CHINA’S LEAKED CSRC REPORT FIVE YEARS LATER: BASELINE FOR VIE TRAJECTORY?

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I. INTRODUCTION

Over the course of the past decade, the investment vehicle known as the Variable Interest Entity (VIE) has increasingly become a focus of controversy regarding U.S.-listed Chinese firms. While the VIE structure—commonly known in China as the “Sina-structure”—was historically used as a vehicle for tax evasion by U.S. companies, it has become popularized in its current form as a means to penetrate China’s more restricted industries.¹ The structure essentially capitalizes on an accounting workaround, which allows one party to acquire controlling interest over another, without the assumption of equity ownership.² A foreign parent company can thereby secure de facto control over a Chinese domestic company, the VIE, based solely on the presence of a contractual relationship. In doing so, the parent company may indirectly absorb the dividends of the VIE, and thus consolidate the VIE into its accounting reports.³ The significance, however, is that once consolidated, the parent company gains the ability to list on U.S. markets, which effectively lists the Chinese company by extension.⁴

¹ See Sally Bee & Wang He, Legal Risks of the VIE, CHINA L. & PRAC., June 2011. China produces a Foreign Guidance Catalogue delineating which industries the government will designate into one of three categories: encouraged, restricted, or prohibited. Id. VIEs help foreign investors access restricted and prohibited industries that are otherwise subject to a greater level of governmental scrutiny and ownership limitations for foreign parties. Id.


³ Thomas A. Gavin, Update on Consolidation of Variable Interest Entities, BANK ACCT. & FIN., Aug.-Sept. 2010, at 10, 15-16 (2010). If a parent company determines that one of its assets qualifies as a VIE, and that it, too, is the primary beneficiary—i.e., the entity that will bear the majority of expected losses and receive the majority of expected benefits—of the VIE, then, under the principles of U.S. Generally Accepted Accounting Principles (GAAP), it is required to consolidate the assets and liabilities of the VIE into its accounting reports. See id. at 18.

⁴ While the introduction of FIN-46 and FIN-46R by the GAAP was meant to improve financial reporting practices and promote corporate transparency, it unintentionally opened a backdoor for Chinese companies to list on U.S. markets. See id. at 10-11 (examining the intended use of FIN-46 and FIN-46R in identifying controlling
Given that the VIE structure allows both foreign and domestic companies to effectively flaunt China's legal regime regarding cross-border transactions and foreign investment, one might have presumed the invalidation of such a mechanism long ago. However, VIEs created quite the catch-22 for Chinese authorities. Although this structure promotes the evasion of compliant trade practices, VIEs encourage a considerable influx of Foreign Direct Investment (FDI) and foster the success of numerous Chinese startups abroad. In fact, over 42 percent of Chinese companies listed on U.S. markets as of 2011 were thought to operate using the VIE structure. Given the VIE’s prevalence, the Chinese government has shown a great deal of reluctance in quashing the VIE outright, as the fallout would likely consist of considerable economic repercussions.

A landmark Draft Foreign Investment Law (“Draft”) promulgated in January 2015, however, foreshadowed a dramatic shift, if not the complete cessation, of VIE practice. The Draft intimated a number of potential regulatory changes that could mean the closing of loopholes upon which the VIE structure depends. Even more worrisome, neither the Draft nor the pertinent regulatory bodies chose to comment on the repercussions of such changes for current VIE-structured companies, particularly foreign-controlled VIEs operating in China.

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5. See Bee & He, supra note 1 (discussing various ways the VIE structure can be used to bypass China’s foreign trade and investment laws).


7. See Shen, supra note 2, at 531.

8. See Man, supra note 6, at 218-19.

9. See id. at 219 (looking at the considerable consequences that the Draft might have for VIEs if enacted in its current form).

10. See David Zhang et al., Draft Foreign Investment Law Proposes Fundamental Changes to the PRC Foreign Investment Regime, KIRKLAND & ELLIS 2-3 (Feb. 2015), https://www.kirkland.com/siteFiles/Publications/Alert_02092015.pdf (looking at potential approaches to address the VIE structure employed by businesses).
restricted and prohibited Chinese industries.\footnote{See id. at 1-2 (describing how the Draft leaves the legality of the VIE structure in currently prohibited or restricted industries in a grey area, alluding only to the publication of a new “Negative” list of industries which would be categorized as restricted or prohibited).} Given the considerable amount of investment tied up in this ambiguous structure, it is essential to define the legal standing and likely trajectory of VIEs.

In light of the Draft, this comment evaluates the potential courses of regulatory action to help determine what will be the most likely outcome for the VIE structure. Specifically, this comment seeks to show that the regulatory actions taken to date are consistent with the notorious “CSRC Leaked Report” (“CSRC Report”), a blueprint on VIE removal leaked by the Chinese Securities and Regulatory Commission (CSRC) in 2011. Once established, this baseline will help distill possible government policy regarding the VIE vehicle, which, in turn, will allow for a more accurate assessment of the VIE’s ultimate prospects.

Given the evidence, this comment finds that the Chinese government has been actualizing the strategy set forth in the CSRC Report with regard to VIE dissolution. In this vein, government policy, by employing a carrot-and-stick strategy,\footnote{The reference to a carrot-and-stick strategy is taken from the CSRC’s leaked report, which advocated a “lead-and-block” strategy in terminating the VIE. Asiaweb Translates Leaked China CSRC Document, GLOBAL CAP. (Nov. 17, 2011), http://www.globalcapital.com/article/k3blsbgd/srmm/asiaweb-translates-leaked-china-csrc-document.} has been gradually and progressively phasing the VIE out of practice. If true, it can be extrapolated that any eventuality with regard to the Draft and VIE practice will likely comport with this regulatory design and, therefore, that foreign investors should anticipate People’s Republic of China (PRC) government actions tailored to this end.

The remainder of this paper is organized as follows. Part II is an overview of the structural ins-and-outs of the VIE vehicle. Part III reviews the regulatory trajectory of the VIE to date. Part IV introduces the notorious leaked CSRC Report of 2011 and provide the blueprint with which to compare subsequent regulatory actions of the PRC government. Part V analyzes both the legal environment and regulatory climate of VIE practice to
demonstrate its adherence to the CSRC Report. Finally, Part VI concludes this comment.

II. OVERVIEW OF THE VIE STRUCTURE

A. VIE Practice in Context of China

In short, the VIE structure is a chain of contractual agreements whereby nonvoting de facto control is assumed over an operating company—the VIE—by a parent company, typically for the exploitation of specific strategic, financial, or political benefits.13 Once contractual control has been assumed over the operating company, future benefits received by the entity are then enjoyed by the parent company as “variable interests.”14 In the case of U.S.-listed companies, these variable interests are required to be consolidated into the company’s financial statements to discourage accounting fraud and duly promote transparency.15

This de facto control is particularly pertinent to China because of the considerable red tape observed in the PRC’s more restricted industries—most notably telecommunications and e-commerce.16 The web of agreements constructed by the VIE acts to effectively mimic ownership, thus allowing for the assumption


of foreign control, while, at the same time, still abiding by China’s ban on foreign ownership. And thus, instead of outright defiance of the law, the brilliance behind the VIE structure lies within the pseudo-ownership captured in its creative compliance.

B. Breakdown of the VIE Structure

The VIE structure—which for the remainder of this paper will be specific to VIE practice in China—was created almost exclusively to circumvent the foreign limitations in China’s more restricted industries. The sensitivity of these more restricted industries required a creative yet sophisticated model both to comply with the law and to avoid regulatory friction. The following section provides an overview of the elements necessary to form a VIE structure.


18. See id. at 279-80 (detailing the use of wholly foreign-owned enterprises (WFOEs) to establish corporate control that would otherwise be unachievable under current Chinese law).

19. In the context of this Comment, “China” will refer to Mainland China, excluding its special administrative regions (i.e., Hong Kong and Macau).

As indicated in the diagram, the VIE structure can be viewed as a series of steps:

- **Step 1: The Offshore Holding Company.** Chinese, or Chinese and foreign, investors form an offshore holding company, usually in the Cayman Islands or British Virgin Islands for tax preferences, often with the intention of listing on a U.S. stock exchange.

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• **Step 2: Hong Kong Subsidiary.** (Optional and not featured on the above diagram) The Offshore Company creates a 100 percent owned subsidiary in Hong Kong to act as a legal buffer as well as an entry point into China.\(^{24}\)

• **Step 3: Onshore Foreign Invested Enterprise.** The subsidiary in Hong Kong, or the parent company directly, establishes a wholly foreign-owned enterprise (WFOE)—a type of foreign-invested enterprise (FIE) in which the foreign party owns 100 percent of the Chinese company—in Mainland China. The WFOE acts as the VIE’s last link of the chain with actual equity ownership.\(^{25}\)

• **Step 4: Onshore Domestic Operating Company.** The Chinese shareholders that created the initial offshore company also create a domestic operating company (OpCo).\(^{26}\) Through a series of contractual
agreements, the profits and voting rights are thereby transferred unto the WFOE; in practice, this essentially makes the OpCo an extension of the WFOE.\textsuperscript{27}

\textbf{Financing:} (i) Chinese, and possibly foreign, investors form an offshore company; (ii) next, the offshore company creates a subsidiary in Hong Kong; (iii) the Hong Kong subsidiary makes a capital contribution to the WFOE; and (iv) finally, the WFOE provides the necessary capital, typically as a loan from its converted registered capital, for the creation and/or expansion of the Domestic Operating Company.\textsuperscript{28}

\textbf{Profits:} (i) The OpCo makes a profit from its respective business; (ii) the OpCo transfers the profits to the WFOE via a series of contractual arrangements meant to absorb all earnings made, effectively shifting the profit in the form of a business transaction; (iii) next, the WFOE makes a dividend distribution to the Hong Kong subsidiary; and (iv) finally, the Hong Kong subsidiary makes a dividend distribution to the Offshore Holding Company, thereby completing the circuit.\textsuperscript{29}

If tailored properly, this contractual construct will ensure the offshore parent’s ability to maintain \textit{de facto} control as well as safely and efficiently transfer the VIEs profits to the WFOE.\textsuperscript{30}

However, in the end, contractual control still pales in comparison holding the licenses to engage in business within the prohibited industry. \textit{Id.} at 2.

27. In a typical VIE paradigm, two sets of contracts are used to fasten the entities: the first set of contracts acts as a controlling mechanism to prevent the VIE from going rogue (e.g., Equity Pledge Agreement, Call Option Agreement, Voting Rights Agreement); the second set of contracts acts as a cash extraction mechanism to absorb all of the OpCo’s profits (e.g., Loan Agreement, Consulting and Service Agreement, Asset License Agreement). For a description of the various agreements necessary for the formation of the VIE, see Wei, \textit{supra} note 17, at 279-280.

28. \textit{See id.} at 281-82 (looking at the setup of the “round-trip investment” model, a variation of the VIE structure, used by Chinese investors for various tax, regulatory, and legal purposes).

29. \textit{Id.} at 280; see also Xianwu & Lihui, \textit{supra} note 23 (detailing the structure of contracts and cash flows in a VIE).

30. \textit{See Wei, supra} note 17, at 280 (noting that commercial contracts can help the WFOE capture both profits and control over shareholders in the operating company); see also Xianwu & Lihui, \textit{supra} note 23 (asserting that the WFOE may be able to control the operating company through contractual arrangements as though it directly owned the equity interests).
to equity ownership in terms of providing investor security. Despite a meticulously planned contractual leash, an unhappy shareholder or member of the OpCo’s management can bring the VIE structure to its knees if pressure is applied at the right point.\textsuperscript{31} Even in light of several high-profile scandals, however, the VIE continues to be a prevailing market practice for foreign investment.\textsuperscript{32}

III. Trajectory of the VIE Structure in China

A. VIEs Have Provided a Necessary Safety Valve

Given the long-standing legacy of VIE employment in China, the conspicuous absence of a regulatory regime has been widely interpreted as evidence of tacit government approval.\textsuperscript{33} However, both the VIE structure and the lucrative loophole that it creates should have, theoretically, been invalidated long ago. Yet China, through its regulatory rhetoric and actions, has continued to avoid taking a firm position on VIE legality.\textsuperscript{34} The obvious question should then be, “Why?”

The likely answer, most concur, is money—the VIE structure has allowed China’s government proverbially to have its cake and eat it too. VIEs have long facilitated an influx of FDI during a period when China’s liberalization policies would not have otherwise supported it.\textsuperscript{35}

\textsuperscript{31} See generally Xianwu & Lihui, supra note 23 (observing the difficulties that a WFOE may face if an unhappy domestic company chooses not to comply with the drafted contracts).

\textsuperscript{32} See id. (reflecting the establishment of VIE structures by over 100 companies despite the catastrophic backlashes Agria Corporation and GigaMedia received after trying to replace the CEOs of the OpCos); see also Fredrik Öqvist, ZTO’s Unusual VIE, CHINA ACCT. BLOG (Oct. 26, 2016, 8:59 PM), http://www.chinaaccountingblog.com/weblog/ztos-unusual-vie.html [http://perma.cc/9HAX-FWTA] (describing how the VIE structure is still a common way to IPO for U.S.-listed Chinese companies in 2016).

\textsuperscript{33} Xianwu & Lihui, supra note 23; Schindelheim, supra note 16, at 209.

\textsuperscript{34} Since the first adoption of the VIE structure in 2000, China’s government has, to date, avoided the use of any explicit or definitive rhetoric which might deny or confirm the legitimacy of the VIE structure. Man, supra note 6, at 218-19; see also Schindelheim, supra note 16, at 223-25 (discussing how the government’s lack of clarity on the regulatory standing of the VIE structure has been interpreted by commentators as an unwillingness to terminate the VIE).

\textsuperscript{35} See Dinny McMahon & Owen Fletcher, China Studies Foreign IPOs, WALL ST.
In line with this premise, legal scholars have contended that PRC authorities have intentionally remained vague regarding VIEs and related legislation as part of a calculated regulatory strategy. By maintaining a substantial level of legal uncertainty, the government is allowed to selectively advance China’s economy through the evaluation of foreign investment on an industry specific, and even case-by-case, basis. Effectively, the VIE structure therein became a government safety valve of sorts, which permits the occurrence of certain extra-market activities, such as foreign investment in restricted and prohibited industries, while retaining ultimate discretionary powers with China’s regulators. This has allowed China to benefit from the entrance of foreign capital, management expertise, and technological transfer, without threatening the Chinese Communist Party’s (CCP) control of industry development.

B. Tide is Turning Against VIEs

It is perhaps due to the combination of overuse and misuse, in tandem with an evolving regulatory landscape, that the VIE has become an overwhelming focus of both domestic and international concern. Domestically, the VIE is not seen as the fiscal necessity that it once was. As China’s economic role shifts from one of FDI importing to one of FDI exporting, Chinese
companies no longer have to rely on the capital provided by foreign markets. In fact, following the financial crisis of 2007, many Western countries are now looking more toward China for capital, rather than vice-versa. Instead, foreign investment today is often seen as a contributing factor in inflation, trade imbalance, and illegal activity.

In line with this progression, the once pro-foreign investment landscape has also begun to turn, with many foreign multinationals complaining of increasing hostility and a more protectionist regulatory environment. As a result, many foreign-invested firms have begun to question the regulatory standing of the VIE structure. This development in conjunction with the potential for corporate hijacking have all led to an increasing stigmatization of VIE adoption in mainland China.

Internationally, VIEs have also received an increasingly negative reception. The numerous accounting scandals of Chinese-listed firms have resulted in a significant increase in SEC scrutiny for many VIE-structured companies. As VIEs are tailored to operate in a veiled manner, their inherent circumventive nature has made them a particular target of


41. Shen, supra note 2, at 536-37.

42. Many developed countries, including the European Union, looked to China for bailout funding during the recession, thereby illustrating the shift in roles regarding FDI importing and exporting. Id. at 536-37.

43. Id. at 537 (noting that harsher policies towards foreign investment have led to complaints from foreign companies).

44. Id. (arguing that the tide of government opinion in China has turned against the VIE structure in recent years).

regulatory focus.\textsuperscript{47} Essentially, VIEs have faced a crisis of integrity in foreign markets, often resulting in downturned stock prices,\textsuperscript{48} disheartened potential investors,\textsuperscript{49} and numerous delistings.\textsuperscript{50}

In turn, the SEC has put increasing pressure on China to better regulate its business and accounting practices, but rather than serving to address the situation, this pressure has instead created a point of political tension between United States and Chinese regulators.\textsuperscript{51} Furthermore, in addition to the blowback of SEC scrutiny, the welfare of Chinese-listed firms on foreign markets has been equally vulnerable to actions made by China’s regulators. Each time China signals toward potential VIE restriction, the confidence of the foreign investment community becomes shaken, and the stocks of foreign-listed Chinese companies tumble in turn.\textsuperscript{52} As such, the VIE structure is increasingly seen as a significant liability by practitioners and government regulators on both sides of the fence.

\textbf{C. Draft Foreign Investment Law}

Against this backdrop, the PRC Ministry of Commerce (MOFCOM) issued the Draft Foreign Investment Law for public
comment in January 2015. Among other noteworthy features, the Draft was seen as the first instance of official government recognition of the VIE vehicle after 15 years of inaction. Specifically, the Draft circumscribes the concept of *de facto* control, and emphasizes that the new Foreign Investment Law will take a substance-over-form approach in determining whether an entity will be deemed an FIE or a PRC domestic company. In doing so, the new law defines “control” to mean, among other variations, “the ability to exercise decisive influence over a company by way of contractual or trust arrangements.” This language, with its allusion to control via contractual arrangements, is seen as specifically targeting the mechanism by which the VIE operates.

Disappointingly, the Draft does not expound on what will happen to companies currently employing the VIE structure. Instead, Article 158 of the Draft, titled “Treatment of Contractual Control,” merely directs attention to the Explanatory Notes that were published alongside the Draft. In these notes, MOFCOM mentions three possible courses of action regarding currently VIE-structured companies:

- **Approach One: Notice Filing.** FIEs with a VIE structure that are controlled by PRC individuals would file a notice with the appropriate regulatory authority.

- **Approach Two: Certification Application.** FIEs with a VIE structure would apply to the appropriate regulatory authority.

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54. Draft Foreign Investment Law, arts. 11, 12, 18; Zhang et al., *supra* note 10, at 2.

55. Draft Foreign Investment Law, art. 18; Man, *supra* note 6, at 219.

56. See Man, *supra* note 6, at 219 (noting that the specific wording of the Draft is intended to expose foreign control of any entity previously designated as a Chinese domestic company).

57. Draft Foreign Investment Law, art. 158; Zhang et al., *supra* note 10, at 3.

regulatory authority for affirmative certification that it is in fact controlled by PRC individuals.60

- **Approach Three: Market-entry Review.** FIEs with a VIE structure would apply to the appropriate regulatory authority for a full market-entry review that would be determined on a case-by-case basis depending on the entity’s ultimate controlling investors.61

However, while the Explanatory Notes provide possible outcomes of currently VIE-structured entities, they still leave questions unanswered. For a company with an existing VIE structure that is under *de facto* control of one or more foreign investors, substantial uncertainty remains as to (i) whether the company will be operating in a restricted industry after promulgation of the new Foreign Investment Law, (ii) how the conditional approval of the market-entry review will actually be conducted, and (iii) whether the final Foreign Investment Law will include a blanket “grandfather” provision or grace period in which to collapse the structure.62 While currently only a draft, and thus liable to change, the conspicuous void with regard to foreign controlled VIEs has created a great deal of anxiety.63

In conjunction, the PRC National Development and Reform Commission (NDRC) is currently working on its own draft foreign investment law.64 Hence, any final Draft will require consolidation of two documents penned by separate and powerful government bodies.65 With this in mind, practitioners posit that the final Draft to be submitted to China’s National People’s

60. *Id.*

61. *Id.* at 2-3.


63. See *id.* at 2-3 (noting the concerns that have been sparked due to the proposed changes regarding the validity and sustainability of VIEs).


65. *Id.*
Congress will likely deviate from the Draft’s current language. The pertinent question, therefore, becomes: what will be the most likely trajectory of the VIE vehicle in light of these anticipated changes.

D. Potential Regulatory Trajectories

Outright termination of the vehicle does not seem feasible, given the considerable ripple effect that would likely be observed. As VIE-structured companies continue to flourish, the welfare of China’s economy has become increasingly tied to the sustainment of VIE practice. The widespread adoption of the VIE structure by so many PRC companies has thus created, via inertia, its own form of insurance policy. The inverse approach —i.e., attempting to give credence to the VIE structure via legal legitimization—would be in direct conflict with many of the aforementioned laws, thereby also making it an unlikely course of action. Attempting to maneuver such a shift in policy would likely attract mass criticism from foreign pundits, who would duly impeach the integrity of China’s already suffering legal reputation.

66. Id.
67. Chen et al., supra note 62, at 3; Man, supra note 6, at 219.
68. See Schindelheim, supra note 16, at 219-20 (noting that the considerable investments wrapped up in the VIEs are part of the reason why the Chinese government has intentionally remained vague with regards to the VIE practice).
70. See Wei, supra note 17, at 579 (describing how the Chinese government is so intertwined with the VIE structure that any attempt to legalize is not a likely course of action because it would be a direct conflict of interest); Charles Comey et al., China’s VIE’s: Recent Developments and Observations, MORRISON & FOERSTER 1-2 (Aug. 15, 2013), http://www.mofo.com/files/Uploads/Images/130716-Variable-Interest-Entities-China.pdf [http://perma.cc/5B99-3H6U] (discussing the negative impact of the ChinaChem and CIETAC decisions on investors due to the lack of guidance from the Supreme People’s Court concerning VIE enforcement).
71. See Man, supra note 6, at 221-22 (describing how PRC law has suffered with regard to its “dignity and credibility” because of the regulatory approach to the VIE
These constraints will likely force regulators to operate in a more regulatory neutral capacity, which, to date, has generally been the status quo.\textsuperscript{72} Through extrapolation, however, one might see the underlying trend encouraging the future dissolution of VIE practice altogether. In continuing to limit VIE parameters through additional regulations, the government has directed the evolution of VIE usage by progressively circumscribing it, and duly encouraging a gradual phasing out policy.\textsuperscript{73} In addition, the government has also introduced an increasing number of reform policies that would effectively negate the impetus behind VIE practice in China, thereby making the structure redundant.\textsuperscript{74} This comment thus surmises that the Chinese government, in dealing with the VIE structure, has been actualizing the regulatory strategy set forth in the 2011 Leaked CSRC Report tantamount to a “carrot-and-stick” approach. Essentially, this is a strategy whereby China’s government, over time, uses incentives and disincentives to increasingly make the VIE a less appealing investment prospect, thereby letting it peter out organically. To date, the CSRC Report is the only substantive source in which the PRC government takes a comprehensive position on the subject of VIE practice.\textsuperscript{75} As such, it is one of the only authorities that gives insight into the regulatory disposition of the PRC government on such an important and ubiquitous topic.\textsuperscript{76}

IV. CSRC REPORT OF 2011

Often associated with the finer nuances of politics, a “leaked” report can provide the public with insight into the regulatory environment of the machine at work, while at the same time offering no “official” statement, thus remaining seemingly

\begin{footnotesize}
\begin{enumerate}
\item See id. at 221 (describing how regulatory agencies have traditionally ignored problematic VIE structures for policy purposes).
\item For a deeper analysis, see infra Part V.
\item See infra Part V.
\item See Man, supra note 6, at 218-19 (describing how the PRC government has staunchly avoided the topic of VIE practice).
\item See id.
\end{enumerate}
\end{footnotesize}
neutral. As such, a leak can offer a hint with regard to potential shifts in practices, and, in turn, allow the entity in question to gauge public opinion and tune its policies accordingly. In 2011, the CSRC Report was leaked to four different law firms in China. The Report directly targeted the use of the VIE investment vehicle.

Seen as a major threat to China’s national security, the VIEs were indicted for openly flaunting the Chinese legal regime, and thus eroding China’s strength of law. Among others, the CSRC Report highlights a number of factors that have encouraged the proliferation of VIE use, including (i) restrictions on foreign investment in certain industries, (ii) the difficulty of listing domestically, (iii) the “celebrity effect” of listing on a U.S. exchange, (iv) the exit requirements of the mostly-foreign private equity firms, and (iv) greater flexibility with regard to transferring assets. To counteract these variables, the CSRC advocated a strategy to encourage policies that would undercut the impetus behind VIE use, while at the same time “resolutely deterring” future abuse of the VIE. The following provides a summary of the policy recommendations.

A. Policy Recommendations

**Strengthen the Monitoring.** The Report recommended that the government not look to completely remove the structure, but rather regulate it with a legal framework. This indicates that

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79. See *Asiamoney Translates Leaked China CSRC Document*, supra note 12 (describing how the leading Chinese enterprises are seriously threatening the national security of China’s internet sector by choosing to be listed in the United States).


81. See *Asiamoney Translates Leaked China CSRC Document*, supra note 12 (describing how the government should consider a “lead-and-block” strategy).

82. *Id.*
future companies who are interested in employing the VIE structure should be required to gain approval from MOFCOM and CSRC before publicly listing overseas.\textsuperscript{83} This preliminary review, in collaboration with the SEC, will help investors more accurately determine the substance and validity of a VIE-structured company prior to its IPO.\textsuperscript{84} In doing so, this policy would allow for continued access to foreign stock markets while at the same time encouraging more positive business practices and maintaining a greater level of regulatory supervision.

In addition, the CSRC Report suggests implementing a sort of “grandfather clause.”\textsuperscript{85} As quashing the VIE vehicle outright would be detrimental to a great number of Chinese companies, many of which represent China’s lucrative online industry, the CSRC instead suggests that the government implement strategies which restrict future use of the VIE structure.\textsuperscript{86} In doing so, the scope of application would be limited to new companies, while existing companies—those already listed overseas—would be grandfathered in with the old regulations.\textsuperscript{87}

\textbf{Policy Guidance.} The CSRC also recommended implementing macro policies that would help inspire promising PRC companies to list on PRC exchanges, so as to act as bellwethers in encouraging more domestic listings.\textsuperscript{88} One such

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\textsuperscript{83} \textit{Id.} The Report states that both bodies should approve the VIE structure, and that if one rejects the VIE’s filing of protocol control, then the other should also reject.

\textsuperscript{84} \textit{Id.}

\textsuperscript{85} \textit{Id.} The Report suggests using the principle of “old methods for the old, new approaches for the new” to help avoid market volatility of domestic and overseas capital markets.

\textsuperscript{86} \textit{Id.} These strategies are to encourage companies listed overseas to gradually return to the A-share market, which will restrict future VIE use through a “lead-and-block” strategy. Through this strategy, the CSRC will lead those high-tech companies into the domestic market while blocking those companies that abuse the VIE structure from attempting to transfer their assets.

\textsuperscript{87} \textit{Id.} The “old methods for the old, new approaches for the new” strategy will restrict the future use of the VIE structure by limiting new companies to the new strategies, while the old companies would be allowed to continue operating under the old methods.

\textsuperscript{88} \textit{Id.} Some of the factors that have encouraged the proliferation of the VIE structure include restrictions on foreign investment in certain industries, the difficulty of listing domestically, the “celebrity effect” of listing on a U.S. exchange, the exit requirements of the mostly-foreign private equity firms, and greater flexibility with regard to transferring assets.
policy was to allow for dual listing both on China’s domestic A-share market as well as abroad. This approach would mean that companies would not have to decide between a domestic listing and a foreign listing. A second suggestion was for the creation of an additional approval system that would focus on helping particularly promising start-ups gain access to the stock markets, where they otherwise would be denied. These strategies look to bolster the standing of domestic markets by fostering and encouraging the presence of high-caliber companies.

**Improve Onshore Listing.** At a foundational level, the CSRC Report suggests that if there were greater support for the development of the domestic market, and thus greater access to domestic venture capital, Chinese companies would not be forced to look overseas for start-up funds. The Report proposes that policies be introduced which would encourage the development of a multi-layer capital market as well as help facilitate the listing of domestic companies. This strategy, thus, effectively looks to target the variables that create the financial necessity of VIEs in the first place and duly lessen China’s dependency on foreign capital.

**Improve Offshore Listing.** The Report acknowledges that some industries, such as online start-ups, greatly benefit from the access to foreign markets, as these markets tend to offer the greatest support and experience in this related niche. In addition, domestic companies often look to foreign stock markets because the domestic markets require a comparatively higher standard, thus limiting the ability for start-ups to access early-growth capital. With these considerations, the Report suggests that for those companies with a solid reason and desire

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89. *Id.*

90. *Id.* The Report states that China should follow the lead of Korea and Taiwan to create circumstances that help Internet companies gain A-share listing through minimum threshold conditions of GEM and priority listings.

91. *Id.*

92. *Id.* (discussing the benefits of strengthening the multi-level capital market development, such as more companies being able to enter the capital market at early stage).

93. *Id.*

94. *See id.* (referring to the requirements for A-share listing and protocol control in foreign markets).
to list overseas that a more feasible, government-approved method of direct offshore listing be implemented. This policy would thus allow for the necessary growth capital of these companies until a point in time when China’s own capital markets could sustain them.

B. Implications

As previously stated, the scope of a “leaked” report means that it does not actually qualify as legislation, or even official policy. In fact, shortly after its release, news agencies clarified that the Report had been drafted by a research department of the CSRC, and created solely for internal use. As such, the Report was not to be considered an official study intended for either the State Council or subsequent legislation. However, the conspicuousness of its release prompted people to question if it was meant to portend a potential policy shift. This case is exceptional because the VIE structure was explicitly addressed, rather than through the abstract and implicative language common to VIE-related rhetoric.

If true, the CSRC Report might offer practitioners the greatest source of guidance as to the direction of potential regulatory trajectories regarding VIE practice. Not only does the CSRC Report offer a comprehensive government opinion on the subject, it also provides the only blueprint with which to glean regulatory strategy. And now, five years later, in review of

95. Id.
96. Xiang et al., supra note 80, at 1. In particular, the CSRC Memo was intended for internal purposes, and was not officially endorsed by the CSRC nor submitted to the State Council for review or comment. Id.
97. Ping, supra note 13.
98. Id.
99. Xiang et al., supra note 80, at 1.
100. See id. at 3 (noting that the CSRC Memo summarized the history and nature of the VIE structure, along with trends of usage); see also Li Guo, Chinese Style VIEs: Continuing to Sneak under Smog?, 47 CORNELL INT’L L.J. 569, 580-81 (2014) (discussing previous notice documents from Chinese agencies that attempted to regulate VIE management without explicitly mentioning the VIE structure).
101. See Man, supra note 6, at 218-19 (referring to the lack of alternate sources against which to create a baseline).
102. See Asiamoney Translates Leaked China CSRC Document, supra note 12
subsequent regulatory actions, evidence would seem to corroborate that the CSRC Report was, in fact, representative of China’s macro strategy regarding VIEs. The following will provide an analysis of those regulatory trends to substantiate that the PRC government has been actualizing the policies and carrot-and-stick strategy advocated in the report.

V. ANALYSIS OF GOVERNMENT ACTIONS

A. China’s Carrot-and-Stick Strategy: Stick

1. Increasingly Stringent Regulations

The sum of China’s policies to date indicate an overarching trend towards taking an increasingly hardline stance toward VIE practice. To begin with, by removing the lucrative tax advantages that once attracted so many early VIE employers, the structure therein lost a key perquisite. Following the promulgation of the Corporate Income Tax Law, the VIE structure became largely limited to its use as a circumventive tool for accessing China’s more restricted industries and for listing offshore. Subsequent laws and regulations, it would seem, have similarly endorsed a trend of flanking the VIE, and thus gradually limiting its permissible scope. While these measures

103. Wei, supra note 17, at 584.

104. See Shen, supra note 2, at 528 (describing how the promulgation of the Corporate Income Tax of 2008 removed considerable financial incentives, including a two-year exemption and three-year reduction of income taxes for new companies, in favor of a new standard CIT rate of 25 percent).

105. See id. (describing how the VIE structure has been used to access China’s restricted industries, such as the telecoms industry, and provided tax avoidance and tax-differential treatment between local and foreign investors).

have not targeted the VIE head on, their encompassing nature has commanded increasingly tight regulatory parameters.\(^\text{107}\)

In doing so, this has given Chinese regulators the ability to direct the evolution of the VIE without having to officially recognize it. Officially recognizing it would break the spell by which the VIE structure persists, and thereby force the government’s hand in actually confronting this legal hornet’s 


\(^{107}\) See Provisions for the Acquisition of Domestic Enterprises by Foreign Investors, arts. 3, 4, 7, 8 (increasing regulation and oversight of mergers between foreign parties and domestic parties).
nest. Instead, China’s government has spearheaded a policy tantamount to taming the VIE by placing an increasingly tight fence around it. While this does mimic a regulatory regime, per se, by both giving China’s regulators a degree of control and duly limiting the scope in which VIEs can operate, it still falls short of a sustainable legal solution on its own. This strategy has, however, made the employment of the VIE and other round-trip investment structures an increasingly demanding task, while, at the same time, offering fewer rewards in return.

2. Negative Government Rhetoric

As a general rule of thumb, the Chinese government has neither expressly endorsed nor prohibited the use of the VIE in any official communiqué to date. In doing so, this has left the investment community largely speculating as to the intent and direction of government policy. Actually making a definitive statement—assuming in light of evidence that it would be in the negative—would be counterintuitive to a gradual phasing out policy. Such an action would likely devastate U.S.-listed Chinese companies, damage China’s already slowing economy, and prematurely force PRC companies to depend on a still developing capital market.


109. Wei, supra note 17, at 584.

110. See Man, supra note 6, at 220-21 (describing how the PRC approach was damaging to China’s strength of law, which in turn discourages investment).

111. See id. (discussing how China’s adoption of strict regulations towards the VIE structure will be constructive for China’s domestic market, but limiting for foreign investors, thus providing fewer rewards for investors).

112. Id. at 218-19; see also Schindelheim, supra note 16, at 215-18 (describing the PRC government’s intentional silence on the subject).

113. See Schindelheim, supra note 16, at 216-17 (describing the concern of the foreign investment community regarding this conspicuously vague area of law).

114. See Asiamoney Translates Leaked China CSRC Document, supra note 12
However, by intimating state sentiment through unofficial channels, investors may be inspired to jump ship on their own volition and without the unnecessary fallout that would likely accompany a sudden shift in paradigm. In that vein, the government could thus maintain their current hands-off approach, while, paired with a precarious legal element, promoting a progressively uncertain—and thus risky—VIE terrain. The leaked CSRC report in 2011 duly supports this end game. Leaked government information is notorious for directing and gauging public opinion; thus, this incident, in publicizing negative VIE rhetoric, encouraged the inception, or at least the perception, of an anti-VIE regulatory climate.

3. Discouraging Enforcement Prospects

Finally, the invalidations of VIEs and VIE-like structures, as seen in the ChinaChem and CIETAC cases, have duly pushed investors away from adopting the VIE. To date, this is the closest the Supreme People’s Court (SPC), or any empowered body for that matter, has come to making a substantive call on VIE practice. China’s Civil Law guarantees that without a statute that explicitly invalidates the VIE arrangement, the mechanism is, and shall remain, legally permissible. In theory, (intimating that a slower transition period would be strategic to allow for China’s then immature capital markets to develop).

115. Shen Wei, a law professor at Shanghai Jiao Tong University, thinks the most pragmatic solution exists between tightening up the related regulatory regime, while at the same time maintaining an outwardly welcome stance towards FDI, and keeping the “official” attitude pointedly vague. Wei Shen, Deconstructing the Myth of Alipay Drama – Repoliticizing Foreign Investment in the Telecommunications Sector in China, 36 TELECOMM. POL’Y 929, 940 (2012).


117. See Andrew McGinty et al., China VIE Structure for Foreign Investment Under Attack from Multiple Directions: Will it Emerge (Relatively) Unscathed or is its Very Survival Threatened?, HOGAN LOVELLS 9 (Jan. 2012), http://documents.lexology.com/138914db-39ab-4710-bbe8-a7ed6d008bd1.pdf [http://perma.cc/6VHY-Y2KG] (stating that the leaked CSRC report is an attack against the VIE structure, and may be an indication of future attacks to come).

118. See Comey et al., supra note 70, at 1-2.

119. Man, supra note 6, at 219.

120. See Interpretation on Certain Issues Concerning the Application of Contract Law of the People’s Republic of China (I) (promulgated by the Supreme People’s Court,
while numerous VIEs could come to court, and numerous judges could invalidate each and every one, the structure and the practice would endure. As long as investors are willing to employ the VIE, as long as the SEC continues to qualify the arrangement, and as long as the SPC and National People’s Congress (NPC) are unwilling to promulgate anything decisive, VIE practice will persist.\textsuperscript{121} While these cases cannot create a precedent, they can, however, shape business practice.\textsuperscript{122} The episodic character of a civil law judicial system allows the government to effectively sustain VIE practice, while at the same time wearing away at the presumed legal foundation upon which the VIE stands.\textsuperscript{123} With every VIE overturned, the prospect of enforceability becomes increasingly remote and duly discourages investors from adopting the structure altogether.

\textbf{B. China’s Carrot-and-Stick Strategy: Carrot}

1. Improve Onshore Listing

While it remains to be seen, China may currently be at a watershed point in the development of its securities practice. Within the communiqué from the Third Plenum of the 18th People’s Congress (“Communiqué”), the text referred to a number

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\begin{quote}
Dec. 29, 1999), no. 19, art. 4, \url{http://www.asianlii.org/cn/legis/cen/laws/itspecictaotclotproco1363/} [\url{http://perma.cc/LV6K-YK48}] (stating that a contract may not be invalidated based solely on conflict with a regulatory promulgation); \textit{see also} Zhenbao Jin, \textit{From a Supplementary Legislator to a Legitimate Judicial Lawmaker – On the Role of the Supreme People’s Court in Developing the Law in Mainland China, in Toward a Chinese Civil Code: Comparative and Historical Perspectives 29, 30} (Lei Chen & C.H. (Remco) van Rhee eds., 2012) (stating that only the NPC, as mandated by the PRC Constitution, and the SPC, as authorized by the NPC, are vested with statutory interpretation power).

\textsuperscript{121} \textit{See} Interpretation on Certain Issues Concerning the Application of Contract Law of the People’s Republic of China (I), no. 19, art. 1 (stating that if the contract was formed before the operative date of the law, the effective law of that time would apply); \textit{see also id. at art. 4} (stating that a contract can’t be invalidated unless the NPC, among others, adopt new laws that renders a contract invalid).

\textsuperscript{122} \textit{See} Jin, supra note 120, at 31 (discussing how inconsistent regulatory interpretation and application by Chinese courts has negatively impacted the economic sphere).

\textsuperscript{123} \textit{See} Comey et al., supra note 70, at 2-4 (stating that previous decisions have undermined the viability of the VIE structure, resulting in uncertainty as to how the SPC will enforce of VIE arrangements in the future).
\end{quote}
of substantial securities reforms, one of which included the introduction of a registration-based IPO system.\textsuperscript{124} Under the new regime, PRC companies will no longer be subject to the lengthy and cumbersome approval structure that has typified China’s IPO process in the past,\textsuperscript{125} but instead only be required, like the U.S. system, to register with the relevant authorities.\textsuperscript{126} Additionally, much of the vetting process will now be entrusted to the brokerages underwriting the companies, as well as the auditing firms doing the necessary financial due diligence.\textsuperscript{127} By removing the CSRC’s discretionary powers, presumably this will also remove at least some of the political bias that has so often been previously cited as an inherent fault with China’s current securities practice.\textsuperscript{128}

While the investment community is still waiting in anticipation to see the extent and effect of these new measures,
the CSRC warns that it will likely be a gradual transition.\textsuperscript{129} And given the significant volatility and instability witnessed in China’s capital markets in the summer of 2015, any tentative timeline with regard to progress has likely now been extended.\textsuperscript{130} More to the point, however, the underlying precedent as seen in these reforms will ultimately redress many of the market impediments that have previously contributed to Chinese firms adopting the VIE in favor of offshore listing.\textsuperscript{131} As consistent with the CSRC Report, by improving the domestic market conditions and listing framework, these reforms will increasingly remove a fundamental impetus behind VIE practice in China.

2. Improve Offshore Listing

\textit{Circular 45.} In 2013, China observed two rather profound developments regarding its offshore listing regime. The first, \textit{Guidelines on the Supervision of the Application Documents and Approval Processes for Joint Stock Companies Intending to Issue Shares and List Overseas}, saw a complete regulatory overhaul of its former 15-year-old self.\textsuperscript{132} In the updated version, which is specific to firms incorporated as joint stock companies, PRC regulators have both relaxed and streamlined a significant portion of the approval process. The new framework has removed many of the previous substantive qualifications,\textsuperscript{133} eliminated the


\textsuperscript{130} See Man, supra note 6, at 219-20 (explaining that the uncertainty regarding when the Draft will be enacted into law has fueled a rush in the market to dismantle VIE structures); see also Charles Riley & Sophia Yan, \textit{China’s Stock Market Crash...in 2 Minutes}, CNN Money, (Aug. 27, 2015, 10:09 AM), http://money.cnn.com/2015/07/09/investing/china-crash-in-two-minutes/ [http://perma.cc/8L9S-WWQH] (discussing the volatility of China’s stock markets during the summer of 2015 and the government’s aggressive involvement in attempting to stabilize the market).

\textsuperscript{131} See Asiamoney Translates Leaked China CSRC Document, supra note 12 (arguing that the development of China’s capital market has created an environment that encourages overseas-listed, domestic companies to return to China’s A-share market).


\textsuperscript{133} Under the Draft, foreign investments will no longer be subject to the Commerce
pre-approval process, and generally consolidated what before was considered a largely redundant structure. In doing so, the new regime, as consistent with the CSRC Report, is expected to encourage more PRC companies to list overseas via legitimate legal channels, and, with the removal of previous substantive qualifications—including a minimum financial capacity—allow for smaller enterprises similarly to enjoy this avenue where they previously could not.

**Direct Listing Framework.** The second development occurred in November of 2013, when the CSRC announced that they, along with the Singapore Securities Exchange (SGX), had jointly established a Direct Listing Framework (DLF) to facilitate the direct listing of Chinese companies in Singapore. According to the SGX, once given the administrative license to go abroad by the CSRC, companies can effectively register and launch an IPO within 12 weeks in Singapore. Given the weight of the above, some predict that this reform signals an important shift in both business and regulatory practice, especially for VIEs.

In his article in the Wall Street Journal, Paul Gillis suggests that the DLF blueprint, or what he refers to as the “Singapore Solution,” would help address many of the shortcomings seen as a result of current VIE practice in China. In particular, the article highlights that the DLF mechanism will allow for Chinese

Committee’s case-by-case review and approval unless they fall on the Negative List of industries that are restricted or prohibited. Chen et al., supra note 62, at 1.

134. Under the new regulations, many corporate actions conducted by domestic companies no longer require approval from the Commerce Committee. Id.

135. The Draft indicates a move to further simplify the regulatory approval process by strengthening the connection between market-entry review and national security review. Id. at 4.

136. Id.


139. See Gillis, supra note 137 (stating that the Singapore Solution is a seed of reform that will address current flaws in VIE overseas-listings and clarify regulatory authority, thusly benefitting investors).

140. Id.
companies to have a secondary listing.\textsuperscript{141} As described earlier, many companies take on the VIE structure at an early stage to acquire early growth capital. However, once structured as a VIE, the company is effectively prevented from ever listing on one of the mainland exchanges, further precluding the possibility of a domestic investor having the opportunity to buy shares at home.\textsuperscript{142} However, if the company follows a legally prescribed method of listing offshore, such as the DLF mechanism, then there will be no legal impediment preventing them from also listing at home.\textsuperscript{143} This policy would duly be in line with China’s strategy, as stated in the CSRC report, of attempting to ultimately lure companies back to the mainland.\textsuperscript{144}

3. Creation of a Multi-tier Market System

Historically, given the steep financial requirements, China’s capital markets have only been accessible to a select stratum of companies, usually of the larger and state-owned variety.\textsuperscript{145} However, China has made considerable progress in the development of a comprehensive multi-tier market in recent years, presumably intended to bring the supply of capital more in line with the demand of companies of all sizes and capacities.\textsuperscript{146}

\textbf{ChiNext Board.} Started in 2009, ChiNext has been described as China’s version of NASDAQ, a market dedicated to fostering companies still in the startup phases, with an emphasis on high tech and fast growth industries.\textsuperscript{147} As such, the listing

\begin{itemize}
\item[141.] \textit{Id.} (describing the tension between the SEC and CSRC stemming from both lacking jurisdictional authority to regulate U.S.-listed Chinese companies because they are neither wholly-foreign nor wholly-Chinese; the Singapore Solution enables these companies to have a secondary listing on China’s stock exchange).
\item[142.] \textit{See id.} (explaining that the Singapore Solution will open the door to secondary listings, thus providing Chinese investors with the opportunity to purchase local shares).
\item[143.] \textit{Id.}
\item[144.] \textit{Id.}; \textit{Asiamoney Translates Leaked China CSRC Document, supra note 12.}
\item[146.] \textit{See Asiamoney Translates Leaked China CSRC Document, supra note 12} (stating that the PRC should consider allowing for dual listings and a multi-level capital market to increase market choices that will encourage companies to list on China’s exchanges).
\item[147.] \textit{Li, supra note 128; Cai Xiao, Exchanges Consider New Methods to Assist}}
requirements are more commensurate with companies at a less mature stage in their development. In doing so, ChiNext has significantly improved market accessibility and duly facilitated the listing of many of China’s up-and-coming tech companies that were previously unable to do so.

**ChiNext 2.0.** Due to the success of ChiNext, Shanghai is considering creating a counterpart to ChiNext on the Shanghai Stock Exchange. Specifically, the new board would cater to companies in the strategic emerging sectors—e.g. information technology, advanced machinery, new energy—that might not yet be profitable, and thus ineligible to list on China’s other exchanges.

**National Over-the-Counter (OTC).** In 2013, China launched its first national OTC board, the National Transfer System for the Shares of Small and Medium Enterprises (NTSSSME). Like the Pink Sheets in the United States, the nature of OTC shares implies lower financial standards, a simpler listing mechanism, and a shorter application period for start-ups. Thus, China’s authorities have advocated that the new OTC board will complement the existing boards by offering an effective alternative means of financing early growth SMEs, specifically for those in the tech industry.

With the growth and development of China’s capital markets, and given that China is increasingly a source rather than destination of FDI, many PRC companies are now looking more

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148. See Communiqué, supra note 124, art. 12 (stating that one of China’s intended goals was to spearhead the creation of a multi-layer market system to facilitate a stronger market and better access to financing).

149. Xiao, supra note 147.

150. Id.

151. Id.


153. See id. (“[T]he OTC market provides more financing opportunities for small companies because the threshold for listing is lower...”).

154. Id.
for financing at home. In fact, in the first half of 2015, numerous U.S.-listed Chinese companies were abandoning their listings on NASDAQ and the NYSE for a chance to list on China’s then booming A-share markets. And while China’s subsequent market crash was seen as a significant setback, the general trend can be seen as China’s capital markets approaching maturity. Therefore, as consistent with the CSRC Report, the concerted efforts to develop a multi-layer capital market will increasingly help to provide access to capital at all stages of growth and thereby remove the impetus behind VIE use in ascertaining financing.

4. Loosening of Foreign Restrictions
   Within the text of the 2013 Communiqué, the NPC intimated that they, in accordance with the “bring in” and “go global” strategies, intend to further open up China’s economy as well as loosen foreign investment restrictions. Among other industries, Article 24 of the Communiqué mentioned increased foreign investment in both education and e-commerce. As pertinent to VIEs, these two industries account for a significant portion of VIEs currently listed on U.S. markets, with nearly all U.S.-listed Chinese companies in both education and internet industries employing the VIE structure, including internet giants Alibaba, Tencent, Baidu, and Sina, as well as education giant New Oriental.

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155. See id. (discussing how companies entering the OTC boards are finding alternative funding through financial backing, investment, and sponsorship).
157. See Lee, supra note 152 (quoting a Shanghai lawyer’s remarks that some predict the OTC market to have a larger market capitalization than SHSE and SZSE within the next ten years).
158. See Communiqué, supra note 124, art. 7 (stating that China will work to modernize and assimilate into the market economy and embrace new trends in internationalization).
159. Id. art. 24.
160. See Xianwu & Lihui, supra note 23 (describing the wide spread usage of VIEs by many of China’s biggest industry players); see also ROBERTS & HALL, supra note 108, at 1 (describing how US-listed companies in the Internet and private education industries almost exclusively employ the VIE structure); see also Fredrik Öqvist, Statistics on VIE
Given this consideration, it then stands to reason then that if foreign restrictions were sufficiently lifted and foreign investors were free to directly invest in these industries, the VIE structure would largely become obsolete. VIEs have long provided foreign investors with a back door to participate in China’s more restricted industries. However, it would be illogical for companies to continue to use the VIE, given the aforementioned dangers, if equity ownership became a viable alternative. Furthermore, if the bulk of U.S.-listed Chinese companies were given a feasible mechanism with which to exit the VIE structure, there would be little reason for China’s regulators to continue to tolerate its practice.

While it remains to be seen with what speed and to what extent China plans on pursuing the above reforms, the precedent, in itself, signals an important shift in regulatory practice and further prompts the inception of a potential future that is absent the VIE vehicle. 2015 saw a great deal of momentum in this direction, as the e-commerce industry, which has historically included the largest base of VIE-structured companies, opened up in China to participation by fully foreign-owned companies.

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Usage, CHINA ACCT. BLOG (Apr. 11, 2011, 7:20 PM), http://www.chinaaccountingblog.com/weblog/statistics-on-vie-usage.html [http://perma.cc/U85A-DEJY] (providing statistics on how more than 80 percent of companies in education or “business services,” which includes telecommunication companies, were employing the VIE structure in 2011).

161. Cf. Asiamoney Translates Leaked China CSRC Document, supra note 12 (explaining that the VIE structure is utilized by Chinese companies, such as those in the Internet industry, to bypass restrictions, such as the strict management and government supervision).


163. See Man, supra note 6, at 216-17 (describing how the strength of PRC law has suffered because policy has encouraged FDI and internet startups).

164. See Communiqué, supra note 124, § 3, art. 9 (stating PRC’s intent to enact market rules that are fair, transparent and bring about a reform of the investment system that allows enterprises to independently decide whether to employ the use of foreign investment).

165. David Livdahl et al., China’s New Policy for Foreign Investment in E-Commerce, PILLSBURY 2 (Feb. 6, 2015), http://www.pillsburylaw.com/siteFiles/Publications/
Additionally, the tentative “negative list”—which will replace the Foreign Guidance Catalogue currently used to delineate which PRC industries are restricted for foreign ownership when the Foreign Investment Law is ultimately promulgated—has indicated that at least 35 previously restricted industries will open up to foreign ownership. As such, both the Communiqué and the liberalization policies currently being actualized appear consistent with the macro strategy of the CSRC Report in removing a stated impetus behind VIE use.

C. Summary

The successful propagation of the VIE structure over the last 16 years has culminated in the precarious legal paradigm we now observe today. Investment in China has increasingly become tied to a vehicle, which, by its very premise, was an unsustainable mechanism from the get-go. However, the nature of the beast is such now that the outright termination of VIE practice is no longer a feasible course of action. Instead, China’s government has, as enumerated above, laid the groundwork to eventually phase the VIE structure out of practice by employing a gradual series of incentives and disincentives.

With regard to the disincentives, the progressively stringent regulatory environment has, while allowing for the protraction of the practice, made the VIE an increasingly less rewarding investment prospect. In removing the once substantial tax advantages, the VIE has become largely relegated to its functions as an offshore listing mechanism and back door into China’s more

166. U.S. DEPT. OF STATE, 2015 INVESTMENT CLIMATE STATEMENT—CHINA 8 (2015), http://www.state.gov/documents/organization/241728.pdf (indicating that the number of restricted industries has declined from 79 to 38).

167. See Chen et al., supra note 62, at 3 (listing MOFCOM’s suggestions for the treatment of pre-existing VIE companies after new regulations are implemented, which does not include outright termination of the structure).

restricted industries. In fact, the VIE now, if aggregating in double business tax, transfer price avoidance, and the potential for inaccessible residual profits, has become a largely inefficient vehicle. When this consideration is then combined with increasingly ominous enforcement prospects and a seemingly unwelcoming political climate, the sum of government actions would circumsticate a policy meant to deliberately discourage VIE employment. As such, this would support the position advocated in the CSRC Report of “resolutely deterring” future abuse of the VIE vehicle by implementing policies that effectively block future adoption through frustration of attainable benefits.

As for incentives, the recent scope of economic and regulatory reforms all indicate a regulatory trend that encourages Chinese companies to list both onshore and offshore via legitimate, and legally sanctioned, channels. In doing so, this duly undercuts a fundamental purpose behind VIE adoption. By improving market accessibility, Chinese companies secure a straightforward means of capitalization, which in turn eliminates dependency on the VIE structure to acquire early growth funding, as has historically been the case. If this is taken in conjunction with the fact that China is steadily becoming a source, rather than a destination, of FDI, scholars predict that PRC companies will increasingly look inwards for their financing needs, which will

169. See Joanne Eales, The Future of Chinese Foreign Investments: An Exploration of the Perils and Consequences of Investing in Variable Interest Entities, 2 KENT STUDENT L. REV. 19 (2015) (explaining how the adverse tax implications may diminish the economic viability of the VIE structure). Compare Shen, supra note 2, at 528 (stating that tax advantages and facilitating foreign investment into China are the two major functions of VIE), with Asiamoney Translates Leaked China CSRC Document, supra note 12 (suggesting that the tax authorities should not accept the filing or approval of protocol control).

170. See Dienst, supra note 24, at 52 (positing that the VIE structure is tax inefficient compared to an offshore structure using only a WFOE).


172. See discussion supra Part V, Section B.

173. See Asiamoney Translates Leaked China CSRC Document, supra note 12 (“If Chinese companies can raise enough capital through the onshore capital market, they do not need to use VIE as a vehicle to gain access to the offshore markets.”)

174. See id. (noting that through a reformed capital market, more Chinese companies could enter the capital market in their earlier stages).
further negate the justification for a continued VIE presence. Accordingly, these developments comport with the policy recommendations of the CSRC Report with regard to improving market access, thereby encouraging PRC companies to abandon their VIE structures and return home.

Finally, if the “opening up” expressed in the Communiqué is actually realized, and is foreign investment is sufficiently permitted to invest in these industries of interest, the VIE structure would therein lose the last focal justification for its current practice in China. While the working timeline remains to be seen, the promise of greater foreign participation in these sectors coupled with the above listing reforms may indicate a trajectory in which the government effectively removes all impetus behind VIE practice, and duly encourages the adoption of a more sustainable capital regime in its stead. The fact that the e-commerce industry—the industry with the most VIE-structured companies—opened to foreign investment this past year suggests that such an eventuality may not be too far off. Thus, recent events, and anticipation of a more liberal investment environment under the Foreign Investment Law’s “negative list,” would be consistent with the CSRC Report’s proposal to implement policies that address the reasons behind VIE adoption.

The gradual nature of this carrot-and-stick strategy would also allot the time necessary for the transformation of China’s still developing markets. Removing the VIE structure prematurely would likely create a void between developing PRC companies

175. E.g., Kaiser, supra note 162, at 4; see also UNCTAD, supra note 40 (noting the increasing trend of China’s FDI outflows over the years).
177. See Communiqué, supra note 124, art. 24 (stating that more industries currently closed to foreign investors, such as e-commerce, will be opened to foreign investment).
178. See id. art. 12 (referring to the stated goals of the Third Plenum, including both strengthening China’s legal regime and developing China’s capital markets).
179. Livdahl et al., supra note 165, at 2.
180. See Asiamoney Translates Leaked China CSRC Document, supra note 12 (indicating that the CSRC strategy takes into account the fact that China still needs time to develop its markets).
and their ability to access capital.\textsuperscript{181} However, in gradually phasing out the VIE vehicle, this ensures that China is given sufficient time to properly establish a new market regime as well as further strengthen its ability to finance PRC companies domestically. Most importantly, this strategy would facilitate all of the above without the economic fallout that would result from a sudden shift in paradigm—a paramount concern in any VIE discourse.\textsuperscript{182}

In review of the above, the current evidence would substantiate a regulatory trend designed to ultimately phase the VIE structure out of practice in a manner consistent with the CSRC Report. Most related PRC policies and regulations have either served to discourage VIE use or undercut the impetus behind its adoption. Moreover, the fact that the Chinese government has \textit{staunchly} avoided taking an official policy position on such a ubiquitous subject stands to further corroborate this interpretation. Once this premise is established, it can then be reasonably inferred that any far-reaching regulatory trajectory is most likely in line with government policy.\textsuperscript{183} And, \textit{ipso facto}, if the CSRC Report is representative of the macro trends of VIE-related policy, then it is also, to a degree, representative of the VIE strategy being actualized by the PRC


\textsuperscript{182} According to Man, the carrot-and-stick strategy is a win-win scenario for both Chinese regulators and market participants. Regulators can fulfill two contradictory policy objectives, while market participants that obtained funding using the VIE structure can return home when domestic financing is adequate. See Man, \textit{supra} note 6, at 219-20.

\textsuperscript{183} As seen with the Communiqué, the CCP’s role is to set the direction of policy, and the government’s role is then to see these policies executed. William H. Overholt, \textit{China’s New Reforms in Theory and Practice}, ASIAN PERS. GLOBAL ISSUES (Nov. 21, 2013). According to Zheng, although it is slowly changing, historically, the NPC and the local people’s congresses have been the rubber stamp of the Party; the Party makes a decision first, and then has the congress simply “approve” the CCP’s verdict. Zheng Yongnian, \textit{The Chinese Communist Party as Organizational Emperor: Culture, Reproduction and Transformation}, 119 (2010). If the CCP is the foundation of all policy, then it stands to reason that any policy currently in action must then be in agreement with CCP strategy.
government. As the CSRC Report is, to date, the only comprehensive source by which practitioners can attempt to glean the VIE’s regulatory trajectory, this knowledge may prove useful in establishing a baseline against which alternate trajectories may be evaluated.

VI. CONCLUSION

The VIE, more or less, has come to its proverbial tipping point. As the investment terrain in China continues to shift, much of the original paradigm that previously supported VIE use has begun to wane, accordingly. While the propagation of this structure over the past decade may have encouraged billions of dollars of much-needed FDI, the continued presence of foreign investment has been largely contingent on the premise that the structure was, in fact, a sustainable investment vehicle. As has been suggested by recent cases, however, the contractual agreements, if taken to court, would likely be unenforceable. The increasing realization of this prospect by both scholars and practitioners alike has, in tandem with an ostensibly negative regulatory outlook, led to a growing stigmatization of VIE practice.

This negative regulatory outlook has only been compounded with the release of the Draft Foreign Investment Law in January of this past year. The language that appears to target the VIE vehicle, in conjunction with the conspicuous absence of references with regard to foreign-owned VIE structures, has left the foreign investment community anxious with regard to possible outcomes. Thus, the question is: How can the foreign

184. Man, supra note 6, at 219.
185. See id. at 217-18 (describing the lack of discouragement toward foreign investors and the allowance of the VIE structure as elements that depicted this sort of investment as sustainable, hence the listing of over 200 Chinese companies on the U.S. stock exchange within ten years).
186. See Comey et al., supra note 70, at 2 (discussing the Chinachem decision and the overall legal effectiveness of the entrustment arrangement that the parties entered into).
187. Zhang et al., supra note 10, at 1 (pointing out that the PRC foreign investment legal regime may be profoundly impacted by the Draft).
188. See id. at 3 (pointing out that the ability of Chinese companies to raise capital from foreign investors and foreign investors' investment options in China could be heavily
investment attempt to gauge the likelihood of regulatory action? If one were to use the CSRC Report as a policy baseline, such an analysis would support a regulatory trend that employs a carrot-and-stick strategy to discourage VIE use, while at the same time doing so in a neutral manner so as not to collapse the proverbial house of cards upon which the VIE rests.

As such, the Draft, in itself, acts as a tool of discouragement and is consistent with former policies of indirectly attacking the VIE vehicle. By not referencing foreign-controlled VIEs, the government avoids making an affirmative attack on VIEs, while at the same time promoting the inception of a negative regulatory environment. In doing so, this maneuver encourages currently foreign-owned VIEs to collapse their structure during the interim between the publication of the Draft and the ultimate promulgation of the Foreign Investment Law. While it remains to be seen, and academics and practitioners disagree on, whether the ultimate Foreign Investment Law will include a grandfather clause or grace period for incompliant VIE structures, this consideration may be of little consequence if the foreign investment community takes preemptive measures to collapse their VIEs.

In conclusion, this comment asserts that the CSRC Report has been representative of the carrot-and-stick strategy being actualized by the PRC government with regard to VIE dissolution, and that the language of the Draft is consistent with this strategy in continuing to discourage VIE use in a regulatory neutral capacity. While this author believes that there will likely be some sort of grace period contained in the ultimate Foreign Investment Law, given the historic risk-averse approach taken by the PRC government, it would, regardless, be advisable to heed

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189. See discussion supra Part V, Section A.
191. Compare id. (noting the proposal of a three-year period for companies to transition and change their legal form and governance structure) with Rocky T. Lee, China’s New Foreign Investment Law: Implications for Restricted Industry Investments in China, CADWALADER (Mar. 13, 2014), http://www.cadwalader.com/uploads/cfmemos/9ed3bb457036d2d0f55d2e283e4e2098.pdf [http://perma.cc/AEP3-EE5B] (stating that the Draft, as is, indicates that there will not be a grandfather clause, but intimates a possible grace period).
the signposts of the Draft and take concerted efforts to collapse any foreign-owned VIE in the meantime.