# Accounting Matters

# Guest Series

## Variable Interest Entities in China

18 September 2012

**There is a growing feeling that VIEs are becoming unworkable – hardly surprising for a structure which is trying to tell Chinese regulators that the business is owned by Chinese and to foreign investors that it is owned by foreigners. That's a concern given that half of all overseas listed Chinese companies use it. So, why don't the Chinese simply allow private companies to list overseas with a dual share structure to preserve control? Well, maybe there's a desire for them to list at home.**

### Why are VIE's used?

Private companies in China have had difficulty in getting access to capital and have looked to foreign investors as a source of funds. Unfortunately, Chinese companies need permission to list overseas and foreign companies are restricted from operating in certain domestic sectors.

### How are they structured?

The solution has been to create a domestic vehicle that contains the restricted businesses and is owned by a Chinese individual. However, through a series of legal agreements, as opposed to share ownership, the economic interest is transferred to a domestic vehicle which, in turn, is owned by a foreign listed company. As the economic interest ultimately lies with the foreign company, it is able to consolidate the VIE.

### Challenges to the VIE structure

Chinese regulations are designed to keep certain sectors out of foreign hands so a structure that puts them back in to those hands will come under scrutiny. There are many regulatory, shareholder and operational risks that have surfaced in scandals such as Alibaba, Sina.com and New Oriental Education. It is felt that VIEs are becoming unworkable, particularly for assets heavy businesses.

### Where to now and how to fix it?

If China allows private companies to directly list abroad in the same manner as state-owned enterprises, VIEs are no longer necessary. Control could be maintained through a dual class share structure. One major beneficiary would be the elimination of the regulatory problems that have been so conducive to fraud.

### Largest US-listed Chinese Companies with VIE Structures

| Companies | BBG | Industry | Mkt Cap (US$m) | YTD US$ (%) |
|---|---|---|---|---|
| Baidu | BIDU | Internet | 40,314 | -1 |
| Netease | NTES | Internet | 6,764 | 15 |
| Sina Corp | SINA | Internet | 4,587 | 33 |
| Youku Tudou | YOKU | Internet | 3,357 | 32 |
| Focus Media | FMCN | Advertising | 3,126 | 25 |
| Qihoo 360 | QIHU | Internet | 2,953 | 58 |
| Ctrip.Com | CTRP | Internet | 2,653 | -21 |
| New Oriental | EDU | Commercial | 2,347 | -37 |
| Sohu.Com | SOHU | Internet | 1,666 | -12 |
| Renren | RENN | Internet | 1,562 | 14 |

Source: Forensic Asia Limited

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Investors in Chinese companies soon encounter an obscure accounting term – the variable interest entity, or VIE. A VIE is a company that is included in consolidated financial statements because it is controlled through contracts, rather than the more conventional control that is obtained through ownership. The contracts attempt, often imperfectly, to mimic the control and economic interest of direct ownership.

***A VIE is a company that is included in consolidated financial statements because it is controlled through contracts***

VIEs are widely used in China. Of the 225 Chinese companies listed on the NYSE and NASDAQ, 108 (48%) use the VIE structure (see Figure 2). Chinese companies traded on other exchanges, including the OTCBB in the U.S., the Hong Kong Stock Exchange, the Toronto Stock Exchange, the London Stock Exchange, and others, also use VIEs. Some multinational companies use VIEs to hold their part or all of their China operations.

## *Why are VIEs used?*

After the Communists took power in China in 1949, private business disappeared and all economic activity was conducted by state-owned enterprises. Following the disastrous Cultural Revolution and the death of Mao Zedong, Deng Xiaoping, in December of 1978, set China on a path of reform and opening up that led to the China becoming the second largest global economy.

China's stock markets reopened in 1990 after having been closed in the early 1950s. Initially the stock markets were used to reform state-owned enterprises by providing capital and instituting corporate governance.

Private enterprise emerged as the opening up process began and entrepreneurs prospered in the new environment. By 2002, the share of GDP produced by the non-state sector exceeded two-thirds. Private companies, however, had great difficulty accessing capital. As late as 2006, a study found that 98% of Chinese companies could not access bank loans. In 2000, only 1% of companies listed on China's stock exchanges were privately owned. That began to change in 2001 when Jiang Zemin invited businessmen to join the Communist Party, signalling the beginning of reforms that would lead to the establishment of Chinese venture capital and private equity firms, the SME board on the Shenzhen Stock Exchange, and ChiNext, China's answer to NASDAQ. These new institutions would increasingly meet the capital needs of China's entrepreneurial sector.

These new capital institutions would lag the development of the private sector in China. Starved for capital locally, privately owned firms looked to overseas markets. Foreign investors were keen to participate in China's economic miracle. Yet, as companies prepared for public listings in overseas markets, obstacles loomed in their way. China required its companies that wanted to list overseas to obtain permission from the State Council, China's highest executive organ. The big state-owned enterprises like PetroChina that listed in the U.S. had no difficulty obtaining this permission, but it was viewed unlikely that a privately controlled business would be able to do the same. Instead the private companies formed offshore companies, typically in the Cayman Islands, to serve as the company that would actually list on the foreign exchange.

***China required its companies that wanted to list overseas to obtain permission from the State Council but only SOEs were likely to get approval***

Using offshore companies as the listing vehicle created a new problem for these companies. China controls foreign investment through an investment catalogue that classifies industries as encouraged, restricted, or prohibited for foreign investment. Many of the sectors in which entrepreneurs were active are restricted, including the Internet sector. The Internet entrepreneurs faced a problem. By using offshore companies they had made their company foreign, yet foreign companies could not operate their business because it was in a restricted sector. The entrepreneurs could have gone to Chinese regulators and asked permission to have foreign investors, but they thought it unlikely they would be successful in doing so.

***Many of the sectors in which entrepreneurs were active are restricted and could not be owned by foreigners***

Necessity being the mother of invention, this is when the VIE concept was created. The VIE structure is commonly called the Sina structure, named after Sina.com which listed on NASDAQ in 2000. Actually the structure was developed for two Chinese Internet companies, Sina and Sohu, which both listed in 2000 and Price Waterhouse (PW) audited both. The solution to the restricted sector problem was to separate the business into two parts – the parts of the business that were open to foreign ownership were put into a wholly foreign owned enterprise (WFOE) that was owned by the Cayman Islands public company. The parts of the business that were restricted to foreign ownership were put into a Chinese company that was owned by Chinese individuals (the VIE). The challenge was to include the restricted part in the consolidated financial statements, which was considered to be an essential requirement for going public. The accounting rules at the time focused on stock ownership; if a company was more than 50% owned it was to be consolidated. Many companies were abusing these rules by creating special purpose vehicles to hold debt. Since these companies did not own more than 50% of the shares of the special purpose vehicle they did not consolidate it, keeping the debt off their balance sheet. Enron made extensive use of this technique, and its collapse led to the establishment of VIE rules.

***Separate the business into two parts: that which operates in restricted businesses (VIE) and that which does not (WFOE)***

***The VIE was owned by Chinese individuals but controlled through legal agreements by the listed vehicle***

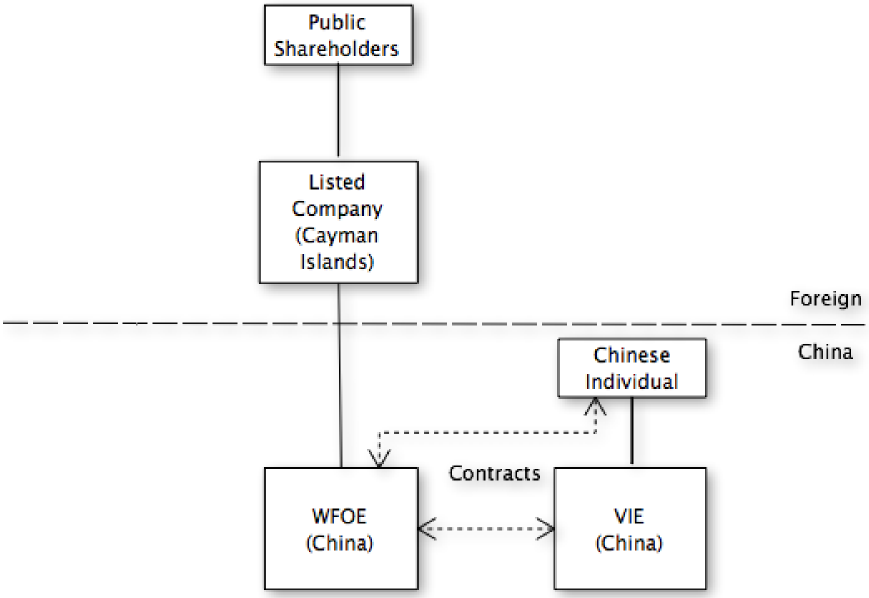
In the Sina and Sohu cases, PW accountants convinced the U.S. Securities and Exchange Commission (SEC) that the Chinese company that held the Internet content provider license and was owned by Chinese individuals should be consolidated into the financial statements of the offshore parent company. They argued that a series of agreements between the public company and the VIE sufficiently mimicked ownership so that the VIE should be consolidated. The accounting rules were formally changed in 2002 after Enron collapsed, and Financial Accounting Standards Board (FASB) Interpretation No. 46: Consolidation of Variable Interest Entities established rules that require consolidation of entities when the parent company has the risks and rewards normally associated with ownership, but the accountants at PW had convinced the SEC to apply the concepts to the Sina and Sohu offerings at an earlier date.

***Auditors persuaded the SEC that VIE be consolidated into the financial statements of the offshore parent company***

## *How are VIEs structured?*

While there is some variation in VIE structures, an archetypal model has developed. Here is a diagram of the archetypal structure:

**Figure 1: Structure of a Variable Interest Entity**




**Source: Paul Gillis**

Some structures have Hong Kong companies between the Cayman Islands company and the WFOE. The objective of these intermediary companies is to minimize withholding taxes on dividends paid from China, but China's treaty shopping rules generally make this practice ineffective.

Starting at the top of the structure there are shareholders in the public company. The VIE structure is only used on overseas listed Chinese private companies. It is not used for State controlled companies like PetroChina or China Life, even when they are listed overseas. It is also not used with private companies listed on Chinese stock exchanges. While the VIE structure is most common on the NYSE and NASDAQ, it can also be found in companies listed on other foreign exchanges, including Hong Kong and Toronto. Because the VIE is an American accounting term, entities controlled through contracts are not called VIEs in those markets, but operate in the same manner.

***While the VIE structure is most common on the NYSE and NASDAQ, it can also be found in companies listed on other foreign exchanges, including Hong Kong and Toronto***

The listed company for non-state controlled companies listing abroad is always an offshore company. The most popular location for incorporating these companies is the Cayman Islands, although the British Virgin Islands, the United States, and other jurisdictions are sometimes used. The listed company typically has no operations and serves only as a holding company.

The WFOE is a Chinese subsidiary that is wholly owned by the offshore listed company. A WFOE is the conventional entity used by multinational corporations to conduct business in China. Most overseas listed Chinese companies that do not use the VIE structure will conduct all of their China business in a WFOE. WFOEs are heavily regulated by Chinese authorities and must conduct their business within the scope of a business license that is granted to them. Companies using the VIE structure tend to conduct any part

***The WFOE is a Chinese subsidiary that is wholly owned by the offshore listed company***

of the business that can be done by foreign invested enterprises in their WFOE. Often the WFOE obtains a business license that allows it to conduct a consulting business, and its only customer is the VIE.

The VIE is a Chinese company that is owned by an individual who holds Chinese nationality. The Chinese individual is typically the founder and chairman of the public company. In situations where the founder is not a Chinese citizen, another trusted employee is usually selected to own the VIE. This allows the VIE to claim it is domestically owned when it applies for permits to operate a business in a sector that is restricted for foreign investors. However, in order to consolidate the VIE in the financial statements of the public company, the VIE must meet certain accounting requirements.

***The VIE is a Chinese company that is owned by an individual who holds Chinese nationality***

FASB Interpretation No. 46: Consolidation of Variable Interest Entities (FIN 46) contains the accounting rules for VIEs. It has been amended and is now known as FIN 46R, and is included in the FASB Codification of Accounting Standards in Section 810. The rules as presently written require an entity to be consolidated where the parent company has the power to direct the activities of the entity which most significantly impact economic performance, has the obligation to absorb the expected losses of the entity, and has the right to receive the expected residual returns of the entity. When the VIE is initially formed, none of those conditions are met. In order to consolidate the VIE, a series of agreements are put in place to meet those requirements. These VIE agreements vary somewhat between companies, but most follow what has become a standard protocol.

***The rules as presently written require an entity to be consolidated where the parent company has the power to direct the activities of the entity***

## *What are the standard VIE agreements?*

The concept that underpins a VIE structure is that control is obtained through legal agreements rather than through share ownership. Taken together, the agreements are intended to provide the WFOE with substantially all of the economic benefits from the VIE and the obligation to absorb all of its losses. The typical VIE will use five agreements to achieve this:

***Control is obtained through legal agreements rather than through share ownership***

### Loan agreement

The first two agreements deal with capitalizing the VIE, and attaining some sort of collateral for the loan given to provide funds for the capitalization. To achieve this, a loan agreement is set up and the equity in the VIE is pledged as collateral in the event of any failure to comply with the agreement.

The loan is normally given to the owners of a VIE by the WFOE and is typically in the form of an RMB denominated, interest free loan running for a number of years with the potential for extension. A loan from the offshore public company would face regulatory problems with the State Administration of Foreign Exchange. Regulatory problems remain, however. The authorized business scope of the WFOE is unlikely to include making loans to Chinese individuals, although no companies appear to have been challenged on this issue.

***The loan is normally given to the owners of a VIE by the WFOE***

The loan agreement typically transfers most shareholder rights from the Chinese shareholder of the VIE to the WFOE, giving the WFOE the power to vote shares in the VIE, collect dividends, and make other important corporate decisions.

***The loan agreement transfers most shareholder rights from the Chinese shareholder of the VIE to the WFOE***

### Equity pledge agreement

In order to establish security for this loan the owners of the VIE pledge their equity as collateral. Because an equity pledge is a form of security interest, it needs to be registered with the relevant Chinese authorities before it is perfected. If there is no registration, the equity pledge agreement may be unenforceable. In the past, companies have had difficulty getting these equity pledges properly registered. Pressure from the SEC has led to greater compliance by companies in seeking the registration of equity pledge agreements.

***Owners of the VIE pledge their equity as collateral***

### Call option agreement

The call option gives the WFOE the legal right to purchase the VIE at a set price. This price is typically the amount of the loan granted to the founders to capitalize the VIE, or the "lowest permissible price under PRC law". However, because the VIE is usually in an industry that is restricted to foreign investment, the call option cannot be exercised by the WFOE and would instead need to be transferred to another Chinese individual.

***Gives the WFOE the legal right to purchase the VIE at a set price***

### Technical service agreement

The major challenge with VIE arrangements is the requirement that the parent company have a right to the residual profits of the VIE. This is typically accomplished through an agreement or series of agreements that name the WFOE as the exclusive provider of technical services to the VIE. The services provided by the WFOE to the VIE vary by company and industry, but often include website maintenance, programming, sales support, fulfilment services, curriculum development, etc. The agreements give the power to set the pricing for these services to the WFOE, and often explicitly provide that the WFOE can extract all of the profits of the VIE through these service agreements. In practice, however, many companies do not extract all of the profits through service agreements. Some companies also use an asset licensing agreement, under which the WFOE licenses certain assets, typically including intellectual property, to the VIE in exchange for royalty fees.

***WFOE can extract all of the profits of the VIE through service agreements***

### Power of attorney

The founders of the VIE typically give a power of attorney to the WFOE that assigns to it all of the normal shareholder rights, including voting, attending shareholder meetings, and acts necessary to execute the call option agreement.

***Give a power of attorney to the WFOE***

## *Challenges to the VIE structure*

Despite its widespread use for privately held Chinese companies listing abroad, the VIE structure has come under considerable attack in recent years. These risks fall into three broad categories: regulatory risks, shareholder misappropriation risks, and operational risks.

### Regulatory Risks – Will the government shut down my company?

The raison d'être for VIEs is to avoid the effect of regulation. Companies that use the VIE structure tell two inconsistent stories. To Chinese regulators they say that the business is owned by Chinese and not by foreigners. Yet, to foreign investors they claim that foreigners own the business. It is unsurprising that VIEs face regulatory challenges.

***To Chinese regulators they say that the business is owned by Chinese and not by foreigners. Yet, to foreign investors they claim that foreigners own the business***

Chinese regulators initially ignored the growing use of VIE structures, even as most of China's Internet sector was developed under this model.

***Chinese regulators initially ignored the growing use of VIE structures***

No PRC regulatory body has officially approved a VIE structure, yet many investors and advisors believe that they have tacit approval to use the structure. There have been several challenges to VIE structures by regulators in recent years.

The first regulatory attack on VIEs came in 2009 when the General Administration of Press and Publication (GAAP), and two other regulators published Xin Chu Lian [2009] No. 13, (Notice 13). Notice 13 specifically prohibited the use of contractual arrangements to control Chinese Internet game operators. No action, however, has been taken against companies in this sector that use the VIE structure and the rules have essentially been ignored.

***The first regulatory attack on VIEs came in 2009...***

A more serious attack on the VIE structure occurred in late 2010 when Jack Ma of Alibaba Group attempted to obtain a license for Alipay from the People's Bank of China (PBOC). The PBOC had decided to regulate online payment processors and as a first step required them to obtain a license. Alipay is the market leader among online payment processors in China. It operated as a WFOE that was wholly owned by the Alibaba Group, a Cayman Islands company owned in turn by Yahoo!, Softbank and Jack Ma, a Chinese individual and CEO of Alibaba Group. Jack Ma was apparently told by regulators that Alipay could not obtain the required license if it was a WFOE, so the entity was converted to a VIE with Jack Ma as shareholder. Jack Ma was then informed by regulators that the license would not be granted to a VIE, so the VIE was unwound and Jack Ma ended up owning Alipay entirely by himself. Yahoo! and its shareholders were obviously outraged at the loss of Alipay, and negotiations ultimately lead to a deal for Alibaba to buy out Yahoo!.

***...and then a more serious attack in 2010...***

Buddha Steel, Inc. pulled its planned IPO in March of 2011 after local regulators in Hebei province told the company that its VIE structure contravened current Chinese management practices related to foreign invested enterprises and, as a result, was against public policy. Steel is a restricted industry for foreign investment.

***...and let's not forget Buddha Steel***

In August 2011, the Ministry of Commerce issued regulations requiring a national security review when foreigners acquire domestic companies. These regulations specifically provide that the required review could not be avoided through use of VIE or similar structures.

***National Security review needed***

In September 2011, a report surfaced in the Chinese press that was purported to come from the China Securities Regulatory Commission (CSRC). The report advocated greater regulation of the VIE structure (particularly in sensitive areas such as the internet), and suggested that Chinese companies should be encouraged to list at home. The report was widely reported and lead to a significant decline in the price of companies using the VIE structure. Over the next year, however, no significant changes in the regulation of VIEs transpired.

***Greater regulation of the VIE structure***

### Shareholder misappropriation risks – Will someone steal my VIE?

The nightmare scenario for investors in companies using the VIE structure is that the Chinese shareholder of the VIE will one day take the VIE and refuse to acknowledge the VIE agreements. The VIE structure is dependent on the enforceability of the contracts between the WFOE and the VIE. If those

***The Chinese shareholder of the VIE will one day take the VIE and refuse to acknowledge the VIE agreements***

contracts can be breached, not only does the accounting treatment fail, but also the public shareholders lose the business that is in the VIE.

Lawyers have given opinions that VIE structures are legal under Chinese law, often using remarkable legal gymnastics to explain why specific rules such as GAPP's specific prohibition on the use of VIEs for online games does not apply to their Internet game company. The opinions are consistently caveated with a statement that Chinese law is unclear and that authorities might disagree. The opinions point out that if authorities disagree, the consequences could be disastrous, leading possibly to the business being shuttered. What they do not usually point out is that the shareholder of the VIE might take the position that the contracts are not enforceable and will simply decide to ignore them and take the VIE. Like most countries, China has a rule that says that contracts that frustrate public policy are not enforceable, and as we saw in the Buddha Steel case, local regulators and judges might decide that VIE contracts frustrate public policy.

***Lawyers have given opinions that VIE structures are legal under Chinese law...***

***...but the opinions are consistently caveated with a statement that Chinese law is unclear and that authorities might disagree***

The first case challenging VIE contracts came up with the company that started the VIE trend – Sina. In 2001, not long after Sina's IPO, its board removed a founder who was also the controlling shareholder of its VIE. In the end the founder agreed to sell his shares in the VIE to another insider, and a crisis was averted.

***The first case challenging VIE contracts came up with the company that started the VIE trend – Sina***

Nasdaq listed Agria Corporation nearly lost its VIE in 2008 when its COO, who also owned the VIE, resigned in a compensation dispute. The COO had no share interest in the public company. The dispute was settled through a significant payment of cash and shares to the COO and to management of the VIE, and Agria was able to retain control of its VIE.

Gigamedia, a Nasdaq listed, Taiwan based, online game company lost its VIE when it tried to replace the VIE owner as head of its China operations. The VIE owner took the company chops, registrations and other key documents for both the VIE and the WOFE. The company and the VIE owner are fighting it out in court, but Gigamedia had to start over in China.

The most serious case related to loss of the VIE to the VIE shareholder was that of Alipay and Jack Ma. As previously discussed, Jack Ma ended up with sole ownership of Alipay after the PBOC said that Alipay could not get an online payment processor license if it was controlled by foreigners either as a WFOE or through VIE agreements.

***The most serious case related to loss of the VIE to the VIE shareholder was that of Alipay and Jack Ma***

### Operational Risks – Will the VIE actually work?

VIE structures have been in use in China for a little more than a decade. While the regulatory risks and risks of VIE shareholder misappropriation have gotten most of the headlines, there is growing concern that the VIE structure is unworkable for some companies. When most of the business in the company is conducted in the VIE, China's tax and business laws make it difficult and expensive to operate a VIE.

***There is growing concern that the VIE structure is unworkable for some companies***

The problems arise in asset-heavy VIEs; those where most of the assets and most of the business is conducted in the VIE. Internet companies are examples of asset-light VIEs. They usually have a small proportion of the assets and business in the VIE, operating most of the business in their WFOE. An Internet company will typically put only the Internet content provider license and the servers necessary to host the site into the VIE, retaining all of the

***The problems arise in asset-heavy VIEs***

programming, advertising sales, and fulfilment activities in the WFOE. Consequentially there is minimal profit in the VIE, and this profit can be easily extracted through the service agreements.

Education companies are good examples of asset-heavy VIEs. In this industry it is necessary to put the entire school into the VIE because of restrictions on foreign ownership. Because the school has to collect the tuition, all of the profit of education companies tends to end up in the VIE. That creates problems.

***Tax is a problem***

Under the typical VIE structure, the profits of a VIE are extracted to the public company through service contracts. Chinese tax laws impose a 5% business tax on service payments. The business tax is similar to a sales tax or value added tax (VAT); in fact, China is in the process of turning the business tax into VAT. This tax is a cost of using a VIE since it would not be payable (because there would be no service charge) if the operations were in the WFOE.

***Why would a company pay 100% of its earnings to another company for services?***

There is also concern that Chinese tax authorities might question why a company would pay 100% of its earnings to another company for services. That is especially likely when those services are of dubious value. The authorities might make a transfer pricing adjustment, disallowing a deduction to the VIE for part or all of the service fee. That would significantly increase the tax liability of the VIE (which usually pays tax at 25%). If the tax authorities adjusted the transfer price, they might also allow the WFOE to reduce the income it reports, resulting in a tax refund to the WFOE. But they might not. After all, the cash found its way to the WFOE, so the tax authorities might instead characterize the payment as a dividend to the individual shareholder of the VIE (which is taxed at 20%), followed by a payment from the individual shareholder to the WFOE (which might be characterized as interest on the loan, and taxed to the WFOE at 25%). The end result would be a disaster – raising the effective tax rate above 60%.

***Many asset-heavy VIEs have not been making the payments on the service contracts***

Because of this risk, many asset-heavy VIEs have not been making the payments on the service contracts. Another reason for not making the payments is that the companies typically need the cash in the VIE, not the WFOE. It is usually not in the authorized business scope of the WFOE to be making loans or capital contributions to the VIE, so if the cash is transferred to the WFOE it is difficult to get it back to the VIE where it is needed for operations or capital improvements.

***Companies have not typically been accruing the taxes***

Companies have not typically been accruing the taxes that would result if they made the service payments under the VIE agreements. They argue that they do not intend to ever make these payments. The problem with that argument is that it undermines the basis for treating the company as a VIE in the first place. One of the key requirements for consolidating a company as a VIE is that the parent company has a right to the residual profits of the VIE. If it has no intent to ever distribute the profits of the VIE to the public company, should the public company be considered to have a right to those residual profits?

***A scandal with New Oriental Education***

The most recent scandal with respect to VIEs broke when New Oriental Education (NYSE: EDU) "EDU", announced that it was under SEC investigation as to whether it should be consolidating its VIEs. Shortly after this announcement Muddy Waters, a short-selling research firm, released a report alleging that EDU was improperly consolidating certain operations that were actually franchise operations, not-for-profits, or state-owned. A special committee of the board was formed to conduct an investigation.

## *Where to now?*

***The VIE structure is unsustainable***

The problems with VIEs have led many investors to conclude that the structure is unsustainable. The problems are unsurprising because the structure is based on inconsistent statements. To investors, the company says that it owns its operations, yet to Chinese regulators it claims it does not control them. Neither statement is true and a structure built on lies is not likely to work for long.

The reasons why the VIE structure is needed are related to Chinese regulations restricting foreign investment in certain sectors, or which make it difficult for Chinese companies to directly list abroad. The solution to the problem can be found by addressing those regulations.

***SOEs can list overseas***

A number of state-owned enterprises have listed abroad without using offshore structures or VIEs. China's major telecommunications companies, China Mobile, China Unicom, and China Telecom are all listed on the New York Stock Exchange yet do not use either an offshore holding company or a VIE. Like the Internet industry, the telecommunications industry is restricted for foreign investment. These state-owned enterprises had the political power to obtain permission to directly list ADSs abroad and to have foreign investment. Private companies have not had that level of political clout and as a consequence were forced into offshore holding companies and VIE structures.

***Why not allow private companies?***

The problem with VIEs and offshore companies could be eliminated if permission were given to private companies to directly list abroad. No change in law or regulations appears to be necessary, rather the government simply needs to give the same permission to privately owned companies to directly list abroad that it has given to the large SOEs.

***It would help closing the regulatory hole***

Allowing private Chinese companies to directly list abroad would eliminate the only justification for using a VIE structure – to avoid Chinese regulations that prohibit foreign investment in certain sectors. It has the additional benefit of closing the regulatory hole that these companies have fallen into. Chinese regulators have been unable to effectively regulate overseas listed Chinese companies because the listing entity is usually a Cayman Islands company that is outside of their jurisdiction. U.S. regulators like the SEC and the Public Company Accounting Oversight Board (PCAOB) have likewise been unable to effectively regulate these companies because, despite being Cayman Islands companies, the officers and records are located in China and Chinese regulators will not grant them access. These regulatory holes have been a major factor in creating an environment conducive to fraud. While allowing private companies to directly list abroad does not solve the access issues for U.S. regulators, it would allow Chinese regulators to more effectively supervise the companies.

## *How to fix the VIE structures*

***Ask US-listed Chinese companies to restructure***

If China decides to allow private companies to directly list abroad in the same manner as SOEs, the Cayman Islands and VIE structures are no longer necessary. If Chinese regulators decide to go in this direction, I expect they will approach several leading U.S. listed Chinese companies and ask them to restructure. The companies will be allowed to directly list ADSs of a Chinese company on U.S. exchanges, but first they will be asked to merge the offshore parent company and the WFOE into the VIE. At that point the operating company in China would become the listed company. That is a big win for investors since they now have direct ownership in the entity that actually operates the business. The restructuring solves the regulatory problems, the shareholder moral hazard problems and the operational problems that have plagued the VIE structure. Investors can also hope that Chinese regulators take a more active role in supervising the company, perhaps heading off some of the frauds that have so damaged the market for U.S. listed Chinese companies.

***Investors would actually own the operating company***

***Use a multiple share structure to retain control***

The original concern of Chinese regulators in restricting foreign investment in certain sectors was to make certain that Chinese, and not foreigners, were making the decisions that impact sensitive sectors. Those concerns remain, even though the offshore structures and VIEs have substantially undermined the policy. I expect that Chinese regulators will want to make certain that Chinese remain in control of critical decisions that may impact social stability or state secrecy. The easiest way to accomplish this would be through a multiple share structure. A shares, with full voting rights, would be issued to Chinese nationals. B shares, with limited voting rights would be traded as ADSs on U.S. exchanges. This structure would also facilitate the listing of A shares on Chinese exchanges, which I expect the companies will be encouraged to do. Chinese regulators have indicated they would prefer that the overseas listed companies come home to list, and this could be the first step in making that happen.

Another advantage of allowing Chinese companies to directly list abroad is that the CSRC could be made the first gatekeeper for access to foreign capital markets. Companies that wish to list overseas would need to seek the permission of the CSRC, which could stop listings of companies with state security issues or disreputable management. By making the CSRC the primary regulatory of overseas listed companies, it should be easier for overseas regulators such as the SEC and PCAOB to negotiate workable arrangements for obtaining the information needed to enforce foreign securities laws.

**Figure 2: US Listed Companies With VIE Structure, in Descending Order of Market Capitalisation**

| Company | BBG | Industry | IPO/RTO | Market Capitalisation (US$m) | YTD US$ (%) |
|---|---|---|---|---|---|
| Baidu Inc-Sp Adr | BIDU | Internet | IPO | 40,314 | -1 |
| Netease Inc-Adr | NTES | Internet | IPO | 6,764 | 15 |
| Sina Corp | SINA | Internet | IPO | 4,587 | 33 |
| Youku Tudou Inc | YOKU | Internet | IPO | 3,357 | 32 |
| Focus Media-Adr | FMCN | Advertising | IPO | 3,126 | 25 |
| Qihoo 360 Te-Adr | QIHU | Internet | IPO | 2,953 | 58 |
| Ctrip.Com-Adr | CTRP | Internet | IPO | 2,653 | -21 |
| New Oriental-Adr | EDU | Commercial Services | IPO | 2,347 | -37 |
| Sohu.Com Inc | SOHU | Internet | IPO | 1,666 | -12 |
| Renren Inc-Adr | RENN | Internet | IPO | 1,562 | 14 |
| Changyou.Com-Adr | CYOU | Software | IPO | 1,416 | 38 |
| 51job Inc-Adr | JOBS | Commercial Services | IPO | 1,260 | 4 |
| Giant Intera-Adr | GA | Internet | IPO | 1,219 | 34 |
| Home Inns & -Adr | HMIN | Lodging | IPO | 1,163 | -1 |
| Shanda Games-Adr | GAME | Software | IPO | 1,073 | 24 |
| Soufun Holdi-Adr | SFUN | Internet | IPO | 1,090 | 7 |
| Spreadtrum-Adr | SPRD | Semiconductors | IPO | 985 | 2 |
| Asiainfo-Linkage | ASIA | Internet | IPO | 880 | 57 |
| Tal Educatio-Adr | XRS | Commercial Services | IPO | 662 | -14 |
| E-House Chin-Ads | EJ | Real Estate | IPO | 661 | 34 |
| 21vianet-Adr | VNET | Internet | IPO | 619 | 21 |
| Autonavi Hol-Adr | AMAP | Software | IPO | 608 | 22 |
| Elong Inc-Sp Adr | LONG | Internet | IPO | 567 | 10 |
| Perfect Worl-Adr | PWRD | Internet | IPO | 546 | 23 |
| E-Commerce C-Adr | DANG | Internet | IPO | 435 | 24 |
| Nq Mobile Inc- A | NQ | Software | IPO | 381 | 52 |
| Hisoft Techn-Adr | HSFT | Software | IPO | 358 | 24 |
| Fushi Copperweld | FSIN | Electrical Compo&Equip | RTO | 349 | 21 |
| Cninsure Inc-Adr | CISG | Insurance | IPO | 324 | -7 |
| Synutra Internat | SYUT | Pharmaceuticals | RTO | 309 | 7 |
| Bona Film Gr-Adr | BONA | Entertainment | IPO | 308 | 33 |
| Isoftstone -Ads | ISS | Commercial Services | IPO | 298 | -39 |
| 3sbio Inc-Adr | SSRX | Biotechnology | IPO | 299 | 32 |
| Yingli Green-Adr | YGE | Electrical Compo&Equip | IPO | 295 | -51 |
| Kongzhong-Adr | KONG | Telecommunications | IPO | 284 | 65 |
| Phoenix New -Adr | FENG | Media | IPO | 275 | -37 |
| Noah Holding-Ads | NOAH | Diversified Finan Serv | IPO | 264 | -22 |
| Xueda Edu Gp-Adr | XUE | Commercial Services | IPO | 231 | -4 |
| Ambow Educat-Adr | AMBO | Commercial Services | IPO | 209 | -60 |
| Charm Commun-Adr | CHRM | Advertising | IPO | 200 | -39 |
| Bitauto Hold-Adr | BITA | Internet | IPO | 180 | 8 |
| China Nepsta-Adr | NPD | Retail | IPO | 181 | 46 |
| Cdc Corp-Cl A | CDCAQ | Software | IPO | 180 | 3,088 |
| Chindex Intl Inc | CHDX | Healthcare-Products | RTO | 177 | 22 |
| China Digita-Adr | STV | Electronics | IPO | 173 | -8 |
| Jiayuan.Com Inte | DATE | Internet | IPO | 172 | -6 |
| Utstarcom Holdin | UTSI | Telecommunications | IPO | 170 | -21 |

| Company | BBG | Industry | IPO/RTO | Market Capitalisation (US$m) | YTD US$ (%) |
|---|---|---|---|---|---|
| China Transinfo | CTFO | Software | RTO | 144 | 63 |
| Taomee Holdi-Adr | TAOM | Internet | IPO | 135 | -20 |
| Airmedia-Adr | AMCN | Advertising | IPO | 122 | -49 |
| The9 Ltd-Adr | NCTY | Software | IPO | 121 | -31 |
| Chinacache-Adr | CCIH | Internet | IPO | 113 | 24 |
| China Distan-Adr | DL | Commercial Services | IPO | 108 | 56 |
| Chinaedu Cor-Adr | CEDU | Commercial Services | IPO | 105 | 0 |
| Linktone Ltd-Adr | LTON | Internet | IPO | 93 | 94 |
| Ata Inc-Adr | ATAI | Software | IPO | 98 | -39 |
| Syswin Inc-Ads | SYSW | Real Estate | IPO | 94 | 111 |
| China Nuok-Adr | NKBP | Pharmaceuticals | IPO | 92 | 69 |
| Acorn Intern-Adr | ATV | Advertising | IPO | 81 | -33 |
| Kingold Jewelry | KGJI | Retail | RTO | 79 | 30 |
| L&L Energy Inc | LLEN | Coal | RTO | 74 | -24 |
| Sky-Mobi Ltd-Adr | MOBI | Retail | IPO | 70 | -30 |
| Cogo Group Inc | COGO | Computers | RTO | 60 | 0 |
| China Techfa-Adr | CNTF | Telecommunications | IPO | 55 | -42 |
| Lentuo Inter-Adr | LAS | Retail | IPO | 56 | -24 |
| Noah Educati-Adr | NED | Software | IPO | 54 | -33 |
| Ku6 Media-Adr | KUTV | Internet | IPO | 50 | -17 |
| Ninetowns In-Ads | NINE | Software | IPO | 43 | -15 |
| Agria Corp - Adr | GRO | Agriculture | IPO | 41 | -29 |
| Mecox Lane-Adr | MCOX | Internet | IPO | 37 | -45 |
| Sinocoking Coal | SCOK | Coal | RTO | 38 | -21 |
| Origin Agritech | SEED | Biotechnology | RTO | 33 | -39 |
| Tri-Tech Holding | TRIT | Environmental Control | IPO | 32 | -15 |
| China Informatio | CNIT | Telecommunications | RTO | 27 | -21 |
| Daqo New Ene-Adr | DQ | Chemicals | IPO | 30 | -49 |
| Vimicro Inte-Adr | VIMC | Semiconductors | IPO | 31 | -38 |
| Trunkbow Interna | TBOW | Telecommunications | RTO | 29 | -58 |
| China Financ-Adr | JRJC | Internet | IPO | 28 | -22 |
| Visionchina -Adr | VISN | Advertising | IPO | 27 | -79 |
| Advanced Battery | ABAT | Electrical Compo&Equip | RTO | 24 | -26 |
| Chinacast Educat | CAST | Commercial Services | RTO | 24 | -92 |
| China Natural Ga | CHNG | Pipelines | RTO | 21 | na |
| Telestone Techno | TSTC | Telecommunications | RTO | 18 | -64 |
| China Hgs Real E | HGSH | Real Estate | RTO | 15 | -45 |
| Efuture Informat | EFUT | Software | IPO | 15 | -14 |
| Skystar Bio-Phar | SKBI | Pharmaceuticals | RTO | 13 | -40 |
| Shengkai Innovat | VALV | Miscellaneous Manufactur | RTO | 12 | -43 |
| Andatee China | AMCF | Transportation | IPO | 12 | -61 |
| Biostar Pharmace | BSPM | Pharmaceuticals | Other | 11 | -38 |
| Chinanet Online | CNET | Advertising | RTO | 11 | -55 |
| Tianli Agritech | OINK | Agriculture | IPO | 10 | -19 |
| China Jo-Jo Drug | CJJD | Retail | RTO | 10 | -38 |
| China Yida Holdi | CNYD | Media | RTO | 9 | -77 |
| Dehaier Med Sys | DHRM | Healthcare-Products | IPO | 9 | 32 |
| Euro Tech Hldgs | CLWT | Distribution/Wholesale | IPO | 8 | 56 |
| Qkl Stores Inc | QKLS | Food | RTO | 8 | -64 |

| Company | BBG | Industry | IPO/RTO | Market Capitalisation (US$m) | YTD US$ (%) |
|---|---|---|---|---|---|
| Cleantech Soluti | CLNT | Metal Fabricate/Hardware | RTO | 7 | -13 |
| China Advanced C | CADC | Building Materials | RTO | 8 | -81 |
| Sino-Global Ship | SINO | Transportation | IPO | 6 | 0 |
| Recon Technology | RCON | Oil&Gas Services | IPO | 7 | 465 |
| Kingtone Wir-Adr | KONE | Software | IPO | 4 | -15 |
| Jingwei Internat | JNGW | Software | RTO | 3 | na |
| Tibet Pharma | TBET | Pharmaceuticals | IPO | 1 | -95 |
| China Cgame Inc | CCGM | Internet | RTO | 1 | -81 |

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