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China's Foreign Ownership Restrictions and the VIE Structure

[CHINA REGULATION WATCH](#)¹

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1. Foreign Ownership Restrictions

Foreign investment in the People's Republic of China (the "PRC") is either restricted or prohibited in several industries such as the telecommunications industry, which includes most internet focused businesses. The primary regulation with respect to foreign investment restrictions in China is the Special Administrative Measures for the Access of Foreign Investment (Negative List) (外商投资准入特别管理措施(负面清单)), as amended from time to time on a regular basis, which provides a negative list that contains the prohibited and restricted categories of industry for foreign investment.² The telecommunication industry, for example, is classified as restricted,³ while internet cultural activities and online publishing services are classified as prohibited.⁴

In certain restricted industries, such as the telecommunication industry, foreign investment must take the form of an equity joint venture and the foreign ownership interest in the joint venture may not exceed fifty percent. In prohibited industries, such as those involving internet cultural activities and online publishing services, foreign investment is not permitted in any form. For example, the National Press and Publication Administration (国家新闻出版署) ("NPPA") will not accept applications from foreign-invested entities for an online publishing service license.

2. Variable Interest Entity (VIE) Structure Overview

Notwithstanding these foreign investment restrictions, many of China's companies that operate in restricted or prohibited industries have received financing from foreign venture capital

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² The latest version being the Special Administrative Measures for the Access of Foreign Investment (Negative List) (2021 Edition) (外商投资准入特别管理措施(负面清单)(2021年版)), issued by the National Development and Reform Commission (国家发展和改革委员会) ("NDRC") and the Ministry of Commerce (商务部) on December 27, 2021 (the "2021 Negative List").

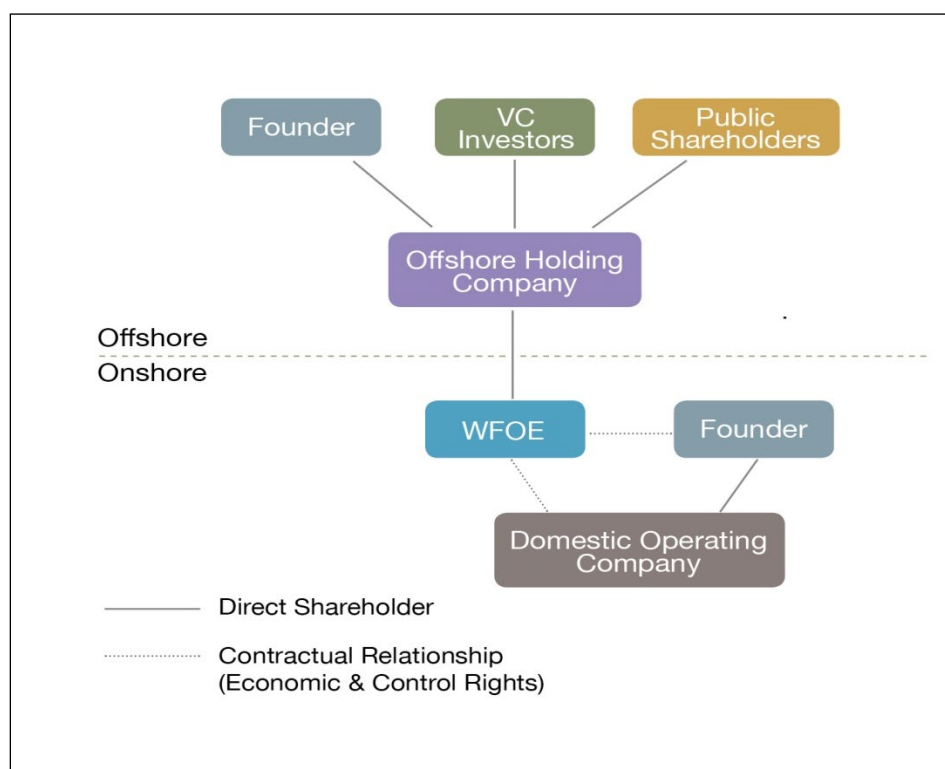
³ See Section 14 of the 2021 Negative List.

⁴ See Section 15 of the 2021 Negative List.



funds and listed their shares on overseas stock exchanges.⁵ Such companies have achieved what they believe to be technical compliance with the foreign ownership restrictions by establishing a variable interest entity (“VIE”) structure in which the foreign-invested entity does not have a direct ownership interest in the domestic operating company that holds the licenses required to operate in the restricted or prohibited industry in China.

Under a VIE structure, the foreign-invested entity generally is a wholly owned subsidiary of an offshore holding company (the “WFOE”), in which the original founders, the venture capital investors and the public shareholders invest. Although the WFOE does not have a direct equity interest in the domestic operating company, the WFOE does control the operating company through a series of contractual relationships with both the operating company and the operating company’s nominee shareholders, which are often the company founders, relatives of the founder or trusted employees. In addition, the WFOE generally enters into a consulting agreement with the operating company pursuant to which the WFOE extracts substantially all of the operating company’s profits.



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Although the contractual relationships among the WFOE, the operating company and the operating company’s shareholders vary from one VIE structure to another, these contractual relationships generally include, or should include, the features summarized below. (For a list of

⁵ Internet companies in China with shares listed on overseas stock exchanges include: Kingsoft Corporation Limited (“Kingsoft”), Netease.com, Inc. (“NetEase”), Sina Corporation (“Sina”), Tencent Holdings Limited (“Tencent”) and The9 Limited (“The9”).



the specific features of the VIE structures for a sample group of internet companies in China, see Annex I.)

- (1) Purchase Option. The WFOE generally has a right to purchase the shares of the operating company from its nominee shareholders once such a purchase is permitted by applicable law.
- (2) Control Rights. The WFOE is generally able to exercise control over the operating company through agreements with the shareholders of the operating company or with the operating company directly, such as a voting rights agreement, a proxy, or a power of attorney. The VIE structures of some companies use more than one form of control rights agreement.
- (3) Revenue Agreements. The WFOE generally enters into one or more agreements with the operating company that permit the WFOE to extract substantially all of the profits from the operating company, such as a consulting agreement, a technical service agreement, and a variety of copyright license agreements. The fees charged under these agreements are generally not fixed amounts, but vary depending upon costs incurred, revenue generated or some other set of variables.
- (4) Loan Agreement. In situations where the operating company requires additional capital investment, the WFOE often enters into loan agreements with the nominee shareholders of the operating company and the shareholders then use the loaned funds to increase the registered capital of the operating company. If, however, the WFOE is a newly established company, in accordance with the usage restrictions on WFOE registered capital required by the State Administration of Foreign Exchange, the WFOE might not be permitted to provide a loan with its registered capital.⁶ As a result, the parties might need to explore other funding mechanisms, such as direct investment into the operating company by one or more current or new nominee shareholders.
- (5) Equity Pledge. The nominee shareholders of the operating company generally pledge their shares to the WFOE to guarantee the operating company's compliance with the terms of the revenue agreements and, if relevant, the nominee shareholders' compliance with the terms of the loan agreements. Pursuant to the share pledge agreement the nominee shareholders generally covenant not to sell their shares to any third party or to permit any encumbrance upon their shares.
- (6) Spouse Consent Letter. Any nominee shareholder that is married at the time he receives his equity interest in the operating company, or later becomes married, should have his spouse execute a spouse consent letter. This spouse consent letter should confirm that the equity interest of the operating company is the separate property and personal asset of the

⁶ See Article 4 of the Circular of the State Administration of Foreign Exchange on Reforming the Management Approach regarding the Settlement of Foreign Exchange Capital of Foreign-invested Companies (国家外汇管理局关于改革外商投资企业外汇资本金结汇管理方式的通知), issued by the State Administration of Foreign Exchange (国家外汇管理局) on March 30, 2015.



nominee shareholder, and that if the spouse inadvertently obtains any right to such equity interest then the various VIE agreements executed by the nominee shareholder shall also bind the spouse. Prior to 2011, when Tudou's initial public offering was delayed as a result of the founder's divorce proceedings and an attempt by his spouse to obtain an ownership interest in Tudou's operating company, this risk was not well understood. Accordingly, many current VIE structures do not include a spouse consent letter.⁷

Although this VIE structure has been in use since the first China internet companies listed their shares on NASDAQ in 2000,⁸ there are certain risks associated with the structure. For example, the nominee shareholders of the operating company are often the original founders, their family members or their trusted employees. If a conflict arose between these nominee shareholders and the management of the offshore holding company, the nominee shareholders could attempt to challenge the validity of the various control contracts.⁹ Since the control contracts do not comply with the spirit of the foreign ownership restrictions, a court in China may find that the control contracts are not enforceable. In addition, NPPA or the Ministry of Industry and Information Technology (工业和信息化部) could determine that the VIE structure violates the foreign ownership restrictions and terminate the licenses held by the operating company that are required in order to operate in the restricted or prohibited industries.

In addition to these risks and others listed in the disclosure documents of the various PRC companies operating in restricted or prohibited industries with shares listed on overseas stock exchanges, the VIE structure is also tax inefficient. All of the profits that are extracted from the operating company by the WFOE through consulting agreement fees are subject to a six percent (6%) value-added tax.¹⁰

Finally, although the VIE structure has advanced the development of several industries in China, including the internet industry, by facilitating foreign venture capital investments and overseas public offerings, this same structure is generally not regarded as a viable means for foreign companies that operate in restricted or prohibited industries to enter China's domestic market. Some foreign companies have used the VIE structure to enter China's domestic market for internet culture activities and internet publishing, but they have generally done so in a very low-profile manner with careful consideration given to the branding of the domestic operating company's service platform. High profile foreign companies generally do not view the VIE structure as a viable way to enter China's restricted or prohibited industries. Amazon.com, Inc, however, announced in 2012 that its operations in China were conducted through a VIE, which

⁷ For a discussion of the nominee shareholder's spouse risk factors, see "[Tudou IPO Exposes Yet Another China Risk Factor: the Founder's Wife](#)", by Greg Pilarowski on August 19, 2011 at the New York Times, via Venture Beat.

⁸ Sina, NetEase and Sohu completed their initial public offerings, listing their securities on NASDAQ, in April, June and July of 2000, respectively. All three companies used a VIE structure to complete their initial public offerings.

⁹ See "[GigaMedia will Survive Current VIE Turmoil](#)", posted at Seeking Alpha on June 3, 2011, for a summary of GigaMedia's loss of control over its VIE Shanghai T2 Entertainment. See "[Getting to the Bottom of the Alipay Dispute](#)", posted at Caixin Online on June 24, 2011, for a summary of the unilateral decision of Alibaba's founder Jack Ma to terminate the VIE structure agreements through which Alibaba controlled Alipay, one of the largest online payment platforms in China.

¹⁰ See Notice to Implement Change from Business Tax to Value-Added Tax Pilot Zone Management Nationally (关于在全国开展营业税改征增值税试点有关征收管理问题的公告), issued by State Administration of Taxation (国家税务总局) on July 10, 2013.



suggests that at least one high profile foreign company had entered restricted sectors of China's economy through the use of this structure.¹¹

3. Supreme People's Court Considers the VIE

On July 2, 2016, the Supreme People's Court of China (最高人民法院) (the "Supreme Court") issued a decision related to the VIE structure, which may provide some comfort to the investors in a VIE structure since the court was invited to consider the validity of VIE agreements and to invalidate them for violating PRC law, but the court declined to do so. Although the decision didn't affirm the validity of VIE agreements, the Supreme Court's decision to not invalidate the VIE structure suggests that there is an understanding of the harm that invalidating the structure would likely cause to the many PRC businesses that rely upon this structure for foreign investment and overseas stock exchange listings. Below please find a summary of the key facts of the case and relevant holdings in the Supreme Court decision.

Ambow Education Holding Ltd., a Company established under the laws of the Cayman Islands ("Ambow Cayman"), owns one hundred percent (100%) of Beijing Ambow Online Software Co., Ltd (北京安博在线软件公司), a wholly foreign-owned entity established under the laws of the PRC ("Ambow WFOE"). Through a VIE structure, Ambow WFOE controls Beijing Normal University Ambow Education Technology Co., Ltd. (北京师大安博教育科技有限公司), a domestic company established under the laws of the PRC with two PRC citizens as nominee shareholders ("Ambow Domestic Company").

In 2009, Hunan Changsha Yaxing Property Development Co., Ltd (长沙亚兴置业发展有限公司) ("Yaxing"), the plaintiff, entered into a cooperation framework agreement (the "Framework Agreement") with Ambow Domestic Company, pursuant to which Yaxing sold a kindergarten to Ambow Domestic Company in exchange for cash along with stock issued by Ambow Cayman. In 2010, after the Yaxing deal closed, Ambow Cayman completed its initial public offering and New York Stock Exchange listing. In 2012, however, Ambow Cayman's stock price collapsed, and subsequently the company was delisted, which resulted in Ambow Cayman's stocks becoming largely worthless.

Unhappy with this outcome, Yaxing brought a lawsuit against Ambow Domestic Company in the Hunan Province Higher People's Court (湖南省高级人民法院), claiming that the Framework Agreement was null and void because it is illegal for Ambow Domestic Company to own a kindergarten. Yaxing argued that (i) Ambow WFOE controlled Ambow Domestic Company through various VIE agreements, and therefore Ambow Domestic Company should be deemed to be a foreign-invested company; and (ii) the Framework Agreement shall be deemed void because it violates various mandatory requirements under "PRC laws and regulations," including the Foreign Investment Catalogue, pursuant to which foreign-invested

¹¹ See "MNCs and VIEs" by Paul Gillis at chinaaccountingblog.com. See also page 32 of Amazon's report on Form 10-Q for the quarter ended June 30, 2012, filed with the U.S. Securities and Exchange Commission (the "SEC"). According to Amazon's latest Form 10-Q report (see page 35) filed with the SEC, Amazon is still using this structure to operate its business in China.



companies are prohibited from providing compulsory education services, such as operating a kindergarten.

Hunan Province Higher People’s Court, however, decided in favor of Ambow Domestic Company. Yaxing appealed to the Supreme Court, but the Supreme Court affirmed the Hunan Province Higher People’s Court’s decision. The Supreme Court decision held as follows:

- (1) Although a VIE structure exists, Ambow Domestic Company shall not be deemed as a foreign-invested company because Ambow WFOE is not a shareholder of Ambow Domestic Company and none of Ambow Domestic Company’s shareholders are foreigners. The source of the funds that shareholders used to pay the registered capital of a company is not relevant when determining what of a company the recipient of the registered capital is. The relevant factor is the identity and nature of the shareholders, not the ultimate source of registered capital funds.
- (2) Although it is correct that a contract can be voided if it violates mandatory requirements under “PRC laws and regulations,”¹² “PRC laws and regulations” only refers to the laws and regulations issued by the National People’s Congress (全国人民代表大会) (“NPC”), the Standing Committee of the NPC (全国人民代表大会常务委员会), or the State Council (国务院), and does not refer to local rules or other administrative rules. The Foreign Investment Catalogue is an administrative rule promulgated by the National Development and Reform Commission (国家发展与改革委员会) and the Ministry of Commerce (商务部). As a result, the Framework Agreement is not deemed void due to the violation of the Guidance of Foreign Investment Industries.

Although the Supreme Court did not hold the Framework Agreement void, the decision also does not constitute formal judicial recognition of the VIE structure. In the holding, the Supreme Court stated that “whether or not the VIE agreements are valid is not an issue in dispute between Yaxing and Ambow Domestic Company, and therefore this issue will not be decided by this court”. In addition, in the holding, the Supreme Court suggested that the Ministry of Education (教育部) should take measures to punish any illegal activities in this field through administrative actions.

4. Abandoning VIE Normalization

Other government authorities, such as Ministry of Commerce (商务部) (the “MOFCOM”), have also struggled with the validity of the VIE structure. In the draft of the proposed Foreign Investment Law (中华人民共和国外国投资法 (草案征求意见稿)) that MOFCOM published for commentary on January 19, 2015 (the “2015 Draft FIL”), MOFCOM introduced “actual control” whereby a company under the actual control of foreign investors would have been classified as a foreign invested company while a company whose equity holder is a foreign entity but is under the actual control of Chinese investors would have been classified

¹² See Article 52, Section 5 of PRC Contract Law (中华人民共和国合同法), issued by the Standing Committee of the National People’s Congress in March 15, 1999.



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as a domestic company.¹³ The 2015 Draft FIL would have also imposed heavy penalties for using contractual control mechanisms, including the VIE structure, to evade the foreign investment restrictions.¹⁴ Under the “actual control” standard, a company that is controlled by non-PRC citizens or non-PRC entities would not have been allowed to operate a business in a restricted or prohibited industry through the utilization of a VIE structure. In contrast, the final Foreign Investment Laws (外商投资法) adopted by the National People’s Congress on March 15, 2019 (the “FIL”) removed all references to “actual control” and penalties associated with using the VIE structure to evade foreign investment restrictions. This change suggests that there was no feasible way to adopt the “actual control” standard given the use of the VIE structure for many Chinese businesses listed on the New York Stock Exchange, Nasdaq and other foreign stock exchanges. Although the definition of “foreign investment” in the FIL suggests that other laws, administrative regulations and provisions issued by the State Council may further change the classification standards for foreign invested and domestic invested companies, given the significant potential negative effects that the “actual control” standard would have had on many of China’s leading internet companies, it is unlikely that the State Council will adopt this “actual control” standard in the future.

¹³ See Article 12 and Article 18 of the 2015 Draft FIL

¹⁴ See Article 149 of the 2015 Draft FIL.



VIE STRUCTURE OF CHINA INTERNET COMPANIES LISTED OVERSEAS

Set forth in the table below is a list of the specific features of the VIE structures for several internet companies in China, which is based upon the public filings of such companies with the U.S. Securities and Exchange Commission or the Hong Kong Stock Exchange.

For a description of each of the headings set forth in the table below, please refer to Section 2 (Variable Interest Entity (VIE) Structure Overview).

Company	Purchase Option	Control Rights	Revenue Agreements	Loan Agreement	Equity Pledge
Kingsoft	X	X	X	X	X
NetEase	X	X	X	NO	NO
Sina	X	X	X	X	X
Tencent	X ¹⁵	NO	X	NO	X ¹⁶
The9	X	X	X	X	X

¹⁵ The purchase option held by the Tencent WFOE with respect to its game operating company provides the WFOE with an option to purchase the assets of the operating company rather than the shares of the operating company.

¹⁶ The equity pledge from the shareholders of the Tencent operating company is with respect to such shareholder's rights to the registered capital of the operating company rather than the actual shares of the operating company.