Is the “Variable Interest Entity” structure a viable model for doing business in China?

An Analysis

Avasant

The restrictive environment for foreign investors in the China business landscape, and willingness of investors to push large amounts of capital into the growing economy, has led to the emergence of alternative business models. Among the many options available to foreign investors, the "Variable Interest Entity" structure offers greatest autonomy and returns for investors.

Options for Foreign Investment in China

The Variable Interest Entity (VIE) structure has been accepted by foreign investors as a mode of investment in sectors that are restricted for foreign capital in China. The structure allows Chinese domestic entities to list on foreign capital markets. From a regulatory perspective, there is neither any clear endorsement nor any specific prohibition of the VIE structure by Chinese authorities. Hence, the VIE structure has remained a grey area within the Chinese legal system. Though the VIE structure permits both foreign and domestic investors to work within the framework of governmental regulations and reviews, but without a clear endorsement of the VIE structure by regulatory authorities the structure poses several legal and regulatory risks. The future of China's regulation for VIEs is based on its anticipated creation of an improved environment for all market players, by way of laws that address uncertainties in the investment sector.

The current analysis explores the options that are available to foreign investors in China and explores why VIEs have been the preferred vehicles of investment. Also, the article discusses possible regulations that may affect the legitimacy of VIE business structures.

The main forms of options available to Foreign Investment Enterprises (FIEs) in China are

- Operations involving Chinese partners
  - Joint Ventures – Equity Joint Venture (EJV) or a Cooperative Joint Venture (CJV)
- Operations without partners
  - Wholly Owned Foreign Enterprises (WFOE)
  - Representative Offices (Rep Office)

Joint ventures

An EJV (Equity Joint Venture), organized as a limited liability company, is a legal entity established by one or more foreign investors with one or more Chinese investors. Ownership and the investor's share of profits and losses are determined based on the relevant contributions to the registered capital of the EJV. Investors hold equity interests, but no stock. Voting authority is vested in the board of directors, rather than in the shareholders. The directors are appointed by the investors and, in general, the power to appoint directors reflects the ratio of the capital contributions of the partners.

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CJVs (Cooperative Joint Ventures) are more flexible than EJVs, allowing multiple parties to contribute in terms of assets both in cash or kind. The distribution of dividends, residual asset shares, and governance participation in a CJV, reflect the terms of cooperation, rather than the proportion of registered capital contributions. Recently, however, the PRC (Peoples Republic of China) Commerce authorities, which have approval authority over JVs, have imposed stricter reviews of the proposed terms of CJV contracts, reducing some of the flexibility associated with CJV structures.

Chinese regulatory authorities cap foreign investment to 50% in multiple restricted and prohibited industries. Consequently, Joint Ventures do not offer foreign investors avenues to participate in such industries if they require autonomous decision making and control.

Wholly foreign-owned enterprises

A WFOE, organized as a limited liability company, is generally the desired investment vehicle for foreign investors, provided that the participation of a Chinese partner is not required under investment regulations. The WFOE offers foreign investors sole control of the business operations and avoids lengthy negotiations with a Chinese partner, as may be required in the case of a JV.

A WFOE must establish a board of directors or a managing director for its management structure. The company must also have an independent supervisor for corporate governance purposes. Aspects on the detailed management structure must be set out in the articles of association of the WFOE.

A WFOE is required to appropriate 10% of its annual after-tax profits for its statutory general reserve fund account until the account balance reaches 50% of the company's registered capital. The distributable profits of the WFOE may be initially lower than a JV, whose board or joint management committee may decide not to contribute to such a reserve.

Representative office (RO)

A representative office is a base from which to manage relationships, attend meetings, and it is not a "legal person". Foreign companies, particularly those in the trade and service industries, often choose an RO to conduct liaison and marketing activities in China. Although ROs allow foreign investors to enter the Chinese market with little initial investment, they are prohibited from direct profit-making activities.

In general, an RO of a foreign company may engage only in indirect business activities in China, such as acting as a liaison with clients and the head office, introducing products of the head office, conducting market research, collecting information. Thus, an RO of a foreign company may not sign and conclude contracts with Chinese customers directly and is prohibited from engaging in any direct business operations with certain exceptions, such as the RO of a law firm.

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Why are WFOEs preferred vehicles of investment in China?

Since ROs are primarily useful for liaison and marketing activities, foreign investors in China have the option of a JV or a WFOE to invest in China. The Variable Interest Entity structure involves setting up a WFOE, which has several benefits over a JV, and hence is a preferred vehicle of investment in China.

1. The Chinese Ministry of Commerce ("MOFCOM") issued the Catalogue of Industries for Guiding Foreign Investment 2017 revisions (the "Catalogue"), effective from 28 July 2017. This list divided Chinese industries into Encouraged, Restricted and Prohibited industries. If an industry is not in the list of Encouraged industries, MOFCOM permits foreign investment in the Restricted categories, only in partnership with Chinese companies.

   The Special Administrative Measures on Access to Foreign Investment 2018 ("the Negative List" effective 28 July 2018) has replaced the 2017 list and lowered the number of industries with restrictions/prohibitions on foreign investment. However, the basic tenets of categorization still apply.

   To cater to restricted industries, without having to get into equity partnership with a local Chinese company, a WFOE that utilizes the VIE structure is the only way for foreign investors to address the market. The structure, as explained in this paper, provides the Foreign investor with complete Management Control.

2. The national telecom regulations have imposed a 50% foreign equity ownership cap on organizations holding a Value Added Telecom Service (VATS) license. Foreign investors cannot operate in such sectors without a JV with a Chinese partner, where foreign investment capped at 50%, for engaging in VATS businesses. Despite the route of JV offered under the national regulations, in practice it has been extremely difficult to obtain the VATS license from the Ministry of Industry and Information Technology (MIIT) for the actual establishment of a JV. This has led many foreign investors to adopt the so-called VIE structure, that involves a WFOE, for operating a VATS business in China.

3. The Limited Liability Company structure of a WFOE offers foreign investors sole control of the business operations and avoids lengthy negotiations with a Chinese partner, as may be required in the case of an EJV or CJV. A WFOE provides a simpler approval procedure and complete management control by way of contracts with a VIE, as detailed later.

4. WFOE status permits greater use of RMB to pay for business expenses and local sales. Hence, WFOEs can issue invoices to their customers in RMB and receive revenues in RMB. They also have the capability of converting RMB profits to US dollars for remittance to its parent company, outside of China.

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Currently, 62% of Chinese companies listed on U.S. exchanges use VIE structures that are based on WFOEs. More than 80% of those that conducted an IPO within the past three years, use VIEs. 20 companies using VIEs had conducted or filed for IPOs up till December 2017, including 15 just during the quarter Sep-Dec 2017.

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Variable Interest Entity structure

Operating model

The VIE structure involves the following entities to operate

- A Public Company (Parent Company), usually set up in a geography like Cayman Islands, with an IPO on a reputed foreign stock exchange
- The Parent Company has a Wholly Foreign Owned Enterprise (WFOE) in China
- A China company owned only by Chinese nationals. This company is eligible for holding a license in an industry where foreign investment is restricted or prohibited by China. This company is known as a Variable Interest Entity (VIE)

The VIE enters into contracts with the WFOE that enable the Parent Company to make all decisions and pay dividends, on behalf of the VIE. The Chinese founders of the domestic company borrow funds from the WFOE and pledge their shares in the operating company (the VIE) as collateral under the loan agreement. Also, there are clauses in the contract for provision of services by the WFOE to the VIE. This enables the WFOE to charge for services, by way of which the profits made by the VIE can be transferred to the WFOE and subsequently, the investor Parent Company.

Together, the above contracts, theoretically provide the WFOE rights over the VIE that a traditional parent company would have over its subsidiary through ownership.

Since the WFOE neither directly owns the VIE, nor owns any assets that are restricted from foreign investment by China's MOFCOM, it may receive foreign investment.

Because the WFOE assumes both the economic costs and benefits of the VIE and the Parent Company directly owns the WFOE, US accounting rules allow the Parent Company to consolidate the VIE on its financial statements despite the absence of equity ownership.

These consolidated financial statements, along with the contractual arrangements, supply the glue that holds the VIE structure together. They enable the Parent Company, a shell company with no meaningful operations of its own, to attract foreign investors who provide capital to what they equate to an emerging Chinese company owned by the Parent Company.

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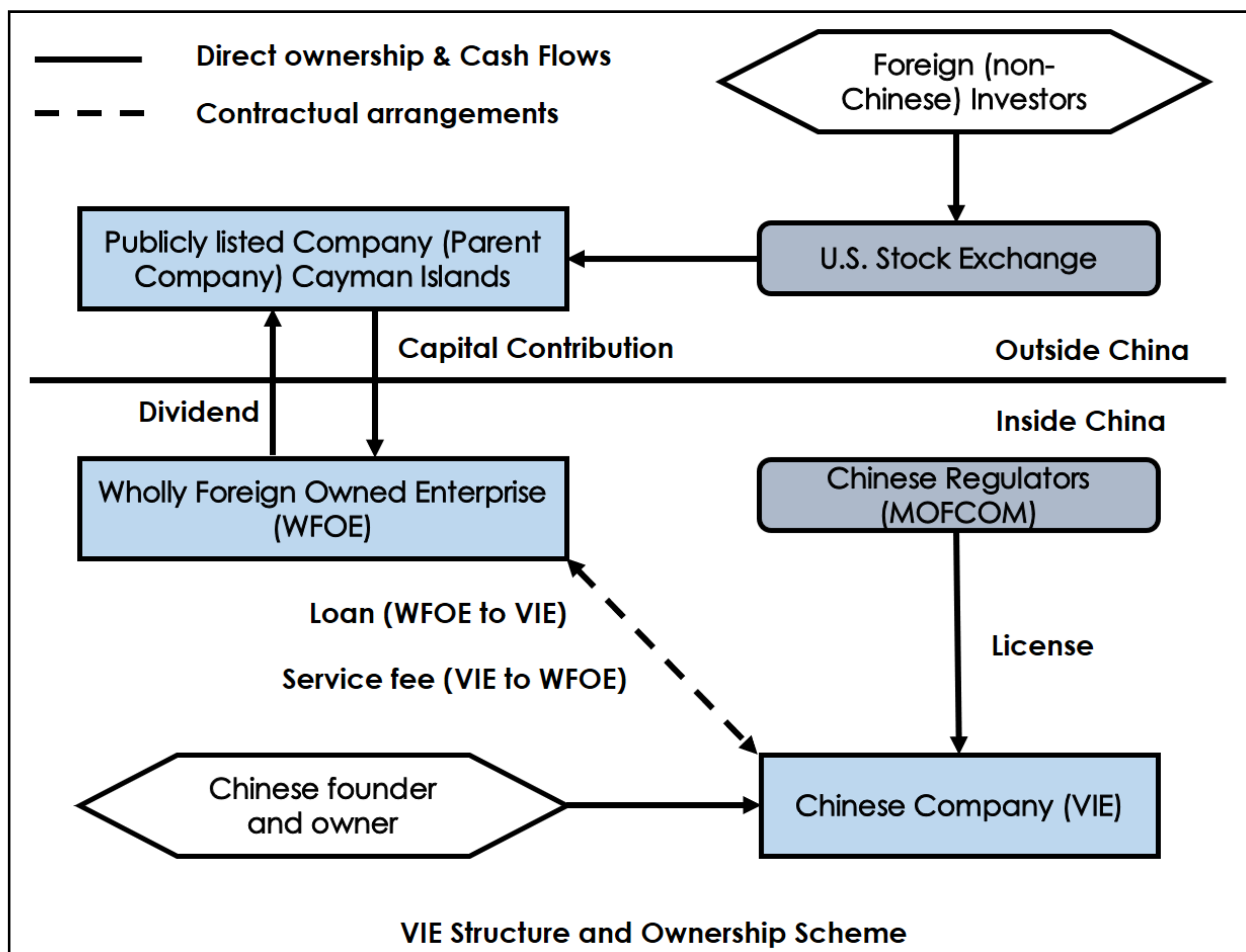

To be effective, the VIE must serve the below basic, but conflicting, functions:

1) Convince Chinese regulators that foreigners do not own or control Chinese companies operating in restricted sectors, and

2) At the same time convince foreign investors that they do, in fact, have effective ownership and control over business operations.

Structuring the financials and cash flow in a VIE

A brief description of the typical cash flow between various entities in a VIE operational structure is given below

- The Parent Company makes a capital contribution to its WFOE in China
- The WFOE extends a loan to the PRC individuals, who in turn establish and finance the PRC domestic company (the VIE)

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- Contractual arrangements between the WFOE and the PRC domestic company(the VIE) contain provisions of service fee payment from the VIE to the WFOE in lieu of services.
- When the PRC domestic company (the VIE) makes a profit, it distributes a dividend to the PRC individuals
- The PRC individuals make a repayment of the loan to the WFOE
- The VIE also makes a service fee payment, for provision of services by the WFOE, as contractually required
- The WFOE uses the proceeds of the loan and the service fee collected to make a dividend distribution to the Parent Company in the Cayman Islands, thus completing the cash flow.

The cashflow described above will be impacted by tax liabilities on various entities in the structure. However, the cash flow can be moderated depending on the assessment of tax liabilities, as explained below.

Tax structure and guideline of profit repatriation rule to Parent Company for WFOE

WFOEs can repatriate funds to their parent companies in a variety of forms, for which tax implications vary, as per the form of repatriation and the Double Taxation Agreement (DTA) in place between China and the recipient country. The four most commonly used channels for profit repatriation are dividends, loans, service fees, and royalties. While WFOEs can repatriate funds in any of these forms, funds may be repatriated using dividends or loans only if the recipient entity is a shareholding company of the WFOE.

- **Dividends** - A WFOE, that repatriates profits to a Parent shareholding company using dividends, will be liable to pay a 10 percent Withholding Tax based on the DTA between China and the US. However, this tax paid in China could be claimed as a foreign tax credit in the US, to reduce the parent company's income tax burden
- **Loans** - The WFOE may also remit undistributed profits to the parent shareholding company by extending a loan. The WFOE's interest income would be subject to a 25 percent Corporate Income Tax (CIT) and a 5 percent Business Tax, although the CIT paid in China may later be used to offset the US income tax liability incurred as per the terms of the DTA
- **Service Fee** - The WFOE may also repatriate funds in the form of a service fee by signing a services agreement with the overseas parent company. The service fee would be subject to a 6 percent Value-added Tax (VAT), related surcharges, and possibly also Corporate Income Tax
- **Royalty** - If the WFOE repatriates funds in connection with the use of intellectual property (which includes patents, copyrights, trademarks, and proprietary technology), it would

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likely be regarded as a royalty or licensing fee, and thus subject to a 10 percent withholding tax and 6 percent VAT with related surcharges

To assess final taxation applicable on the revenue of an organization operating in the VIE structure, it is necessary to consider tax liabilities to be incurred in both China and the recipient country. To minimize tax liabilities on the cash flow, the following guidelines are practiced to reduce cycles of transactions between various entities. These guidelines also enable reinvestment of profits that the VIE makes back into business operations.

Challenges in structuring cash flow in a VIE model

The Chinese administration could apply potential punitive taxation on transactions of a VIE entity's operations and cash flows, as illustrated below with an example scenario:

- Ideally, the VIE should pay 91.5% of its earnings (post 8.5% tax deduction) to the WFOE
- The administration could consider the VIE payment as dividend to the VIE's Chinese owner and subject the VIE owner to a 20% individual income tax
- When the Chinese owner transfers the amount to the WFOE, the administration could charge the WFOE a 25% Corporate Income Tax
- When the WFOE transfers the rest to its Cayman Islands Parent Company, the Chinese administration could apply an additional 10% withholding tax on such a transfer

Considering the above example scenario, most parent companies disclose the potential taxation in their SEC filings, citing corporate tax as a reason not to extract earnings from the Chinese VIE and withholding tax as a reason not to pay dividends. In reality, most VIEs do not seem to transfer cash to the WFOE. Also, less than one fifth of US listed Chinese VIEs currently pay or intend to pay dividends to shareholders. While not uncommon in start-ups, indefinite reinvestment for at least some of these VIE-dependent companies appears more related to probable Chinese taxation on moving money from the VIE to the WFOE and eventually the Parent Company. In short, all the money made in China stays in China. This arrangement potentially leaves investors to rely solely on the appreciation of the company's stock price for a return on their investment.

Risks in a VIE structure

Three risks arise in operating a business with the VIE structure.

Government Enforcement (Legal problems)

VIEs are a grey area under Chinese law - The court may declare a contract void "when a lawful form is used to conceal an unlawful purpose". If the court finds that two parties entered in an

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equity pledge agreement with the purpose of unlawfully concealing foreign investment in restricted business, the contract could be declared void.

Given that the VIE structure has potential to violate the spirit of the law, VIEs could be invalidated at any time, potentially retroactively, leaving foreign investors with little or no recourse to recover their investment.

Owner Expropriation & Other Business risks

Investors don't have access to the assets of the operating company. It is common for them to negotiate a call option agreement (in which the owners agree to sell all the equity interests in the operating company to the WFOE). But arguably the foreign investors may never be able to exercise the option, because they are barred from owning the operating company under Chinese law.

SINA & Alibaba dealt with the above issue by transferring their service platform, their most valuable asset, to the WFOE to mitigate the risk. The operating company, in such a scenario, then holds only licenses and certifications, which are prohibited from foreign ownership.

The Chinese owner of a VIE could decide to breach the contractual arrangements and expropriate the company's earnings. It is far from clear if firms can enforce VIE contracts in Chinese courts. The Chinese legal system, in general, provides fewer protection mechanisms for foreign owners, making it difficult to enforce contracts through the legal system.

Some believe that the Chinese government would never overturn the VIE structure because many of the large revenue generating companies, contributing to GDP growth, are involved and financial chaos would result.

Punitive Taxation

Foreign shareholders are not legal owners of the VIE entity. Hence, any distributions from the revenues of the VIE carry uncertain tax consequences and face possible capital controls. The tax dues in a VIE structure are unclear, and double taxation of revenues may result. Business Taxes are applicable to the Chinese VIE operating as a domestic entity. As illustrated earlier, there might be subsequent tax liabilities in the cash flow from the VIE to the WFOE and further to the Parent Company. In addition, payment of fees from the VIE to the WFOE, which is one method to return capital to the Parent Company, is subject to transfer pricing oversight. In practice, taxation is unclear because VIEs have not generally, to date, attempted to return profits to the foreign investors (as seen in the previous section), either because of tax concerns or because of requirements limiting capital flows out of the country.

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Regulations with future effect on VIEs

The Special Administrative Measures on Access to Foreign Investment 2018 ("the Negative List" effective 28 July 2018) enlists industries that restrict or prohibit foreign investment in China. The VIE structure is essentially prevalent to overcome China's restrictions on foreign investment in such industries.

Foreign Investment Enterprises (FIEs) generally refer to Chinese entities with foreign investment. FIEs are organized as limited liability companies, and the investor's ownership in an FIE is represented by the amount of registered capital it injects into the entity. The main forms of corporate entity for FIEs in China are the WFOE and the JV, and hence, the restrictions placed on Chinese industries in the Negative List are applicable to all such industries.

However, a VIE is currently not categorized by the Chinese authorities as an FIE, which is essentially the reason for the success and continued operations of the VIE enterprises. Since WFOEs are integral to the VIE business structure, any regulations that impact VIEs will potentially impact WFOEs and their Cayman Islands parent organizations.

Foreign Investment Law (Draft)

The Foreign Investment Law (Draft) was released for public consideration in January of 2015. The legislative process of the Foreign Investment Law is moving slowly, but the law will affect all entities operating under the VIE structure, once promulgated.

The draft law expressly provides that Chinese domestic companies having no foreign shareholders but "controlled" by foreign investors contractually be subject to the same restrictions as those imposed on foreign invested companies.

Under the Draft Law, "control" exists where any of the following tests are met:

a) At least 50% equity ownership

b) The right or actual ability to nominate at least half of the directors

c) The holding of voting rights sufficient to exercise major influence over shareholders' or directors' decisions;

Or

d) Decisive influence over operations, finances, human resources or technology through contract, trust or other arrangements

The control exercised by a foreign investor on a Chinese company in the VIE structure will fall under circumstance (d) above, which will in effect lead VIEs to be categorized as foreign controlled enterprises.

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MOFCOM's provisional measures on administration of filing for establishment and change of Foreign Invested Enterprises

Once the Foreign Investment Law is promulgated, the VIEs will be considered as FIEs. Like all other FIEs, the Provisional Measures on Administration of Filing for Establishment and Change of Foreign Invested Enterprises 2017 ("the Measures") will apply to such organizations.

Although the Measures have been revised in 2018, the basic tenets described below still apply for FIEs.

Under the Measures, all FIEs are required to select the nature of the actual controlling person(s), which applicants must select from the following seven (7) options:

- Foreign listed company
- Foreign natural person
- Foreign government agency (including funds controlled by government)
- International organization
- Domestic listed company
- Domestic natural person, and state-owned enterprise (SOE)
- Collective enterprise

Further, FIEs are required to explain how "control" operates under the registered actual controllers by choosing one of the following three options:

- Equity ownership
- Contractual control over the foreign entity's decision-making body
- Rights over the enterprise's operation and management, personal nomination, financial conditions, technology, or other aspects

Using a VIE structure to overcome Chinese rules for prohibited or restricted industries could become difficult if the draft Foreign Investment Law was ever adopted and the 2017 measure of definition of control applied subsequently.

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Grandfather rules and repercussions on defaulting companies

The Foreign Investment Law (draft) requires existing enterprises to complete changes in their corporate organizational forms according to the laws, within three years of promulgation of the law. In case of non-compliance, the Law will retroactively apply to all foreign-invested and controlled entities in China.

Once the Foreign Investment Law finds that the VIE is actually controlled by a foreign entity, the VIE could be ruled illegal, potentially forcing the firm to wind up or sell vital licenses and intellectual property in China. The draft law goes as far as indicating that, on adoption of the law, all existing VIE structures could be deemed illegal (no grandfather rules) unless special exemptions are granted on a case-by-case basis.

Other legal consequences specified by the Foreign Investment Law (Draft) include terminating business, mandatory disposal of shares or assets, confiscation of illegal gains (full tax and expense audit), a fine of up to approximately USD 140,000 or 10% of the investment amount, and imprisonment or criminal detention

"The Measures" include legal consequences for failure to disclose accurate and complete information on a timely basis as required therein. Specifically, FIEs can be compelled to rectify non-compliance within a prescribed time frame and can be fined up to RMB30,000, if the violation is severe or if rectification is not carried out on time. Violations will also be publicized via the foreign investment information disclosure platform of MOFCOM.

Both existing and new VIEs will be required to adopt one of the following three approaches to update their business information or register their business status with MOFCOM. The first two options below are unlikely to be rejected by MOFCOM:

- A VIE could declare that the entity's actual controlling person is a Chinese investor
- A VIE may apply to MOFCOM for a separate recognition of its actual controlling person's status as a Chinese investor
- If a VIE is not able to settle an agreement that has the Chinese investor as its actual controlling person, it will need to start from scratch by applying to MOFCOM for a new market access license. The MOFCOM would make its decision on a case-by-case basis by weighing various factors, including the actual controller of the subject entity

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Relevant Case Studies Which Require Consideration

Cases where China was opposed to VIE (or similar) structures

Case 1

In 1998, the government abruptly prohibited a corporate structure, similar to the VIE structure, that it had previously permitted. Companies used this structure, called China-China-Foreign (CCF), to facilitate foreign investment in violation of MOFCOM's Catalogue prohibitions." Companies were forced to unwind their holdings at a substantial loss to shareholders.

Case 2

In 2011, provincial authorities advised Baosheng Steel that its control agreements "contravene current Chinese management policies related to foreign-invested enterprises and, as a result, are against public policy." Baosheng Steel was a Chinese VIE planning to go public on the Nasdaq through Buddha Steel, its Cayman Islands parent company. In response to the adverse advisory, Buddha Steel withdrew its proposed IPO, transferred all payments and assets to the VIE, and terminated its contractual arrangements with Baosheng.

These precedents underscore the risk of the Chinese government at any time enforcing MOFCOM's Catalogue and ordering Chinese companies to terminate their contracts with the WFOE. Short of dismantling VIEs, however, the Chinese government could also use the threat of enforcement to compel companies to take actions favorable to itself at the expense of shareholders. If implemented, the Foreign Investment Law could proscribe the VIE structure that nearly 100 publicly traded Chinese companies employ.

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

Cases with conflict of interest between VIE and Foreign Investor

Case 1: Alibaba and Yahoo

When the Chinese government tightened its regulations over online payment systems, Jack Ma, acting as the Chairman of Alibaba made the decision to transfer the assets of its online payment platform to a private company owned by him. Before Alibaba went public in 2014, it constructed a VIE structure to court foreign investment from Softbank and Yahoo, which purchased a 43% stake. Under the structure, Alibaba's WFOE controlled the operations for Alipay, a leading online payment platform in China. After failing to secure a license for Alipay from the Chinese

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government because of its foreign ownership, founder Jack Ma abruptly spun off Alipay from Alibaba in 2011, taking control himself allegedly without consulting shareholders.

Yahoo and Softbank (who owned, respectively, 43% and 30% of Alibaba) then complained about the transfer, claiming that they were not notified nor approved the transfer - this incident warns investors that their investment may depend largely on how they would limit the power of the owners of the domestic operating company funders.

Yahoo, no longer able to include Alipay's profits on its own financial statements, ultimately brokered a deal with Ma that entitled Alibaba to up to $6 billion from the proceeds of any future Alipay IPO or sale. That figure, however, represents a 62.5% devaluation of Yahoo's stake in Alipay had it remained fully under Alibaba's control.

Case 2: GigaMedia

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

Cases where China approved of the VIE structure

Case 1: Ambow Education

The Supreme People's Court of China surprised many legal scholars with its finding that the framework agreement between a domestic education institution and Ambow Education, a domestic operating entity under VIE control by foreign investors, was valid. Foreign investment in education industry is restricted in China. When Ambow Education, a provider of educational and career enhancement services in China, got listed on the NYSE in 2010, its Chinese operating entities were controlled by a VIE structure. Ambow Education, however, did not stop with just one operating entity in China. Before it went public, its Chinese VIE entered into a series of transactions to purchase the control right and revenue from other Chinese educational institutions for lump sum payments. The plaintiff of the case had sold one of their schools to Ambow Education's Chinese VIE taking part of the consideration in cash and part in Ambow stock in 2009. The plaintiff sued to unwind the sale, and argued that immediately after the sale, effective control of schools went to the foreign Parent Company.

The disputed structure is illustrated below:

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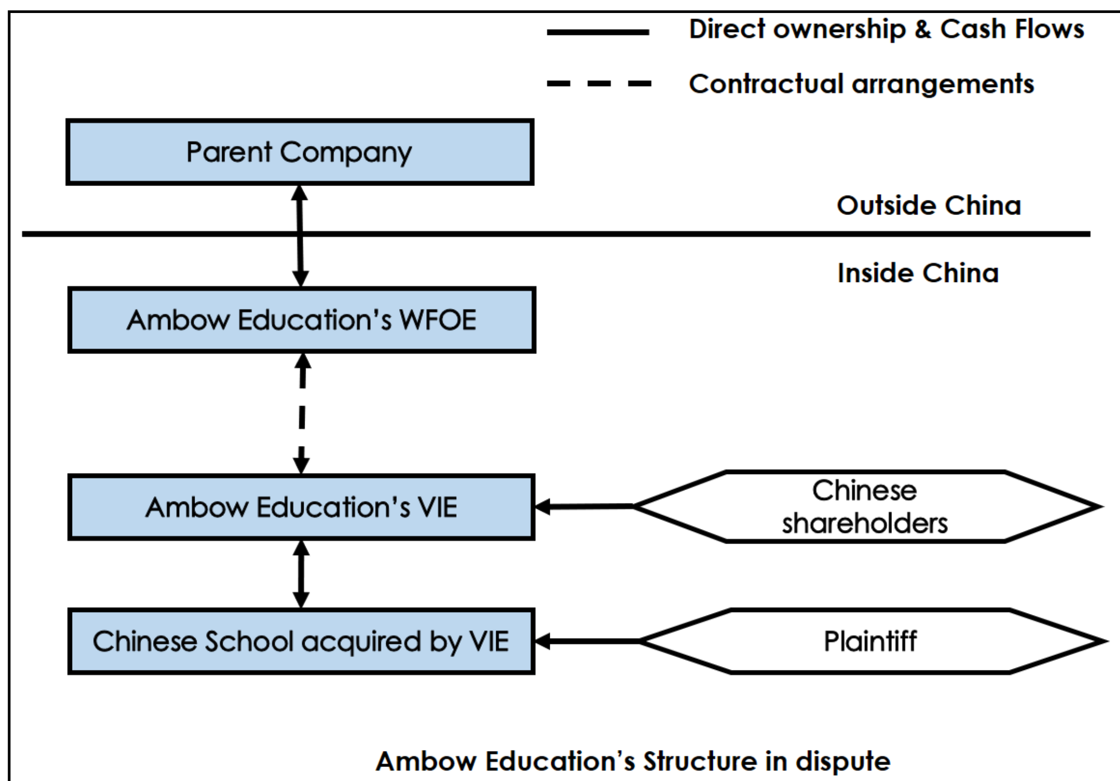

The Supreme People's Court, in this case, drew a distinction between the transfer of controlling rights of a domestic company to another domestic company that is under VIE control of a foreign entity and the typical VIE structure where the control rights and revenue of a domestic company get transferred directly to a foreign owned entity. The Court found that the Parent Company in the scenario did not assert improper influence on its Chinese VIE's operations during its five-year control. In the absence of applicable administrative prohibition of transferring contractual control rights or revenue from one Chinese entity (Plaintiff's company) to another (the Chinese VIE), the framework agreement cannot be invalidated solely based on the indirect equity holdings by foreign investors.

The court also asked the Ministry of Education about the nature of the arrangement, and while the Ministry of Education acknowledged it was a conventional VIE arrangement, they did not express an opinion as to whether the arrangement was legal. Although the Supreme People's Court skirted the question of the ultimate enforceability of VIE arrangements, the Ambow Education ruling offers useful guidance on how to create a "safe harbor" for a VIE arrangement.

Barring complete elimination by the Foreign Investment Law, such a safe harbor can be a powerful tool for VIEs.

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A similar contractual control and revenue transfer agreement is more likely to be upheld by a Chinese court going forward if:

a) Another Chinese domestic company is the recipient of control rights and revenue of a Chinese company

b) The arrangement does not trigger any national security concern

c) There is no material operational interference from the foreign investors that is prohibited by applicable law

d) There is no administrative prohibition of such contractual transfer of control rights and revenue in the relevant industry

Conclusion

In scenarios where VIEs are the only preferred vehicles for investment to either meet the purpose of complete management control or invest in foreign restricted sectors, it is necessary to evaluate regulatory scenarios and comply with a structure that does not have questionable motives. Since consequences of much future regulation that might impact VIE structures are yet to be observed, professional advisory and legal services are recommended to make immediate corrective measures to sustain business operations running on such models, while at the same time maintaining a positive association with Chinese authorities. Immediate takeaways from current analysis suggest avoidance of foreign intervention in the operational control of Chinese VIE functions, making sure that investors in VIE structures are either Chinese or are registered as Chinese investors, and correction of any security concern that the business structure might have been causing.

Professional advice is also recommended to safeguard each party's interests and to ensure that returns are maximized in VIE business model operations. Recommendations on reinvestment of returns within China and the transfer of valuable assets to WFOEs while having VIEs maintain control of required licenses are discussed in the article. It is also necessary to map interests of parent company management with those of Chinese VIE operators for mutual benefit to avoid scenarios of conflict. Moving operations that run on VIE structures to China's Free Trade Zones, which have lower restrictions on wholly owned foreign investment, is also an option in scenarios where VIE structures cannot be made to comply with imminent regulations. However, a complete business structure evaluation is necessary to gauge the impacts on investor returns, multiple management entities' functions and the interests of Chinese authorities.

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