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INTERVIEW

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Policy Above Law: VIE and Foreign Investment Regulation in China

Thomas Y. Man*

Public policy is an essential source of law. It provides not only some fundamental principles underlying the spirit and basic contours of legislation, but also the rationale and practical considerations guiding the enforcement and adjudication of law by the administrative and judicial branches of a national government. The dynamic interplay between policy and law, to a large extent, displays the central characteristics of a legal system. In a system where law is (relatively) more uniformly and strictly interpreted and enforced, policy will generally stay at the background in favor of published statutes, regulations and rules, which gives market participants an enhanced sense of certainty and predictability when relying on established rules to enter into commercial contracts and conduct business activities. By contrast, in a system where policy frequently takes precedence over established rules, strict compliance with law tends to become an option, instead of an obligation, thus creating a sense of (relatively) lesser degree of certainty and predictability of law for market participants. The colorful and elusive life of Variable Interest Entity (VIE) in China in the last 15 years has afforded us a fertile test field to observe the dynamics between policy and law in China’s foreign investment regulatory regime.

For anyone who is interested in learning about the latest development of VIE in China, I highly recommend the preceding note by the JT&N lawyers who are true experts in this fast moving area. This note provides lucid, comprehensive summary of the issues and practical solutions to execute a VIE dismantling exercise. While questions remain with respect to some practical tips offered by the note,¹ its observations are perceptive and its advice is practical, balanced and firmly based on rich practical experience. For

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¹ One example relates to the interesting suggestion that foreign investors wishing to continue to hold interests in an onshore OpCo after dismantlement of the VIE structure may set up a pure domestic Renminbi fund (纯内资人民币基金) to hold such interests. If the definition of “control” used in the Draft Foreign
my purposes, it also provides an excellent starting point to peek into the policy drives that define the paradigmatic changes of VIE over the past 15 years.

Like its immediate prototype, the now infamous “Chinese-Chinese-Foreign” (C-C-F) structure, the VIE structure in various forms emerged in the early 2000s to tackle the seemingly irreconcilable contradiction between two policy objectives. On the one hand, it is the national policy to prohibit or restrict foreign participation in certain industrial sectors (e.g., value-added and basic telecom services, broadcast radio or TV networks, news websites, networked audio-visual programming services or Internet cafes) that are deemed to be sensitive, thus off limits to foreign investment. This policy has been proclaimed in many government documents, most notably the Catalogue Guiding Foreign Investment in Industries, a list of industrial sectors divided into different categories for foreign investment (i.e., prohibited, restricted, permitted and encouraged). On the other hand, it is the national policy to jump start China’s nascent Internet and telecom services industries. When it became clear that the domestic capital market and other financial infrastructure were incapable of providing the financing badly needed by the burgeoning Internet and telecom services companies, the founders of these companies, mostly individual entrepreneurs, turned to foreign capital. Faced with the legal restrictions on foreign involvement in these industries, the Chinese founders adopted the VIE vehicle which, as described in detail in the preceding note, enabled foreign investors to invest in these in-

Investment Law is to be adopted, it is difficult to understand how this pure domestic Renminbi fund set up by the foreign investor would not be treated as “foreign investment,” thus not being subject to applicable PRC legal restriction or prohibition in the related sectors.

2 China Unicom adopted the C-C-F structure in the 1990s to circumvent legal prohibition of foreign investment in the telecommunications sector. It was abandoned by market participants after it was officially declared “irregular” in 1998.

dustries by way of contractual arrangements, instead of direct equity ownership. The Internet portal Sina was one of the first Chinese companies to use the VIE structure to attract foreign investment and complete its listing on NASDAQ in 2000. Although this structure was not officially or publicly blessed by the Chinese government, Sina and other pioneering Chinese Internet companies were able to obtain enough unofficial comfort from the Chinese regulators in order to satisfy the listing requirements of the foreign stock exchanges, mainly in the U.S. and Hong Kong. As a result, this structure has been widely adopted by other Chinese companies to execute their IPOs and listings in foreign stock markets. Within 10 years, about half of the more than 200 Chinese companies listed in the U.S., including most of China’s well-established Internet companies, used VIE structures.4

From a strict legal analysis, the VIE structure, no matter how elaborate in its form, is clearly a vehicle used by the Chinese founders to circumvent the proclaimed legal prohibition or restriction against foreign participation in the relevant industrial sectors. First, under the Catalogue Guiding Foreign Investment in Industries and related government regulations, there is no distinction between foreign participation by equity investment resulting in equity ownership and foreign participation by contractual arrangement resulting in effective control. Thus, it is illogical to conclude that a prohibition or restriction against foreign participation will apply only to equity investment by foreign investors, but not to foreign investment by contractual arrangement that gives effect control of the company to the foreign investors. Second, the PRC Contract Law, which governs many of the onshore agreements under a VIE arrangement, invalidates a contract if this contract is held to “conceal illegal purposes with a lawful form.”5 If the PRC Contract Law, the Catalogue Guiding Foreign Investment in Industries and other relevant statutes and regulations are to be properly interpreted and enforced, it is not difficult to detect the non-compliance

elements embedded in the VIE structure. At the minimum, the arguments against the VIE as inherently non-compliant would easily overwhelm any arguments in favor of its compliance and legal validity.

However, faced with these legal difficulties, the VIE structure has not only survived, but also become more and more commonplace. The multitude of risks—legal, regulatory and contractual—noted by lawyers, accountants and other professionals in connection with VIE based foreign listing and other financing projects, have never manifested in any meaningful fashion to discourage foreign investors, institutional as well as individual, from investing in these projects. The most important reason for the VIE’s survival and even expansion is that the Chinese government, mainly the Ministry of Commerce (“MOFCOM,” the foreign investment regulator), the Ministry of Industry and Information Technology (“MIT,” the Internet and telecom market regulator), the State Administration of Foreign Exchange (“SAFE,” the foreign exchange regulator) and the China Securities Regulatory Commission (“CSRC,” the securities market regulator), has not explicitly challenged the legality of VIE structures. Market participants appeared to have interpreted this tacit acceptance by these key regulators as a gesture of permissibility. Although there has never been any official recognition, it is highly possible that individual officials of these regulators have given oral assurance or even encouragement to market participants in informal consultation sessions which take place frequently in the Chinese regulatory process. It is reported that some individual regulators have credited

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6 The following disclaimer is typical of this type of warning against VIE risks: “The People’s Republic of China government may not agree that these arrangements comply with PRC licensing, registration or other regulatory requirements, with existing policies or with requirements or policies that may be adopted in the future.” Alibaba’s Prospectus, at 40, quoted in Rivers Lan, VIE Structures in China: An Updated Overview (revised Feb. 9, 2015), EIGER (Feb. 11, 2015 12:00 AM), http://www.eigerlaw.com/de/nachrichten/314-qvie-structures-in-china—an-updated-overviewq-now-available-for-download (last visited July 30, 2015).

7 There have been a few isolated occasions in which one or more individual regulators attempted to restrict or curtail the use of VIE structures within a specific industry or a specified scope, but none of them has mounted to a general attack on VIEs as legally impermissible instruments. See David Roberts & Thomas Hall, VIE Structures in China: What You Need to Know, TOPICS IN CHINESE LAW, Oct. 2011, available at http://www.docin.com/p-288038261.htm (last visited July 30, 2015).
the VIE structure for fostering China’s Internet boom, which is probably factually accurate. These same regulators and their colleagues might also take pride, albeit covertly, in themselves for their pragmatism in enforcing the laws and regulations affecting the VIE structure. At the same time, these regulatory agencies have preserved wide discretion in disallowing VIEs when and where they choose to by maintaining official silence on the legality of VIE structures.

The posting for public comment of MOFCOM’s draft PRC Foreign Investment Law (“Draft FIL”) in January 2015 signified that the Chinese regulators are prepared to break their silence on the VIE structure. The Draft FIL provides that a domestic entity established in China that is “controlled” by a foreign investor will be deemed to be a foreign-invested enterprise, even if the domestic entity is directly owned by Chinese shareholders. Specifically, “control” is defined to mean, among others, “the ability to exercise decisive influence over a company by way of contractual or trust arrangements." If the Draft FIL were to be enacted in the current form, it would potentially affect the hundreds of companies with a VIE structure, especially those operating in a sector in which foreign participation (not only by equity ownership, but also by control through contractual or trust arrangements) is either prohibited or restricted. While MOFCOM has declined to grant grandfather treatment or a grace period to the companies with VIE arrangements, it has no intent to wreak havoc in the market by invalidating all existing VIE structures. An explanatory note (“Explanatory Note”) accompanying the Draft FIL MOFCOM indicates that it contemplates three possible approaches to the companies using a VIE structure in a restricted or prohibited sector, all pointing to

8 “My point of view is that VIE is very good and without the VIE structure, China’s Internet industry would not develop so fast,” said one MOFCOM source involved in the industry’s international VIE discussion. Another MOFCOM source said, “Currently MOFCOM doesn’t require all the VIE companies to notify their ongoing M&A deals with MOFCOM under the foreign investment policy.” Quoted in Shaw, Chow & Wang, supra note 5.


the direction of possibly preserving the VIE structure as long as foreign control, as defined in the Draft FIL, is eliminated.

Although it is still not certain if and when the Draft FIL will be enacted into law, the market has taken the cue from the MOFCOM attitude towards VIE structures, which in turn fueled the rush to dismantle the VIE structures and/or delist from the foreign stock markets. Some of these companies will seek listing in the more developed and capital-rich domestic capital market. Whether by design or pure chance, MOFCOM’s newly revealed official position on VIE structures is conveniently coinciding with the maturity of the domestic capital market, which makes it possible for the Chinese Internet and e-commerce companies that have been relying on foreign capital via a VIE arrangement to switch to the domestic capital market to satisfy their financing needs.

For the Chinese regulators and market participants, this appears to be a win-win scenario. The companies (especially their Chinese founders) win because the VIE structure enabled them to utilize foreign capital when domestic financing was not available, and they can now “return home” when domestic financing becomes adequate. The regulators win because, by exercising flexibility and pragmatism, they have been able to fulfill two contradictory policy objectives with different emphases at different times. Their “salutary” neglect of the VIE structures’ non-compliance with PRC laws and regulations since 2000 provided vital regulatory support, albeit tacitly, to the start-up Chinese companies thirsty for foreign financing, fueling their phenomenal growth. With the maturity of the domestic capital market, by adopting a newly crafted definition of “control” in the foreign investment regime, the MOFCOM has shifted regulatory emphasis to strict enforcement, thus shutting down the door for foreign participation, direct or indirect, by equity investment or contractual arrangement, in the sectors in which foreign investment is prohibited or restricted, without invalidating most of the VIE structures already in place.

But this win-win outcome has not been achieved without victims. On the surface, foreign investors, individual or institutional, who have participated in the VIE game and, if lucky, have made

good returns on their investment (for example, through buying Chinese Internet companies’ stock at deeply discounted prices in a foreign stock exchange), are poised to lose as they aren’t likely able to continue this game much longer. However, their loss, if any, would not be real in the sense that they shouldn't have been given the opportunity to invest in these companies in the first place, if the Chinese regulators had done their job to strictly enforce, as they should have, the applicable PRC laws and regulations.

The real victim, in my view, is the dignity and credibility of PRC law. MOFCOM and other Chinese regulatory agencies, as gatekeepers of the Chinese foreign investment regulatory regime, have chosen to ignore those VIE structures that are problematic in complying with proclaimed statutes and government regulations restricting or prohibiting foreign participation in enumerated sectors. They did this apparently for a policy reason—launching China’s Internet sector onto a fast track. But in the process, they have discredited the authority of the very laws and regulations they are charged with the responsibility to strictly enforce in a uniform and consistent manner, taking policy above the law. While administrative discretion is necessary, it must be confined within reasonable and legally permissible limits. Pursuing policy objectives at the expense of manifested legal requirements should not be a reasonable and legally permissible way to exercise administrative discretion. These legal requirements, once proclaimed in published form, must be strictly observed by market participants and regulatory agencies alike. The official authority to enforce legal requirements is not a ticket to ignore or selectively enforce these requirements. In dealing with the VIE structure, the Chinese regulatory agencies should have taken one of the following two courses of action: (1) strictly enforcing the laws and regulations prohibiting or restricting foreign investment by disallowing non-compliant VIE structures in the related sectors; or (2) seeking to amend these laws and regulations to eliminate the relevant prohibition or restriction so as to make VIE structures compliant. Instead, these agencies have taken policy over established rules, resulting in diminished respect for black letter law and, more seriously, deeper distrust of the Chinese legal system by market participants, domestic and foreign.

From a more practical policy perspective, diminished respect
for black letter law, coupled with unprincipled exercise of administrative discretion, will induce a weakened sense of certainty and predictability of law and law enforcement, creating long-lasting negative impact on the market participants’ perception of the China market as a desirable place to conduct business. Thus, a present policy gain in promoting the development of China’s Internet industry may produce long-term loss in the market’s confidence in China’s foreign investment regulatory framework. Hopefully this lesson will not be easily overlooked by the Chinese regulatory agencies.