C’est la ‘VIE’ for foreign investors in China

A new Chinese law will tighten the rules pertaining to VIEs, and this change could have a major impact on American companies

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Introduction

The business environment in the People’s Republic of China, particularly among high-tech companies, may be undergoing a sea change. The Chinese Ministry of Commerce (MOFCOM) has proposed a law that threatens the existence of a commonly used corporate structure employed by some of the biggest tech-related firms doing business in China. This ownership model is called a VIE.

“VIE” stands for variable interest entity, and many foreign companies (and Chinese companies listed on foreign exchanges) adopt this complex structure when doing business in China. As a VIE, a company can raise foreign capital and yet remain in compliance with regulations that restrict foreign ownership in certain industries.

The current law prohibits the direct foreign ownership of assets of companies operating in “sensitive” sectors of the Chinese economy, including firms involved in banking, wholesale and retail of certain products, information technology, the Internet, certain telecommunications, and private education—sectors that just happen to include the hottest industries in the world.

Essentially, a VIE permits foreign investors to enjoy the benefits that come with owning a China-based business in one of these sectors without actually acquiring an ownership stake, and it also allows a Chinese company to raise more cash than would be possible if it was only open to Chinese investment—a “win-win” situation. However, operating as a VIE in this way may soon be outlawed.

As reported in the Wall Street Journal, a new Chinese law will tighten the rules pertaining to VIEs, and this change could have a major impact on such American companies as Amazon, Pearson and CBS, each of which has purchased as company operating as a VIE in a restricted sector in the PRC. Many Chinese companies could also be affected by the new law because they are listed on overseas exchanges.

Background

Arguably, the company that made VIEs famous was Sina. Sina adopted this structure when it launched its IPO on NASDAQ in the year 2000, and this is why some refer to VIEs as “Sina Structures.” Sina’s success in acquiring IPO capital encouraged other tech companies to use the model of ownership, and since that time, over 100 other Chinese companies have similarly been listed in the U.S. as a VIE.

Typically, a VIE involves the creation of an off-shore holding company that, in turn, forms a wholly foreign owned entity (WFOE) in China. The WFOE then signs contracts with a Chinese-owned company—the VIE—in the restricted sector. It is through these contracts that the foreign investors effectively control the VIE. The PRC has long been aware of this practice but is only now clamping down.

The new law will create a “negative” list of restricted and prohibited sectors where only companies that are controlled by Chinese nationals will be allowed to conduct business even if such companies have been structured as VIEs. Thus, this law may require that foreign controlled VIE entities sell their controlling stakes to Chinese nationals—or dissolve!

Almost all of the major Chinese players in today’s emerging industries have adopted VIE structures to attract foreign venture capital financing, including Alibaba, Baidu, Dangdang, Focus Media, New Oriental and Tudou. But many of these firms will not be at risk when the new law comes into effect because, despite the fact that they are VIEs, they are ultimately under Chinese control.

Conclusion

Since the proposed law is still open for comment and review, it is still too early to fully ascertain its potential impact. The U.S. Chamber of Commerce has nevertheless written a statement that calls for a 25-year grace period, or the grandfathering in of existing VIEs. Therefore, any company considering an overseas venture should work with closely with legal counsel in order to stay abreast of the situation.

The Chinese business environment is subject to frequent and drastic change, which requires that firms remain agile. A successful business strategy largely depends on a firm’s ability to acquire information, and this means having boots on the ground in China. It is this knowledge that enables businesses to make quick adjustments in order to stay ahead of the competition.

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