hostility toward the West and a strong desire to regain autonomy of its trade and commerce.¹⁹ Self-reliance via import substitution was a

15. XIANFA pmbl. & art. 11 (1982) (China); see Vivienne Bath, *Foreign Investment, the National Interest and National Security—Foreign Direct Investment in Australia and China*, 34 SYDNEY L. REV. 5, 6 (2012) (“China is a one-party unitary state which describes itself as being in ‘the primary stage of socialism’ and aiming to develop a ‘socialist market economy’.”). *But see* George Finch, *Modern Chinese Constitutionalism: Reflections of Economic Change*, 15 WILLAMETTE J. INT’L L. & DISP. RESOL. 75, 94–102 (2007) (noting that the term did not appear in the PRC Constitution under its 1993 amendment to follow Deng Xiaoping’s call to introduce market economy into China).

16. See Jinyan Li, *The Rise and Fall of Chinese Tax Incentives and Implications for International Tax Debates* (Comparative Research in Law & Political Economy Research Paper 05/2008, Vol. 04 No. 01, 2008) (“China had no foreign direct investment (“FDI”) before 1979.”); Stefan Kaiser et al., *Foreign Direct Investment in China: An Examination of the Literature*, in GREATER CHINA: POLITICAL ECONOMY, INWARD INVESTMENT, AND BUSINESS CULTURE 44 (Chris Rowley & Mark Lewis eds., 1996) (noting that FDI was allowed into the PRC with the announcement of the Open-Door policy).

17. See XUEYUAN ZHANG ET AL., HISTORICAL ATTITUDES AND IMPLICATIONS FOR PATH DEPENDENCE: FDI DEVELOPMENT AND INSTITUTIONAL CHANGES IN CHINA, ERIM REP. SERIES RES. IN MGMT. 11 (2004) (suggesting that the anti-commercial attitude in the Confucian Chinese state is related to its “traditional suspicion of merchants”); *Four Occupations*, WIKIPEDIA, http://en.wikipedia.org/wiki/Four_occupations (last visited Dec. 17, 2013) (noting that under the hierarchical system in ancient China, traders and merchants had the lowest social rank).

18. See Finch, *supra* note 15, at 77 (providing an overview of the series of unsuccessful attempts by the Chinese government to fight foreign aggression and forced trade); HUI FENG, *The Road to the WTO*, in THE POLITICS OF CHINA’S ACCESSION TO THE WORLD TRADE ORGANIZATION: THE DRAGON GOES GLOBAL 40, 41 (2006) (noting that as a result of China’s defeat in the two Opium Wars the country was forced to accept a humiliating treaty system under which foreign powers controlled Chinese tariffs and coastal trade).

19. See ZHANG ET AL., *supra* note 17, at 14–16 (explaining how the Western domination and exploitation of China starting with the Opium War has contributed to Chinese protectionism); Axel Berger, *The Politics of China’s Investment Treaty-Making*

resounding theme of the Maoist era.²⁰ The key turning point in the PRC's path to modernization occurred after the demise of Mao Zedong and the disastrous Cultural Revolution.²¹ 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.²² The new policy advocated the use of "market mechanisms and foreign resources" to spur economic growth.²³ It also marked the first time that the PRC welcomed non-PRC investments into the country.²⁴ On the

Program, in THE POLITICS OF INTERNATIONAL ECONOMICS LAW 162, 171 (Tomer Broude et al. eds., 2011) (discussing the PRC's hostile view of Western investments as a means used by the imperialists to carry out "aggression, oppression and exploitation").

20. See ZHANG ET AL., *supra* note 17, at 19 (noting that the CCP used the import substitution approach to achieve its highly-emphasized goal of self-reliance); *Import Substitution Industrialization* ("ISI"), INVESTOPEDIA, <http://www.investopedia.com/terms/i/importsubstitutionindustrialization.asp> (last visited on Feb. 24, 2014) ("Implementation of [import substitution] focuses on protection and incubation of domestic infant industries so they may emerge to compete with imported goods and make the local economy more self-sufficient."); Ross Terrill, *China and the World: Self-Reliance or Interdependence?*, FOREIGN AFF., Jan. 1977, available at <http://www.foreignaffairs.com/articles/27034/ross-terrell/china-and-the-world-self-reliance-or-interdependence> (analyzing the sources of China's principle of self-reliance from a historical and cultural standpoint).

21. See, e.g., TANG TSOU, THE CULTURAL REVOLUTION AND POST-MAO REFORMS: A HISTORICAL PERSPECTIVE 144 (1986) ("The Third Plenary session . . . held in December 1978 may turn out to be the landmark of the beginning of a new historic era in China."); Michael Elliot, *Thirty Years After Deng: The Man Who Changed China*, TIME, Dec. 10, 2008, <http://content.time.com/time/world/article/0,8599,1865539,00.html> (calling the Third Plenary session in 1978 the meeting that "laid the groundwork for a generation of economic reform").

22. See Kaiser et al., *supra* note 16 (examining the evolution of the CCP's ideology and policy in the period); Alexander E. Csordas, Note, *Funding Entrepreneurial Ventures in China: Proposals to More Effectively Regulate Chinese Foreign Private Issuers*, 38 BROOK. J. INT'L L. 373, 376 (2012) (identifying the emergence of the Open Door Policy following Mao's death).

23. William I. Friedman, Alumni Article, *One Country, Two Systems: The Inherent Conflict Between China's Communist Politics and Capitalist Securities Market*, 27 BROOK. J. INT'L L. 477, 477 (2002) ("Deng Xiaoping, adopted an 'open door' policy, centering on economic reforms utilizing market mechanisms and foreign resources to speed up the growth and modernization of the economy."); Csordas, *supra* note 22, at 376 (discussing the central theme of the Open Door Policy).

24. See Yongnian Zheng, *Reform, Openness and Social Policy in China*, in CHINA'S SOCIAL DEVELOPMENT AND POLICY: INTO THE NEXT STAGE? 19 (Litao Zhao ed., 2013) ("In the 30 years under Maoist Rule (1949-79), China's doors were closed to the outside world, especially the West."); Jeffrey K.D. Au, Note, *The Hopes and Fears of Foreign Direct Investment: A Comparative Evaluation of FDI Regulation in the People's Republic of China and Taiwan*, 2 J. CHINESE L. 359, 359 (1988) ("Rejecting past policies of autarky and strict 'self-reliance,' the PRC embarked on a new path, which sought to

whole, the new leadership welcomed FDI because it attracted the capital and technical expertise necessary for accelerated economic growth.²⁵ FDI-friendly policies have ranged from preferential tax treatment of overseas investments to special trade zones for economic experimentation.²⁶ In the 1990s, economic reforms accelerated as the “conventional state planning system” transitioned into “a more market-oriented macro-economic regulation and control” regime.²⁷ This transition continued into the new millennium with the PRC’s joining the World Trade Organization in 2001.²⁸

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.²⁹ Despite progressive policy changes, protectionism

encourage the transfer of advanced technology from abroad and the investment of foreign capital in the PRC.”).

25. See, e.g., Ding Qingfen, *Favorable FDI Policy is Essential, Says Report*, CHINA DAILY (Nov. 30, 2011), http://www.chinadaily.com.cn/bizchina/2011-11/30/content_14186406.htm (commenting on the PRC’s intention to maintain a favorable FDI environment, as it facilitates the advancement of the nation’s economy); *Foreign Direct Investment—The China Story*, WORLD BANK (July 16, 2010), <http://www.worldbank.org/en/news/feature/2010/07/16/foreign-direct-investment-china-story> (recognizing the PRC’s success in mobilizing FDI and achieving economic development and export success).

26. See, e.g., Zhaodong Jiang, *China’s Tax Preferences to Foreign Investment: Policy, Culture and Modern Concepts*, 18 NW. J. INT’L L. & BUS. 549, 550–59 (1998) (outlining a brief overview of China’s tax preferences for FDI starting in the late 1970s); Associated Press, *China Opens Shanghai Free-Trade Zone*, GUARDIAN (London) (Sept. 29, 2013, 7:40 AM), <http://www.theguardian.com/world/2013/sep/29/china-shanghai-free-trade-zone> (reporting that the newly established free-trade zone in Shanghai has been billed by the PRC government as a major step for financial reforms and economic experimentation).

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).

29. See, e.g., Schindelheim, *supra* note 4, at 198 (characterizing the PRC government’s current attitude toward foreign investments as “cautious and protectionist”); Edward M. Graham & Erika Wada, *Foreign Direct Investment in China: Effects on Growth and Economic Performance* (Inst. for Int’l Econ., Working Paper No. 01-03, 2001), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=300884

has persisted partly in the form of regulatory restrictions of non-PRC investments in a variety of industries.³⁰ 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.³¹ 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.³²

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.³³ The current version of the Catalogue expressly assigns over four

(observing 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).

30. See Shen Wei, *Will the Door Open Wider in the Aftermath of Alibaba? —Placing (or Misplacing) Foreign Investment in a Chinese Public Law Frame*, 42 H.K.L.J. (PT. 2) 561, 561 (2012), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2320402 (“Recent years witnessed a rising chorus of complaints from the foreign business community concerning China’s protectionist regulatory environment and increasing hostility to foreign multinationals.”); John Lee, *China’s FDI Obstacle Course*, BUS. SPECTATOR (Sept. 18, 2013, 7:37 AM), <http://www.businessspectator.com.au/article/2013/9/18/economy/chinas-fdi-obstacle-course> (describing the foreign investment approval process as “labyrinthine”); OECD, FDI REGULATORY RESTRICTIVENESS INDEX (2012), available at <http://www.oecd.org/investment/fdiindex.htm> (ranking China as the number one most restrictive of all OECD and G20 countries with respect to FDI).

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).

32. See Simon Luk, *Certain Recent Entrepreneurial Responses to China’s Mergers & Acquisitions Rules*, SIMON LUK’S ARTICLES BLOG, <http://simonlukarticles.blogspot.com/2009/05/certain-recent-entrepreneurial.html> (last visited Dec. 17, 2013) (“The Chinese government may impose tighter control over M&A activities involving Chinese entrepreneurs in order to preserve stability in both its foreign exchange policy and national capital account.”); Bath, *supra* note 15, at 32 (observing the pressure from “popular resistance to foreign takeover of well-regarded Chinese companies”).

33. See Shen, *supra* note 27, at 516 (“The Catalogue signaled the state policies in attracting foreign investment.”); Li Wanqiang, *Chinese Foreign Investment Laws: A Review from the Perspective of Policy-oriented Jurisprudence*, 19 ASIA PAC. L. REV. 35, 37 (2011) (indicating the central importance of the industry-based FDI guidance catalogue).

hundred industry sectors into three categories, designating non-PRC investments as either “encouraged,” “restricted,” or “prohibited,” respectively.³⁴ Non-PRC investments in sectors not specifically listed in the Catalogue are considered “permitted.”³⁵ Those investments placed in a “restricted” category require government approval, which usually involves a complex and opaque process.³⁶ Finally, those in the “prohibited” category are technically forbidden under PRC law.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.³⁸

34. See Waishang Touzi Chanye Zhidao Mulu (外商投资产业指导目录) [Catalogue for the Guidance of Foreign Investment Industries] (promulgated by the Nat'l Dev. & Reform Comm'n, and the Ministry of Com. (“MOFCOM”), Dec. 24, 2011, effective Jan. 30, 2012) (China); Jane Bu et al., *China's New Foreign Investment Catalogue Comes into Effect*, MORRISON FOERSTER I (Jan. 30, 2012), <http://www.mofo.com/files/Uploads/Images/120130-Foreign-Investment-Catalogue.pdf> (“‘Encouraged,’ ‘restricted[,]’ and ‘prohibited’ projects are expressly enumerated in the Catalogue.”).

35. 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’ . . .”).

36. 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”).

37. See CHUNLAI CHEN, *The Evolution and Main Features of China's FDI Laws and Policies*, in FOREIGN DIRECT INVESTMENT IN CHINA: LOCATION DETERMINANTS, INVESTOR DIFFERENCES AND ECONOMIC IMPACTS 33, 60 (2011) (“Foreign direct investment in prohibited industries by any foreign investors is not allowed at all.”); *China Business Center—Encouraged, Permitted, Restricted and Prohibited Industries*, LEHMAN BROWN http://www.lehmanbrowncpa.com/en/resources/class_view.asp?id=509 (last visited on Jan. 28, 2014) (“Investment in ‘prohibited’ industries is completely off limits to foreign investment.”).

38. See Steve Dickinson, *VIEs in China. The End of a Flawed Strategy.*, CHINA L. BLOG (Oct. 10, 2011), http://www.chinalawblog.com/2011/10/vies_in_china_the_end_of_a_flawed_strategy.html (stating that direct foreign ownership in the internet sector is prohibited); Greg Pilarowski, *Tudou IPO Exposes Yet Another China Risk Factor: The Founder's Wife*, VENTURE BEAT (Aug. 19, 2011), <http://venturebeat.com/2011/08/19/tudou-ipo-exposes-yet-another-china-risk-factor-the-founder%E2%80%99s-wife> (noting that all US-listed Chinese internet companies use a VIE structure).

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.”).

41. See Scott Yunxiang Guan, *China’s Telecommunications Reforms: From Monopoly Towards Competition, Part 2*, 9 ASIAN ECON. & POL. ISSUES 11 (2003) (explaining the complex three-way management contracts between the PRC operator, the joint venture entity, and the non-PRC investor); INFORMATION GATEKEEPERS INC., CHINATELECOM 2000 V.6: NEW TELECOM POLICY AND STRUCTURE AFTER REORGANIZATION 58, exhibit 2.5 (1999) (demonstrating graphically the CCF joint venture 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.⁴³ A dramatic disintegration of the structure ensued.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.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.⁴⁶ As a result, some of the CCF investors incurred considerable losses on their investment pursuant to the prohibition of the structure.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

43. *China VIE Structure for Foreign Investment Under Attack from Multiple Directions: Will It Emerge (Relatively) Unscathed or Is Its Very Survival Threatened?*, HOGAN LOVELLS (Jan. 2012), <http://www.hoganlovells.com/newsmedia/pubDetail.aspx?publication=7669>; Ian Macintosh, *Regulating the New Economy: Implications of WTO Accession for Telecommunications and E-Commerce in China*, in *CHINA AND THE WORLD TRADING SYSTEM: ENTERING THE NEW MILLENNIUM* 263, 266 (Deborah Z. Cass et al. eds., 2003) (“[I]n October 1999, the MII announced that the CCF project contracts were ‘irregular’ under state policy and regulation.”).

44. See Robert Lewis, *Investors at the Gate*, 26 *INT’L FIN. L. REV.* 36, 36 (2007) (noting the “spectacular and well-publicized demise” of the CCF structure); Leontine D. Chuang, Comment, *Investing in China’s Telecommunications Market: Reflections on the Rule of Laws and Foreign Investment in China*, 20 *NW. J. INT’L. L. & BUS.* 509, 510 (1999) (calling the birth, development, and demise of the CCF structure an ill-fated and a perfect example of the lack of clarity in the PRC’s investment law).

45. See Philip Sohmen, *Taming the Dragon: China’s Efforts to Regulate the Internet*, 1 *STAN. J. E. ASIAN AFF.* 17, 23 (2001), available at <http://www.stanford.edu/group/sjeaa/journal1/china1.pdf> (“[The CCF structure] had been sanctioned at the highest level, but in 1998 the MII announced suddenly that such investment was in fact illegal, as it was equivalent to equity ownership.”); CADWALADER, *Understanding the VIE Structure supra* note 6, at 3 (explaining that CCF was unacceptable “because FDI in the basic telecom service sector . . . was, and remain[ed], prohibited”).

46. See Yuka Kobayashi, *The Impact of the World Trade Organization on China’s Trade Policy*, in *CHINA’S FOREIGN TRADE POLICY: THE NEW CONSTITUENCIES* 143, 157 (Ka Zeng ed., 2007) (noting that the PRC authority changed its attitude from turning a blind eye to tightening control); IGI CONSULTING INC., *supra* note 41, at 57 (“[M]any foreign companies are surprised by the Chinese government’s sudden move.”).

47. See Kobayashi, *supra* note 46, at 157 (indicating that the total loss suffered by non-PRC investors in the CCF aftermath was likely substantial); Lynnette Luna, *CCF Investors in China May Not Go Quietly*, *RCR WIRELESS* (Aug. 23, 1999), <http://www.rcrwireless.com/article/19990823/sub/ccf-investors-in-china-may-not-go-quietly> (“You won’t find very many happy investors. . . . They are going through turmoil and uncertainty. They have to negotiate a way out of these deals.” (quoting Hui Pan, chief economist with IGI Consulting in Boston)).

FDI restrictions.⁴⁸ 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.⁴⁹ 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.⁵⁰

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”).⁵¹ US investors purchase equity in the ListCo, which owns one hundred percent of the WFOE.⁵² To establish a connection between the ListCo and the OpCo, the WFOE typically executes five essential contracts with the OpCo and its PRC owners.⁵³ These contracts include: (1) a loan agreement,

48. See *China VIE Structure*, *supra* note 43, at 1 (noting that after the CCF structure was declared “irregular,” other workarounds have “since re-emerged in various forms and guises”); *Q+A-Variable Interest Entities in China*, REUTERS (Sept. 23, 2011), <http://www.reuters.com/assets/print?aid=USL3E7KJIAU20110923> (describing the VIE as “a structure lawyers devised to permit foreign investors to get around Chinese rules barring foreigners from owning certain domestic enterprises”).

49. See Gillis, *supra* note 8, at 3 (noting the emergence of the VIE structure in 2000); Barboza, *supra* note 10 (citing Sina as the first one to use the VIE structure).

50. See Paul Gillis, *Explaining VIE Structures*, CHINA ACCT. BLOG (Mar. 20, 2011), <http://www.chinaaccountingblog.com/weblog/explaining-vie-structures.html> (“The concept that underpins a VIE structure is that control is obtained through legal agreements rather than through share ownership.”); Lawrence, *supra* note 6 (stating that VIE allows non-PRC investors to set up agreements to mimic equity ownership).

51. See David Roberts & Thomas Hall, *O’Melveny & Myers Publishes Paper on VIE Structures in China: What You Need to Know*, O’MELVENY & MYERS 1–3 (Oct. 2011), <http://www.omm.com/files/Uploads/Documents/VIE%20Structures%20in%20China%20-%20What%20You%20Need%20to%20Know.pdf> (analyzing the components of a basic VIE structure); CADWALADER, *Understanding the VIE Structure*, *supra* note 6, at 1–3 (examining the typical VIE structure).

52. See CADWALADER, *Understanding the VIE Structure*, *supra* note 6, at 2 (noting that the offshore ListCo owns or controls the onshore WFOE); Roberts & Hall, *supra* note 51, at 1 (describing the step where the offshore holding company forms a wholly-owned subsidiary in the PRC).

53. See Roberts & Hall, *supra* note 51 (listing call option agreement, equity pledge agreement, voting rights agreement, loan agreement, exclusive service agreement and asset licensing agreement as common agreements comprising a VIE arrangement); *China VIE Structure*, *supra* note 43 (identifying cooperation agreement, voting proxy, equity pledge agreement and option agreement as contractual instruments of control).

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.⁵⁴ 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").⁵⁵

The internet industry was the first to adopt the VIE structure, with other industries quickly following suit.⁵⁶ 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.⁵⁷ Like

54. See *supra* note 53 and accompanying text (discussing in detail the common contracts comprising of a basic VIE structure).

55. See FIN. ACCT. STANDARDS BD., FASB INTERPRETATION NO. 46(R): CONSOLIDATION OF VARIABLE INTEREST ENTITIES (2003), available at http://www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175820923530&blobheader=application%2Fpdf&blobheadername2=Content-Length&blobheadername1=Content-Disposition&blobheadervalue2=540473&blobheadervalue1=filename%3Daop_FIN46R.pdf&blobcol=urldata&blobtable=MungoBlobs (interpreting the primary beneficiary test for the recognition and consolidation of VIEs under the US GAAP accounting standard); see also Paul Gillis, *The Emperor's New Suit: VIEs in China*, CHINA ACCT. BLOG (Mar. 9, 2011), <http://www.chinaaccountingblog.com/weblog/the-emperors-new-suit-vies.html> (observing that the "anti-Enron" accounting rule FIN 46(R) creates unintended loopholes for PRC-domiciled VIEs).

56. See *Variable Interest Entities in China*, *supra* note 48 at 2 ("The VIE structure was first used in the Internet sector . . . and has since spread to other industries."); see also *Heightened Scrutiny to VIE Structures under the New M&A Rules*, BLANK ROME (Nov. 2011), <http://www.blankrome.com/index.cfm?contentID=37&itemID=2632> ("The use of VIE structure has been widespread.").

57. See Joy Shaw et al., *China VIE Structure May Hold Hidden Risks*, FIN. TIMES (Nov. 11, 2011, 12:27 AM), <http://www.ft.com/intl/cms/s/2/0a1e4d78-0bf6-11e1-9310-00144feabdc0.html#axzz2giY4RPml> ("Most of China's well established internet companies – Sina (NASDAQ: SINA), Baidu.com (NASDAQ: BIDU), Tudou (NASDAQ: SOHU) among them – are listed in the US using this structure."); see also Dickinson,

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-idUSS1E78MIVA20110923> (“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.”).

62. *See* Telis Demos et al., *US Door Swings Ajar to China IPOs*, WALL ST. J. (June 3, 2013, 8:32 PM), <http://online.wsj.com/news/articles/SB10001424127887324423904578523463905850332> (“A US listing can help up-and-coming Chinese companies boost

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.⁶³ In the US capital markets, both institutional and retail investors are zealous about high-growth investment projects in the PRC.⁶⁴ Absent a better alternative to invest in the PRC's prohibited sectors, VIE has remained their investment structure of choice.⁶⁵

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).

63. Aubin, *supra* note 13 ("By leaving the issue in a legal gray area, China can attract foreign investment to bolster key sectors of the economy, while keeping the right to clamp down when it desires."); *see* Ken Davies, *China Investment Policy: An Update* 7 (Org. for Econ. Co-operation and Dev., Working Papers on International Investment, Jan. 2013), available at http://www.oecd.org/china/WP-2013_1.pdf ("China remains the largest recipient of FDI among developing countries and FDI continues to play a disproportionately large role in promoting China's trade, investment and tax revenue generation . . ."); *see also* Chris Leahy & Max Hirsch, *Variable Interest Entities: Risks and Rewards*, BLACKPEAK, http://blackpeak.eheliens.com/images/uploads/news/VIEs_in_China.pdf (last visited Dec. 17, 2012) (noting that the VIE structure enables "valuable access to foreign investments and capital markets").

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 Kroeber, 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”).⁶⁶ 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.⁶⁷ 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.⁶⁸ 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

66. See *China VIE Structure*, *supra* note 44 (discussing the Security Review Circular in the context of recent legislative attacks on the VIE); see also *The People’s Republic Strikes Back? China Issues National Security Review Regulations for Foreign-Funded M&A*, GREENBERG TRAURIG (Feb. 2011), <http://www.gtlaw.com/News-Events/Publications/Alerts?find=148219> (“Nearly five years after issuing the first rules on the subject, and following several years of merger control business concentration filings, on February 3, 2011 the PRC State Council promulgated [the Circular].”).

67. Guowuyuan Bangongting Guanyu Jianli Waiguo Touzizhe Binggou Jingnei Qiye Anquan Shencha Zhidude Tongzhi (国务院办公厅关于建立外国投资者并购境内企业安全审查制度的通知) [Circular of the General Office of the State Council on the Establishment of Security Review System Regarding Merger and Acquisition of Domestic Enterprises by Foreign Investors] (promulgated by the Gen. Office State Council, Feb. 3, 2011, effective Mar. 3, 2011) (China) (“The scope of security review of mergers and acquisitions is the mergers and acquisitions by foreign investors of . . . units concerning national security; and such domestic enterprises as . . . key technologies . . . whose actual control right may be gained by foreign investors.”) (unofficial translation); see *New Review System for Foreign Investor M&A Deals with Domestic Enterprises*, SQUIRE SANDERS (Feb. 2011), http://www.squiresanders.com/new_review_system_for_foreign_investor_m&a_deals_with_domestic_enterprises (stating that the definition of “actual control” under the Circular is extensive, which includes de facto control despite actual equity stake).

68. See Laney Zhang, *China: Security Review Rules on Foreign Mergers and Acquisitions Published*, GLOBAL LEGAL MONITOR (Feb. 25, 2011), http://www.loc.gov/lawweb/servlet/lloc_news?disp3_1205402543_text (discussing the “actual control” test); see also Wang Xing, *Review of Foreign Takeovers Won’t Hurt Investment*, CHINA DAILY (Feb. 17, 2011, 8:01 AM), http://www.chinadaily.com.cn/cndy/2011-02/17/content_12029238.htm (noting confirmation by the National Development and Reform Commission that minority ownership would not trigger 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").⁷⁰ 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*.⁷¹

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."⁷² 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").

71. Shangwubu Shishi Waiguo Touzizhe Binggou Jingnei Qiye Anquan Shengcha Zhidude Guiding (商务部实施外国投资者并购境内企业安全审查制度的规定) [Announcement No. 53 of 2011 of MOFCOM Concerning the Provisions of the MOFCOM for the Implementation of the Security Review System for M&A of Domestic Enterprises by Foreign Investors] (promulgated by the Min. of Com., Aug. 25, 2011, effective Sept. 1, 2011) (China) (emphasis added); see also David Yu et al., *MOFCOM Issues the Official Implementation Provisions on the Security Review Regarding Mergers and Acquisitions of Domestic Enterprises by Foreign Investors*, LLINKS L. OFFICES (Sept. 2011), <http://www.llinks.com/shangchuan/201199130644.pdf> (analyzing the "substance over form" concept in Section 9).

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-u-s> ("[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

73. See Malcolm Riddell, *VIEs: How Foreigners Invest In China's 'Prohibited' Industries—And The New Risks*, CHINA DEBATE (Jan. 26, 2012), <http://www.chinadebate.com/2012/01/vies-how-foreigners-invest-in-chinas-prohibited-industries-and-the-new-risks> (noting that the VIE structure has helped big Internet companies in China to raise “billions of dollars by effectively skirting Chinese regulations that ban foreign investors from acquiring stakes in companies operating in restricted industries”); Gough, *supra* note 58 (arguing that VIE takes advantage of regulatory loopholes).

74. See, e.g., Dickinson, *supra* note 38 (“[I]t 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-d493-11e0-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.⁷⁷ This is a promising sign, indicating that the PRC might soon open more sectors to equity investments from the United States.⁷⁸ A successfully negotiated treaty could entirely eliminate the need for the VIE structure and its associated investment uncertainties.⁷⁹ Having said that, it is too early to tell whether and when such a treaty will come to fruition.⁸⁰ Moreover, even if the two governments eventually reach an agreement, any opening of the restricted sectors will likely occur gradually over time.⁸¹

77. See, e.g., Betsy Bourassa, *U.S. and China Breakthrough Announcement on the Bilateral Investment Treaty Negotiations*, U.S. DEPT. TREASURY (July 15, 2013), <http://www.treasury.gov/connect/blog/Pages/U.S.-and-China-Breakthrough-Announcement.aspx>; see also Annie Lowrey, *U.S. and China to Discuss Investment Treaty, but Cybersecurity Is a Concern*, N. Y. TIMES, July 11, 2013, http://www.nytimes.com/2013/07/12/world/asia/us-and-china-to-discuss-investment-treaty-but-cybersecurity-is-a-concern.html?_r=0 (noting that the BIT may potentially open a vast number of sectors to investments from the other side).

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/b02eea48-00d6-11e3-8294-0ee5075b840d_story.html (expecting the negotiations to be “long and tortuous”).

81. Compare Lester Ross et al., *Prospects for Further Market Access and Protections in China: US-China Bilateral Investment Treaty Developments*, WILMERHALE (Oct. 4, 2013), <http://www.wilmerhale.com/pages/publicationsandnewsdetail.aspx?NewsPubId=10737422352> (emphasizing the significance of the PRC’s willingness to adopt a “negative list” approach, which should afford non-discrimination and other protections of BIT to all sectors, absent negotiated exceptions), with Yu Ran, *FTZ’s “Negative List” Policy to Be Modified*, CHINA DAILY (Nov. 16, 2013, 9:42 AM), http://www.chinadaily.com.cn/business/shanghai-freetradezone/2013-11/16/content_17109879.htm (reporting that the “negative list” approach currently tested in the

D. *Role of the United States Securities and Exchange Commission in Regulating Variable Interest Entities Listed in the United States*

All publicly-held companies in the United States, including VIEs, are subject to the regulation of the SEC.⁸² The SEC was created in wake of the Great Depression by the Securities Exchange Act of 1934.⁸³ Its core mission is “to protect investors,” “maintain fair, orderly, and efficient markets,” and “facilitate capital formation.”⁸⁴ 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.⁸⁵

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.⁸⁶ 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).

82 . See *US Securities and Exchange Commission (SEC)*, DELOITTE, <http://www.iasplus.com/en/resources/regional/sec> (last visited Feb. 26, 2014) (“In the United States, the public capital markets are regulated primarily by the US Securities and Exchange Commission (SEC), a national government agency.”). See generally *The Investor’s Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation* U.S. SEC. & EXCH. COMM’N, <http://www.sec.gov/about/whatwedo.shtml#intro> (last visited Feb. 26, 2014) [hereinafter *The Investor’s Advocate*] (emphasizing the requirement for public companies to file periodic reports with the SEC, which ensures that the investing public have equal and timely access to important corporate information).

83. See Securities Exchange Act of 1934 § 4(a), 15 U.S.C. § 78d (2012) (“There is hereby established a Securities and Exchange Commission”); *The Investor’s Advocate*, *supra* note 82, at 3 (chronicling the historical background in which the SEC was born).

84. See Paul S. Atkins & Bradley J. Bondi, *Evaluating the Mission: A Critical Review of the History and Evolution of the SEC Enforcement Program*, 13 FORDHAM J. CORP. & FIN. L. 367, 368 (2008) (“Historically, the SEC’s mission has focused on investor protection.”); see also *The Investor’s Advocate*, *supra* note 82, at 1 (stating the mission).

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) [t]o 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

Disclosure, a Murky Definition of Material, N.Y. TIMES (Apr. 5, 2011, 5:57 PM), <http://dealbook.nytimes.com/2011/04/05/in-corporate-disclosure-a-murky-definition-of-material> (explaining that public companies in the United States must periodically file reports disclosing all material information with the Securities and Exchange Commission).

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 & CIRESI 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/3232709/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

91. Benjamin Wey, *Avoiding Problems: How to Identify Quality China Based Companies Listed on the U.S. Stock Exchanges*, YAHOO (Feb. 3, 2011), <http://voices.yahoo.com/avoiding-problems-identify-quality-china-based-7702620.html?cat=3> (“China Based Companies with VIE Structures Are the Single Biggest ‘Time Bombs’ in the U.S. Markets”); Shaw et al., *supra* note 57 (quoting an expert’s statement that “this is one of the greatest investment frauds ever perpetrated in the US market”).

92. See generally Stan Abrams, *The VIE Meta-Narrative: Illegal vs. Invalid*, CHINA HEARSAY (Oct. 13, 2011), <http://www.chinahearsay.com/the-vie-meta-narrative> (differentiating the concept of the VIE investment structure being declared illegal and that of particular VIE contracts being unenforceable); Sasser, *supra* note 35 (discussing the regulatory risk of the PRC government’s outlawing the structure and the operational risk of bifurcating ownership and control); Steven M. Davidoff, *Fraud Heightens Jeopardy of Investing in Chinese Companies*, N.Y. TIMES (Apr. 24, 2012, 5:40 PM), <http://dealbook.nytimes.com/2012/04/24/fraud-heightens-jeopardy-of-investing-in-chinese-companies> (noting the two ways a VIE investment could go wrong).

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

foreign parent company only controls the VIE through potentially unenforceable legal agreements, it is possible that the domestic VIE shareholders could breach the agreements and take the VIE and licenses, which would force the parent company to sue to enforce the controversial contracts in PRC and non-PRC courts.”).

96. See Bill Bishop, *Bloomberg Keeps VIE Fears Alive: China Companies Evading Rule With US Listings Stump Regulators*, DIGICHA (Oct. 10, 2011), <http://digicha.com/index.php/2011/10/bloomberg-keeps-vie-fears-alive-china-companies-evading-rule-with-u-s-listings-stump-regulators/> (“[S]o many powerful interests have financial stakes in VIEs that it would be career suicide or worse for a Chinese bureaucrat to destroy this structure on a wholesale basis.”); Fredrik Öqvist, *Consolidating Recent Opinions on VIEs*, CHINA FIN. (Oct. 10, 2011), <http://zhongguojinrongblog.wordpress.com/2011/10/10/consolidating-recent-opinions-on-vies> (“[T]he risk of a general government clampdown on listed VIEs is extremely unlikely . . .”).

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/2012VIEsandtheFutureofInternetRelatedInvestmentinChina5.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.”¹⁰⁰ The announcement prompted Buddha Steel to withdraw from its IPO process on the NASDAQ.¹⁰¹ Practitioners generally view the incident as limited to this locality, and not necessarily reflective of a definitive trend in national policy.¹⁰² Yet, other observers have suggested that the CCP could take a case-by-case approach and effectuate systemic changes in a piecemeal fashion.¹⁰³ 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.¹⁰⁴

(Form 8-K) (Mar. 28, 2011) (“In March 2011, Baosheng Steel was advised by local governmental authorities in Hebei Province of the People’s Republic of China that the Control Agreements contravene current Chinese management policies related to foreign-invested enterprises and, as a result, are against public policy.”).

100. Thomas M. Shoemith, *PRC Challenge to Variable Interest Entity Structures?*, PILLSBURY 2 (Mar. 31, 2011), http://www.pillsburylaw.com/siteFiles/Publications/ChinaAlertPRCChallengeToVIEStructures_03_31_11pdf.pdf (“In March 2011, however, the local government authorities in Hebei Province apparently advised the operating company that the VIE agreements ‘contravene current Chinese management policies related to foreign-invested enterprises and are against public policy.’”); Buddha Steel Inc., Report (Form 8-K) (Mar. 28, 2011).

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., Shoemith, *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).

104. See Yingxi Fu-Tomlinson & Niping Wu, *What the Future Holds for China’s VIE*, KAYE SCHOLER (Sept. 25, 2012), <http://www.kayescholer.com/news/publications/What-the-Future-Holds-for-Chinas-VIE-25September2012> (emphasizing “the underlining vulnerability of the VIE structure when facing regulatory scrutiny in China”); *Who Owns What?*, ECONOMIST, July 7, 2011, <http://www.economist.com/node/18928526> (noting the anxious debate following the Buddha Steel incident).

On the national level, the central CCP leadership has also addressed the use of VIE structures in a few instances.¹⁰⁵ 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.¹⁰⁶ Notably, in a recent pronouncement, the MOFCOM expressly referenced and disapproved of the use of the VIE structure for the first time.¹⁰⁷ 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.¹⁰⁸

2. Validity of the Contracts

Aside from a possible categorical invalidation of the investment structure, US investors could lose their investments if

105. See K&L GATES, *supra* note 12, at 3 (giving an overview of the recent government actions indicating stricter regulation of VIEs); Gao Yuan, *China Approves Wal-Mart Control of Yihaodian*, XINHUANET (Aug. 14, 2012), http://news.xinhuanet.com/english/business/2012-08/14/c_131784990.htm (“Wal-Mart must not engage in value-added services operated by Yihaodian through the variable interest entity (VIE) ownership structure, according to the ministry.”).

106. Cf. *supra* note 102 and accompanying text (discussing the view that the singular provincial government fiat in the Buddha Steel incident likely does not reflect trend in national policy).

107. See Michael Han, *MOFCOM Conditionally Clears Wal-Mart's Acquisition of Yihaodian*, FRESHFIELDS BRUCKHAUS DERINGER (Aug. 30, 2012), http://www.freshfields.com/en/knowledge/MOFCOM_Conditionally_Clears_Wal-Mart_Acquisition_of_Yihaodian/?LangId=2057 (calling the pronouncement “the first time that MOFCOM has explicitly prohibited the use of a VIE structure when imposing a remedy”); Yingxi Fu-Tomlinson & Steven Wright, *MOFCOM's Conditional Approval of Wal-Mart's Acquisition – What Does it Mean for Wal-Mart and Yihaodian and for the Future of the VIE Structure?*, KAYE SCHOLER (Sept. 27, 2012), http://www.kayescholer.com/news/publications/MOFCOMs-Conditional-Approval-of-Wal-Marts-Acquisition-What-does-it-Mean-for-Wal-Mart-and-Yihaodian-and-for-the-Future-of-the-VIE-Structure-27September2012/_res/id=sa_File1/Fu-Wright-China-Legal-Article-09272012.pdf (stating that it was the first time that the MOFCOM has specifically mentioned the use of the structure in a formal ruling).

108. See Gao, *supra* note 105; see also Susan Ning et al., *MOFCOM Approved Wal-Mart's Acquisition of Controlling Stake in Yihaodian But Said NO to VIE Structure*, KING & WOOD MALLESONS (Aug. 20, 2012), available at <http://www.mondaq.com/x/193552/M+A+Private%20equity/MOFCOM+Approved+WalMarts+Acquisition+of+Controlling+Stake+in+Yihaodian+but+Said+NO+to+VIE+Structure> (noting that the MOFCOM imposed the VIE prohibition as one of the three conditions of the acquisition).

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

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

110. See e.g., Evelyn M. Rusli, *Yahoo and Alibaba Resolve Dispute Over Alipay*, N. Y. TIMES (July 29, 2011, 9:26 AM), <http://dealbook.nytimes.com/2011/07/29/yahoo-and-alibaba-resolve-alipay-dispute> (calling the dispute a "simmering feud" that reached "soap opera proportions"); Paul Gillis, *Alibaba and the Disappearing VIE*, CHINA ACCT. BLOG (May 16, 2011), <http://www.chinaaccountingblog.com/weblog/alibaba-and-the-disappearin.html> (noting that the dispute was a "very public spat").

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/SB10001424052748703730804576321030705428022> ("[Alibaba, Yahoo and Softbank] agree the Alipay transfer was done to expedite the company's application for a necessary regulatory license.").

structure.¹¹⁴ Alibaba also asserted that the transfer of Alipay was entirely legal, to which Yahoo did not object.¹¹⁵ The parties eventually reached a settlement without legal proceeding, on terms that left many Yahoo investors sorely disappointed.¹¹⁶

The Yahoo-Alibaba dispute was only one of a series of recent heists that demonstrate the dependency of US investor interests on the managerial fiats or personal affairs of OpCo's PRC owner-manager.¹¹⁷ 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.¹¹⁸ Its stock was

114. See CADWALADER, *Understanding the VIE Structure*, *supra* note 6, at 6 (“[T]he relevant government officials have allegedly stated 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 Spat Over Alipay: Jack Ma Needs to Say More*, FORBES (May 16, 2011), <http://www.forbes.com/sites/gadyepstein/2011/05/16/yahoo-alibaba-spat-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 JP 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).

118. See ChinaCast, *Open Letter from ChinaCast's Board of Directors to Shareholders* (Apr. 2, 2012), *available at* <http://www.prnewswire.com/news-releases/open-letter-from-chinacasts-board-of-directors-to-our-shareholders-145781235.html> (“Ron Chan and a few other executives have chosen to unlawfully resist their terminations by refusing to return key company property, including corporate chops necessary to run the business in China.”); SEC Press Release, SEC Charges China-Based Executives with Fraud and Insider Trading (Sept. 26, 2013), <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539844443#.UwkQpoXJzxM> (“The SEC alleges that ChinaCast Education Corporation's former CEO and chairman of the board Chan Tze Ngon illicitly transferred \$41 million out of the \$43.8 million raised from investors to a purported subsidiary in which he secretly held a controlling 50 percent ownership stake.”).

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.¹²⁴ 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.¹²⁵

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.¹²⁶ 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.¹²⁷ 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.”).

124 . See Fredrik Öqvist, *Who Owns What? Or, Aligning Incentives in VIE Organisations*, CHINA FIN. BLOG (Jul. 19, 2011), <http://zhongguojinrongblog.wordpress.com/2011/07/19/who-owns-what-or-aligning-incentives-in-vie-organisations> (discussing incentive alignment under different OpCo ownership structures); Robert Lewis, *Foreign Investors in China Using the Variable Interest Entity Structure*, LAWYER (Nov. 11, 2011), <http://www.thelawyer.com/foreign-investors-in-china-using-the-variable-interest-entity-structure/1010207.article> (suggesting strategies to minimize risks of misaligned incentives).

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.thecorporatetreasurer.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

128. Zhonghua Renmin Gongheguo Hetongfa (中华人民共和国合同法) [Contract Law of the People’s Republic of China] (promulgated by the Second Sess. of the Ninth Nat’l People’s Cong., Mar. 15, 1999).

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, 2013), <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.¹³⁴ 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.¹³⁵ In practice, though, the PRC may be the only jurisdiction for a US investor to sue the OpCo or its owner-manager.¹³⁶ It seems that choice of law provisions are inconsequential in VIE agreements, and that these contracts are always governed by PRC law.¹³⁷ 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.¹³⁸ This is certainly true when such judgment contravenes the PRC law or public policy.¹³⁹

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.¹⁴⁰ First, if the CCP declares the VIE structure per se illegal, then the contracts that make up the structure would be void.¹⁴¹ 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.¹⁴² Third, the PRC courts are known for their lack of judicial independence.¹⁴³ As the PRC central authority continues

138. See Dan Harris, *Suing Chinese Companies In US Courts. The Pros And The Cons*, CHINA L. BLOG (Jun. 27, 2011), <http://www.chinalawblog.com/2011/06/suing-chinese-companies-in-us-courts-the-pros-and-the-cons.html> (“US judgments have virtually no value in China.”); Peter Thorp & Huawei Sun, *Arbitration Guide ei Sun*, INT’L BAR ASSOC. 1 (Feb. 2012), <http://www.ibanet.org/Article/Detail.aspx?ArticleUid=a646cf32-0ad8-4666-876b-c3d045028e64> (“[F]oreign court judgments are very difficult to enforce in the PRC due to a lack of mutual enforceability treaties with other countries.”).

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.¹⁴⁴ As a result, lawyers have almost never sought to enforce VIE contracts in a PRC court.¹⁴⁵

Instead of bringing a lawsuit, US investors might pursue alternative dispute resolution methods, such as arbitration.¹⁴⁶ 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.¹⁴⁷ Indeed, in the two recent

Blanchard, *China's Top Court Urges Judicial Independence, End to Interference*, REUTERS (Oct. 29, 2013), <http://www.reuters.com/article/2013/10/29/us-china-courts-idUSBRE99S0HB20131029> (“China must rid its courts of corruption and stop officials interfering in decisions, a paper on reforms by the top court said on Tuesday, referring to a judicial system that answers to the Communist Party and almost never sides with defendants.”).

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.’”).

146. See Weixia Gu, *Arbitration in China*, in *INTERNATIONAL COMMERCIAL ARBITRATION IN ASIA 77* (Shahla Ali & Tom Ginsburg eds., 3d ed. 2013), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2263058 (“Litigating cross-border business disputes in [the PRC’s] national courts poses various problems and uncertainties . . . Arbitration is today regarded as an indispensable tool designed to afford parties engaged in international trade and investment the requisite of certainty and confidence that rightly demand for dispute resolution in the international transactions.”); Terence Tung, *Commercial Arbitration in the People’s Republic of China*, MAYER BROWN (Jan. 19, 2010), <http://www.mayerbrown.com/publications/Commercial-Arbitration-in-the-Peoples-Republic-of-China-01-19-2010> (“The [PRC] now conducts more arbitrations than any other country and has become of one the most important places for commercial arbitrations in the world.”).

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,

<http://www.mondaq.com/x/250690/international+trade+investment/Recent+Concerns+on+Foreign+Investment+and+VIE> (concluding from the two arbitration cases that VIE contracts adopted to get around the PRC's FDI restrictions or prohibitions could be invalidated by either the court or the arbitration tribunal); Paul Gillis, *Is It Safe to Go Back in the Water?*, CHINA ACCOUNTING BLOG (June 7, 2013, 6:54 PM), <http://www.chinaaccountingblog.com/weblog/is-it-safe-to-go-back-in.html> (“[N]o one has ever succeeded in enforcing the agreements[,] and every time it has come before a judge or arbitrator[,] the agreements have been found invalid.”).

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.”); *New York Convention Countries*, N.Y. ARB. CONV, <http://www.newyorkconvention.org/contracting-states/list-of-contracting-states> (last visited on Feb. 24, 2014) (identifying China as a contracting country to the New York Convention since 1987).

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=f96e8738-5cfe-4e39-8d1d-7a6dbbfd4c21> (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

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=a9d30374-f27f-4be7-84b8-2a3772ee84cf> ("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).

155. 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. They are

creation is expected to produce inadequate results.¹⁵⁶ 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.¹⁵⁷ Additionally, there is little reason to expect that the PRC would help recoup US investment losses or cooperate with US regulators.¹⁵⁸ Second, the market is unlikely to self-correct in time because there is an inherent conflict of interest.¹⁵⁹ 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.¹⁶⁰ Third, the regulatory efforts to date are limited and insufficient.¹⁶¹

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.¹⁶² Both became popular by enabling these businesses to access the US capital markets.¹⁶³ Both involve legal structures and financial jargon that are atypical among public companies and confusing to the general public.¹⁶⁴ Both generate handsome profits for the professionals involved in the transactions.¹⁶⁵ Both exist in a near “regulatory vacuum” between the United States and the PRC.¹⁶⁶ Most importantly, both have caused, or have the potential to cause, substantial losses to even sophisticated institutional investors who are

162. See Nanette Byrnes & Lynnley Browning, *Special Report: China’s Shortcut to Wall Street*, REUTERS (Aug 1, 2011), <http://www.reuters.com/article/2011/08/01/us-shell-china-idUSTRE7702S520110801> (explaining reverse merger transactions which enable PRC companies to list in the US). *But see* Brendan Conway, *Chinese Structure for Tapping U.S. Markets Draws Scrutiny*, WALL ST. J. (Sept. 28, 2011, 1:16 PM), <http://online.wsj.com/news/articles/SB10001424052970204138204576598843235826866> (noting a key distinction between the VIE and reverse merger issues).

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).

164. See Hardy Zhu, *Complex Structures for Investing in China*, MATTHEWS ASIA (Sept. 2012), <http://matthewsasia.com/perspectives-on-asia/asia-insight/article-560/default.fs> (noting that PRC-based VIE entities have complex corporate legal structures); David Barboza & Azam Ahmed, *Muddy Waters Research is a Thorn to Some Chinese Companies*, N.Y. TIMES (June 9, 2011, 9:20 PM), <http://dealbook.nytimes.com/2011/06/09/muddy-waters-research-is-a-thorn-to-some-chinese-companies> (“[T]he Securities and Exchange Commission warned about the potential risks of investing in reverse-merger companies, including murky financials and complicated ownership structures.”).

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.¹⁶⁷

The SEC should look to past practices and issue a similar warning it used to address the risks related to reverse merger.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.¹⁶⁹ The announcement prompted immediate discussion and attention in the financial press.¹⁷⁰

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

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, *Fraud Prevalent in Reverse Merger Companies with Operations in China*, BALLARD SPAHR LLP (July 8, 2011), http://www.ballardspahr.com/AlertsPublications/Articles/2011-07-08_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 damages with no recourse) that the old adage 'buyer beware' is particularly true.").

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, *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.").

169. See SEC OFFICE OF INVESTOR EDUC. & ADVOCACY, INVESTOR BULLETIN: REVERSE MERGERS (June 2011), <https://www.sec.gov/investor/alerts/reverse-mergers.pdf>; SEC Press Release, SEC Issues Bulletin on Risks of Investing in Reverse Merger Companies (June 9, 2011), <https://www.sec.gov/news/press/2011/2011-123.htm> [hereinafter INVESTOR BULLETIN] ("The Investor Bulletin explains the reverse merger process, describes the potential risks of investing in reverse merger companies, and details some of the recent enforcement actions that the agency has brought against reverse merger companies.").

170. See e.g., Azam Ahmed, *S.E.C. Issues Warning About Reverse-Merger Stocks*, N.Y. TIMES (June 9, 2011, 2:42 PM), <http://dealbook.nytimes.com/2011/06/09/s-e-c-issues-warning-about-reverse-merger-stocks>; Michael Rapoport, *Regulators Warn Investors on 'Reverse-Merger' Companies*, WALL ST. J. (Jun. 10, 2011), <http://online.wsj.com/news/articles/SB10001424052702304259304576375773471908358>; Joshua Gallu, *'Reverse-Merger' Stocks May Be Prone to Fraud, Abuse, SEC Says in Warning*, BLOOMBERG NEWS (Jun. 9, 2011, 2:26 PM), <http://www.bloomberg.com/news/2011-06-09/reverse-merger-stocks-may-be-prone-to-fraud-abuse-sec-says-in-warning.html>.

examples of VIE-related risk disclosure language found in the SEC filings.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.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.¹⁷³ Based on prior experience, the SEC may expect the proposed announcement to draw the immediate attention of the media.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.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

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).

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.”).

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).

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).

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.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.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.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.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.¹⁸⁰ First, the SEC should

176. See *supra* note 89 and accompanying text (indicating that the current state of VIE risk disclosure is inadequate).

177. 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); Gillis, *supra* note 88 (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); *e.g.*, *supra* note 5 (regarding the Sina and RenRen 2013 annual reports, liberally referring to “our China operations” and “our products and services” as if the OpCo is owned by the ListCo).

178. See, *e.g.*, HARVEY L. PITT, SEC ORAL TESTIMONY: ACCOUNTING AND INVESTOR PROTECTION ISSUES RAISED BY ENRON AND OTHER PUBLIC COMPANIES (Mar. 21, 2002), available at <http://www.sec.gov/news/testimony/032102oralshlp.htm> (stating that “disclosure by public companies must be truly informative and timely”, “full and fair”); Sarbanes-Oxley Act of 2002, Pub.L. 107–204, 116 Stat. 745 (codified as amended in scattered sections of 15, 18, 28, and 29 U.S.C.) (proclaiming the overarching objective of the Act as “[t]o protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes”).

179. See Mary Jo White, Chair, SEC, Speech at the National Association of Corporate Directors Leadership Conference 2013, The Path Forward on Disclosure (Oct. 15, 2013), available at <http://www.sec.gov/News/Speech/Detail/Speech/1370539878806#Uwn6XIXJzxM> (discussing the problem of information overload rendering disclosure ineffective and the directions of future reform based on past efforts). See generally Arthur J. Radin, *Have We Created Financial Statement Disclosure Overload?*, CPA J. ONLINE, Nov. 2007, <http://www.nysscpa.org/cpajournal/2007/1107/perspectives/p6.htm> (arguing that the excessively long financial statement disclosures are counterproductive and worrisome).

180. See Letter from Daniel M. Gallagher, Commissioner, US Securities and Exchange Commission, to the SEC Staff (Feb. 21, 2014), available at <http://www.sec.gov/News/Speech/Detail/Speech/1370540834506#UwoHf4XJzxM> (urging the SEC to take on such critical projects as reviewing corporate disclosure regime in

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

2014); *supra* note 179 and accompanying text (suggesting that current risk disclosure practice is ineffective and requires reform).

181. See SEC, A PLAIN ENGLISH HANDBOOK: HOW TO CREATE CLEAR SEC DISCLOSURE DOCUMENTS 49 (Aug. 1998) [hereinafter PLAIN ENGLISH HANDBOOK] (noting that boldface text is common in disclosure documents); PLAIN LANGUAGE ACTION & INFO. NETWORK, FEDERAL PLAIN LANGUAGE GUIDELINES 88 (May 2011), <http://www.plainlanguage.gov/howto/guidelines/FederalPLGuidelines/FederalPLGuidelines.pdf> (“Use bold and italics to make important concepts stand out.”).

182. See PLAIN ENGLISH HANDBOOK, *supra* note 181, at 16 (advising drafters of disclosure documents to look through investors’ eyes in deciding where to place information); Radin, *supra* note 179 (“If a company today wanted to hide information, but technically be protected, what better place to hide it than in the footnotes to the financial statements or in the risk factor and operations sections of the 10-K? This is exactly what happened in the case of Enron.”).

183. See *supra* Part III.A–B (discussing the two recommendations).

184. See Richard Pearson, *Looking at Chinese VIE’s*, FORBES (Oct. 18, 2012, 1:39 AM), <http://www.forbes.com/sites/richardpearson/2012/10/18/looking-at-chinese-vies/> (“If the SEC were to take broader action against all VIE structures, presumably they would have to deal with the same implications as the Chinese government, namely that the number of companies and the market value that they represent are enormous. Any broad based action would cause an immediate and very substantial dislocation in the markets.”); Simon Rabinovitch, *Appetite for US-listed Chinese Stocks Transcends Audit Dispute*, FIN. TIMES (Feb. 11, 2014, 2:39 PM), <http://www.ft.com/intl/cms/s/0/f2d07dbe-9314-11e3-8ea7-00144feab7de.html#axzz2rqPiReYw> (noting that investors are not usually known for their long memories, and though US-listed PRC companies were an endangered species due to exposed fraud after fraud not too long ago, their stocks have rebounded and the market has reopened to new listings).

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.