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CII Report Highlights Risks Associated with a Common Chinese Corporate Structure

Washington, D.C., Dec. 14, 2017 — A new [report](#) from the Council of Institutional Investors (CII) underlines the risks posed to investors by a corporate structure called a variable interest entity (VIE). Sixty two percent of Chinese companies listed on U.S. stock exchanges use a VIE, including internet giants Sina, Baidu, Alibaba and JD.com. U.S. exchanges are experiencing a surge of Chinese VIE IPOs, with 20 filings this year, including 15 since September 1, compared to six in 2016 and seven in 2015.

“Chinese companies using VIE structures have made a splash in the U.S. market and elsewhere, but investors should be aware that VIEs lack legal protections that investors normally expect,” said Ken Bertsch, CII’s executive director.

What is a VIE? The Chinese government restricts Chinese companies in certain industries from receiving foreign investment. To sidestep these regulations, companies seeking foreign capital have adopted the VIE structure by constructing a complex network of entities, one of which is an offshore shell company that conducts an IPO on a U.S. exchange. The operating company remains technically owned by Chinese nationals, not foreign shareholders, since the entities are connected through contractual arrangements rather than direct ownership.

Investors in companies with VIEs do not own equity in the Chinese company’s operations. Because the contracts are designed to evade foreign investment restrictions, they might be invalid under Chinese contract law. **As a result, investors are left without any real right to residual profits, control over the company’s management or legal protections and recourse they would ordinarily enjoy through equity ownership.**

Key takeaways for investors from the full report include:

- The shell company conducting the IPO typically neither has operations of its own nor directly owns a company with operations. Its financial statements consolidate the

The Council of Institutional Investors (CII) is a nonprofit association of pension funds, other employee benefit funds, endowments and foundations, with combined assets that exceed \$3 trillion. CII’s non-voting members include asset management firms with more than \$20 trillion under management. CII is a leading voice for effective corporate governance and strong shareowner rights. CII educates its members, policymakers and the public about corporate governance, shareowner rights and related investment issues, and advocates on its members’ behalf.

Chinese operating company since the contractual arrangements are designed to mimic direct ownership. Confusingly, the shell company often bears the same name as the Chinese operating company.

- Since the enforceability of the contracts is in question, investors could suffer financially if Beijing enforces its foreign investment restrictions or the Chinese company's management expropriates the assets or earnings. A high profile case of expropriation took place between Alibaba's Jack Ma and Yahoo in 2011 (see page 9 of the report).
- These companies could be subject to punitive levels of taxation in China as they move money through the structure, and this potential tax liability—possibly as high as 50%—is not fully reflected in the financial statements.
- The vast majority of Chinese VIEs state in their filings with the U.S. Securities and Exchange Commission (SEC) that they have no plans to pay dividends to investors and will reinvest their earnings in China indefinitely. Investors may have to rely solely on the appreciation of the company's stock price for a return on their investment.
- These companies often adopt poor corporate governance practices. Sixty one percent that IPO'd in the last two years employ a dual-class structure with unequal voting rights. Among all Chinese VIEs, 83% are incorporated in the Cayman Islands or British Virgin Islands where required governance provisions are weak, and 56% rely on legal exemptions from board independence standards.

The report concludes by offering five recommendations to the SEC on how to improve transparency and accountability to shareholders of Chinese companies using VIEs by strengthening disclosure rules.

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