Foreign Capital in Chinese Telecommunication Companies: From the Variable Interest Entity Model to the Draft of the New Chinese Foreign Investment Law

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Abstract

The VIE (Variable Interest Entity) model allows offshore companies that control Chinese companies operating in restricted business areas, such as Internet operations, to be listed abroad. In fact, the Chinese legislator has excluded foreign investors from certain companies. Unlike legal systems, the criterion to determine the existence of foreign investments is the acquisition of shares. Therefore, in order to avoid restrictions imposed by Chinese laws applicable to foreign investments, offshore holding companies control the relevant Chinese companies through a bundle of contracts, rather than by acquiring their shares. This scheme has allowed Chinese companies operating in strategic industries to attract foreign investment, thus circumventing the strict provisions of the relevant Chinese Laws on Foreign Investments. At the same time, the VIE scheme has been strongly criticized for both the operational and regulatory risks that it poses. In this essay, I will analyze the regulatory and economic reasons that led Chinese companies to rely on such an opaque structure, through a brief comparison between the EU and Chinese legislation on foreign investments, in paragraph I. In paragraph II, we will discuss in depth the structure of the VIE model and provide some case studies. Finally, in paragraph III and in the conclusions, we will provide some insight into the Draft of a new Foreign Investment Law in China, a project that will finally unite and harmonize the major sets of rules on foreign investments in a sole piece of legislation. In these paragraphs I will also present some ideas on the effect that the adoption of this law might have on existing investments that adopted the VIE scheme.

I. Genesis and Use of Variable Entities

1. An Outline of the Legal Framework of Chinese Restrictions on Foreign Investments and Its Role in the Rise of VIE

The necessity for Chinese companies to resort to Variable Interest Entities (or VIEs) arose from the exclusion of foreign investors from certain sensitive business areas, regulated by Chinese law ('per Chinese law').[1] Before examining the economic reasons that have led to the diffusion of VIE's, as well as the

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[1] K. Rosier, 'The Risks of China's Internet Companies on U.S. Stock Exchanges' 3 *U.S.- China Economic and Security Review Commission Staff Report*, available at https://tinyurl.com/ydavrzak (last visited 27 December 2018).

typical structure of this investment tool and the problems that can arise with the evolution of Chinese legislation on this matter, an outline of the legal framework of restrictions on foreign investments is provided.

A specific feature of Chinese company law is that it distinguishes between (ordinary) companies, foreign companies and FIE (Foreign invested enterprises). The identifying traits of what Chinese Company Law refers to as 'companies' are their establishment and registration within the territory of China, by Chinese citizens or by legal entities that were previously established by Chinese citizens, or by the Chinese government and its agencies. Foreign companies, on the other hand, are those companies incorporated outside the territory of China, that are subject to foreign company laws.[2] These foreign legal persons are allowed to engage in production and operate businesses through the establishment of branches. Branches, according to Art 195 of the Chinese Company law, are not legal persons. The foreign company bears civil liability for the branches' activities. Furthermore, and most importantly, the establishment of branches requires approval by competent national authorities.

Foreign citizens and companies can also engage in economic activities in China through the establishment of a Foreign Invested Company. These companies are incorporated in China. However, aside from being subject to provisions contained in Chinese Company Law, they also obey the rules of the Law on Sino-Foreign Equity Joint Ventures,[3] the Law on Sino-Foreign Co-operative Joint Ventures,[4] and the Wholly Foreign Owned Enterprise Law,[5] as

[2] Art 191 of the 2013 Company Law of the People's Republic of China (adopted at the fifth Session of the Standing Committee of the eighth National People's Congress on 29 December 1993. Revised for the first time on 25 December 1999 in accordance with the Decision of the thirteenth Session of the Standing Committee of the ninth People's Congress on Amending the Company Law of the People's Republic of China. Revised for the second time on 28 August 2004 in accordance with the Decision of the eleventh Session of the Standing Committee of the Tenth National People's Congress of the People's Republic of China on Amending the Company Law of the People's Republic of China. Revised for the third time at the eighteenth Session of the tenth National People's Congress of the People's Republic of China on 27 October 2005).

[3] The Law of the People's Republic of China on Sino-Foreign Equity Joint Ventures, adopted on 1 July 1979 at the second Session of the fifth National People's Congress. Amended on 4 April 1990 at the third Session of the seventh National People's Congress, in accordance with the Decision to Revise the Law of the People's Republic of China on Sino-foreign Equity Joint Ventures. Amended on 15 March 2001 at the fourth Session of the ninth National People's Congress, in accordance with the Decision to Revise the Law of the People's Republic of China on Sino-foreign Equity Joint Ventures).

[4] Law of the People's Republic of China on Sino-Foreign Co-operative Enterprises, adopted on the 13 April 1988 at the first Session of the seventh National People's Congress Revised 31 October 2000 at the eighteenth Meeting of the Standing Committee of the National People's Congress by the Decision on the Revision of the 'Law of the People's Republic of China on Sino-Foreign Co-operative Enterprises'.

[5] Law of the People's Republic of China Concerning Enterprises with Sole Foreign Investment, adopted on the 12 April 1986 at the fourth Session of the sixth National People's Congress. Revised 31 October 2000 at the eighteenth Meeting of the Standing Committee of the National

well as other administrative regulations. Within the framework of administrative regulations disciplining the matter of foreign investment vehicles, the Catalogue of Foreign Investments issued by MOFCOM (Ministry of Finance and Commerce), has a central role;[6] it divides foreign invested economic activities in China into encouraged activities, restricted activities, and prohibited activities.

The establishment of a foreign company or joint venture is subject to the approval of the competent Chinese authorities (MOFCOM).[7] The determining factor in deciding when a company is subject to special laws is the presence of foreign capital. For instance, the Law on Enterprises with Sole Foreign Investment provides, in Art 2, that

> 'Enterprises with sole foreign investment as referred to in this Law are those enterprises established within the Chinese territory, in accordance with the relevant Chinese laws, with their capital provided in full by a foreign investor'.

While the Law on Sino-Foreign Equity Joint Ventures (EJVs) does not provide a corresponding definition, the position of the foreign investor within the EJV is defined by its capital investment, as well. Art 3 of the said Law establishes that an EJV is characterized by the presence of a twenty five percent quota of foreign invested capital.[8]

The aforementioned laws and regulations directly tackle the issue of the establishment of companies in China by foreign investors. Mergers and acquisitions are subject to the 2006 Provisions on Mergers and Acquisitions (M&A Provisions).[9] With regard to the discipline of VIEs, the M&A Provisions provide that

> 'where a domestic company, enterprise or natural person intends to take over its domestic affiliated company in the name of a company, which

People's Congress by the Decision on Revision of the 'Law of the People's Republic of China Concerning Enterprises with Sole Foreign Investment'.

[6] The Catalogue Guiding Foreign Investment in Industries promulgated by the Sate Development and Reform Commission and Ministry of Commerce on 15 March 2015 is available at https://tinyurl.com/j87djle (last visited 27 December 2018).

[7] For instance, the Wholly Foreign Owned Enterprise Law so provides under Arts 6 and 7 thereof.

[8] We did not take into account Co-operative Joint Ventures (CJV) in this explanation, as the presence of foreign investment in these investment vehicles is subtler, considering that they are characterized by the contractual nature of relations between ventures. In any case, CJV's are extremely uncommon.

[9] The Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors (2006 M&A Rules), which became effective in September 2006, was promulgated jointly by MOFCOM, the State-owned Assets Supervision Administrative Commission (SASAC), the State Administration of Taxation (SAT), the State Administration of Industry and Commerce (SAIC), the China Securities Regulatory Commission (CSRC) and the State Administration of Foreign Exchange (SAFE).

it lawfully established or controls, it shall be subject to the examination and approval of the MOFCOM'.[10]

A brief comparison between the Chinese regulations of Foreign Investment and their counterpart in the EU, might allow us to better understand the scope of limitations imposed by the Chinese legislator. In fact, the impetus to limit or exclude foreign influence from certain industries have also led the European legislator towards the promulgation of a variety of protection mechanisms, aimed at excluding certain foreign businesses from entering the EU market or acquiring EU companies.

A necessary foreword is that European scholars have observed how the European system aims to protect relevant local industries. Thus, Foreign Investment regulations in the EU are not only aimed at excluding the foreign acquisition of strategically relevant companies[11]. The latter are usually considered to be industries that are instrumental in providing the Member State with essential services. These are, for instance, defence or energy supplies, which cannot be taken over by foreign entities. On the other hand, protection of local industries from foreign influence is not determined by the sector in which the industry is operating but is rooted in its importance to the national economy. Foreign investments may transplant decision-making processes outside of the Member State, which implies that decisions that will impact the environment, employment and other fundamental issues will not undergo the scrutiny of national authorities and public opinion.[12,13] Furthermore, specific limitations are applied in case the investor is a non-EU sovereign fund.[14]

The sketch of the system provided in the previous paragraph, highlights important differences with the Chinese system. Firstly, the EU legislator has never issued a document such as the Catalogue on Foreign Investments. Foreign Investments, and in particular the establishment of new companies, are permitted and not subject to the approval of any administrative authority. Any limitations imposed are specifically aimed at avoiding a loss of control over pivotal decisions but in general do not prevent any foreign presence from being admitted into entire sectors of the economy. Therefore, even in sensitive industries, the presence of foreign investors is not precluded, as long as the investment is not designed to obtain control over the companies' decision-making process.

Entry barriers still exist in some Member States, but are not targeted at all

[10] Art 11 of the 2006 Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors.

[11] A. Guaccero et al, 'Investimenti stranieri e fondi sovrani: forme di controllo nella prospettiva comparata USA-Europa' *Rivista delle società*, 1359-1394 (2008).

[12] ibid 1376.

[13] It is important to remind that in case the acquiring company is not national but EU, different rules will apply, in order to implement the principles of the EU common market.

[14] See for reference Communication from the EU Commission COM (2008) 115 of 27 February 2008, on 'A Common European Approach to Sovereign Wealth Funds'.

foreign investments. On the contrary, such barriers may only apply to those investments that result in a change of control in an existing, important enterprise. For instance, as provided for by the 1975 Industry Act, the UK has maintained a broad power of intervention, in order to restrict foreign investments that may result in the acquisition of decision-making powers within an enterprise that is of substantial importance to the United Kingdom. This mechanism can, however, only be activated by the British Parliament in Westminster. Thus it cannot compare with the force of the barriers arranged by the Chinese legislator.

Aside from these direct investment limitations, the EU provision, contained in Directive 2004/25/EC, also provides for indirect restrictions, most notably connected to the discipline of hostile takeovers. In Italy, the directive has been implemented through the provision of limited exceptions to the rules of board neutrality, a system that has indeed been criticized because it creates a potential commingling of entrepreneurial and political issues.[15]

What is really interesting here, however, is to highlight how the EU system as a whole does not restrict the flow of foreign capital per se, but only as it is a means of acquiring control of the tools of corporate governance within specific enterprises that are of particular interest to the national economy. In the Chinese system, on the other hand, the legislator has arranged tools that exclude the flow of foreign capital from entire sectors of the economy, and namely those that are defined as prohibited or restricted in the Catalogue of Foreign Investments, regardless of the fact that these investments will result in the displacement of the decision making processes in foreign countries. A further major difference is that the Chinese legislator has not adopted the concept of control in order to determine when a business is excluded from certain industries, relying on a more rigid mechanism of share quotas. The Catalogue of Foreign Investments, in fact, provides quotas of foreign held shares that cannot be exceeded, for each type of restricted industry.

The rigid criterion used to determine the application of the Catalogue of Foreign Investments incentivized the usage of forms of investment that would not require the acquisition of shares by the foreign company, while allowing foreign capital to flow into Chinese companies operating in restricted sectors. This led to the adoption of the VIE scheme, under which corporate governance tools are replaced by a bundle of contracts and, therefore, do not fall within the scope of application of the Catalogue. In fact, as will be discussed in more detail, Variable Interest Entities are complex corporate tools set up with the purpose of financing solely Chinese companies with foreign capital, without falling within the scope of application of the MOFCOM catalogue on foreign investments and the 2006 M&A Provisions.[16] It is worth mentioning that the compliance of the VIE model

[15] A. Guaccero et al, n 11 above, 1387.

[16] L. Guo, 'Chinese Style VIEs: Continuing to Sneak under Smog?' 572 *Cornell International Law Journal*, 570, 604 (2014).

with Chinese Law has been repeatedly questioned. Most of these criticisms rely on the provisions contained in Art 52, para 3, of the Chinese Law on Contracts, according to which a contract is invalid whenever the parties intend to conceal an illegal purpose under the guise of a legitimate transaction.[17] Consequently, the contracts that are conceived to enable control on VIE's by foreign investors are not enforceable in China.[18] Foreign investors are unable to influence the decision-making process of VIE's. On the other hand, foreign entities investing in China through legitimate means such as an EJV or a WOFE (Wholly Owned Foreign Enterprise, *infra*) have the right to choose some or all of the members of the Board of Directors and more in general to influence relevant decisions within the company.[19] The fact that some of the most important Chinese companies have adopted the VIE model is unsurprising and VIEs are now so common they could be considered as a standard corporate model. Nevertheless, the issuance of new sets of rules that the Chinese legislator has announced in 2015, has left foreign investors questioning the legal risk on their VIE investments.

2. Economic Factors Leading to the Proliferation of VIE's

Chinese companies, especially in sectors requiring investments that are not secured by heavy assets, as in the case of the Internet economy, have struggled to raise sufficient funds within the Chinese financial system. In fact, the Chinese financial system was, and still is, unable to meet the rising demand for credit to private economic operators.[20] On the one hand, Chinese banks are mostly State-owned, and focus their efforts on the financing of publicly owned enterprises or publicly sponsored investment projects.[21] Furthermore, these hard to access bank loans represent three fifths of the Chinese financial system.[22] Access to the market is burdensome and tends to favor well-established companies over innovative start-ups.

Some brief highlights on relevant laws might enable us to best assess this statement. Art 15 of the Chinese Securities Law provides that any public issuance of securities must be examined and approved by the CSRC (China Securities Regulatory Commission). Public issuance is defined as an issuance of securities towards non-specified recipients or to more than two hundred specified recipients. In order to obtain such approval, the company must have a net asset value that is higher than thirty million RMB (roughly three point five million USD). Moreover, Art 16 of the Securities Law requires the average distributable profits

[17] See, for instance, K. Rosier, n 1 above, 4.

[18] See the Alibaba case, below.

[19] Art 6 of the Law of the People's Republic of China on Sino-Foreign Equity Joint Ventures.

[20] S. Sen, 'Finance in China after the WTO' 40(6) *Economic and Political Weekly*, 565-571 (2005).

[21] ibid

[22] D.J. Elliot and K. Yan, 'The Chinese Financial System: An Introduction and Overview' (July 2013), available at https://tinyurl.com/y9azvodm (last visited 27 December 2018).

of the previous three years to be sufficient to pay the one-year interest rate on corporate bonds. Furthermore, gathering financial provisions outside of the official markets of Shanghai and Shenzhen can easily result in criminal offenses. According to the Supreme People's Court Interpretation no 18/2010, public offerings made without the approval of the CSRC fall within the scope of Art 176 of the Criminal Law which is triggered when a person 'Illegally tak(es) savings from the public'.

The Chinese market has been partly able to overcome the obstacles represented by a State-owned banking system and a closed financial market. Since the early 2000s, private companies have represented the true engine of Chinese growth and accounted for sixty percent of the Chinese GDP (Gross Domestic Product) and seventy percent of employment.[23] Various forms of credit access usually referred to as shadow banking, have largely fueled this growth.[24] In more recent years, online platforms and online banks have also offered more credit options for start-ups and enterprises operating in high-risk sectors.[25] Nevertheless, due to the fact that China's shadow banking system only began to boom in recent years, its scale is still relatively small, when compared to informal finance in economies such as the USA, the EU or the United Kingdom.[26]

While figures on the participation of shadow banking in China's value-added telecom services companies are unavailable, it is noteworthy how this specific type of company offers highly rewarding, but also high-risk, investment opportunities, while displaying needs for capital funds that informal markets, such as the shadow banking system, might struggle to meet.

Value-added telecom services are restricted, meaning that foreign investors can only own a certain percentage of the company shares.[27] At the same time, relevant Chinese laws require private companies to obtain a special permission in order to be listed on foreign capital markets. Nevertheless, many of the largest Chinese network operators have opted to raise capital abroad, often in the US financial markets. In fact, Chinese network operators listed in the USA are so numerous and so important, both in size and impact on the development of the Chinese economy, that one could say that Chinese Internet companies systemically rely on the US capital market.[28] The following graph reinforces the validity of

[23] X. Feng et al, *The Ecology of Chinese Private Enterprises* (Singapore: World Scientific Publishing, 2015), 71, 73.

[24] D.J. Elliott, 'Shadow banking in China: a primer' 1 *Economic Studies at Brookings*, available at https://tinyurl.com/jopfwf5 (last visited 27 December 2018).

[25] W. Ma, *China's Mobile Economy, Opportunity in the Largest and Fastest Information Consumption Boom* (Southern Gate, Chichester: John Wiley & Sons, 2017), 250.

[26] D.J. Elliot et al, n 22 above, 16.

[27] On the progressive liberalization of telecom services in China see: W. Shen, 'Deconstructing the Myth of Alipay Drama – Repoliticizing Foreign Investment in the Telecommunications Sector in China' 36(10-11) *Telecommunication Policy*, 929–942 (2012).

[28] T.Y. Man, 'Policy above Law: VIE and Foreign Investment Regulation in China' 3 *Peking University Transnational Law Review*, 215, 217 (2015).

this statement:[29]

Table 1[30]

Company	Stock Symbol	Main service	Capitalization (Billion USD)	Stock exchange
Baidu	BIDU	Internet search	$58.27	NASDAQ
JD.com	JD	E-commerce	$33.3	NASDAQ
Qihoo 360	QIHU	Internet security and software	$23.82	NYSE
NetEase	NTES	Web portal	$9.24	NASDAQ
Ctrip.com	CTRIP	Travel website	$7.48	NASDAQ
Weibo	WB	Microblog	$6.04	NASDAQ
YY	YY	Social network	$3.79	NASDAQ
Youku Tudou	YOKU	Online video	$3.77	NYSE
Sohu.com	SOHU	Internet advertising and search	$2.26	NASDAQ
Changyou.com	CYOU	Online games	$1.41	NASDAQ
Renren	RENN	Social network	$1.22	NYSE

The first VIE structures were devised in the early 2000s, when Sina and Sohu, two Chinese companies, were listed on the Nasdaq and Price Waterhouse audited both.[31] As soon as 2012, over fifty percent of the Chinese companies listed in US markets were in fact VIE structures.[32] However, it was only with the record-breaking IPO launched by e-commerce giant Alibaba in 2014 that the issue of legal risk surrounding this investment vehicle became a widely discussed topic in mainstream and specialist publications. A further aspect that makes Alibaba's IPO (Initial Public Offering) particularly interesting is that, unlike other Chinese Internet companies, Alibaba actually matched the requirements to be listed on a Chinese stock exchange, and seemingly opted to go abroad due to the better opportunities that international stock markets can offer, compared to the relatively underdeveloped Chinese market. Furthermore, as will be discussed further, the Alibaba Group is also characterized by an unusual governance structure.

[29] It should also be noted that VIEs are one of many vehicles of foreign direct investment in China, see D. Yang, H. Dingquan and Y. Jiahui, 'Cross-border Merger and Acquisition of Chinese Domestic Listed Companies' 11(2) *Frontiers Law China*, 392-395 (2016).

[30] P. Gillis, 'Variable Interest Entities in China' 1 *Forensic Asia, Guest Series*, 18 September 2012, available at https://tinyurl.com/yaudcg4q (last visited 27 December 2018).

[31] ibid 3.

[32] ibid 3.

II. An In-Depth Analysis of the Legal Structure of VIEs

1. Definition of VIEs

As mentioned in the previous paragraph, the first examples of Chinese VIE were Sina and Sohu. Both companies were network operators and were, thus, engaged in restricted activities. In order to be listed abroad, without directly violating restrictions imposed by Chinese law, business operations were separated among several companies. Non-restricted business operations of Sina and Sohu were incorporated within a WOFE (Wholly Foreign Owned Enterprise) owned by an offshore company (ListCo). On the other hand, restricted business operations were linked to a Chinese company, owned by Chinese natural persons (the Operating Company/Property Company, OpCo).[33] However, the Chinese company was *de facto* owned by the WOFE, as a series of contracts between the two companies mimicked property rights of the latter over the former.[34] Finally, the offshore company owning the WOFE was listed on NASDAQ.

Although such an arrangement struggles to comply with the accountability requirements set by the US Securities and Exchange Commission (SEC) at the time, PwC (PricewaterhouseCoopers) managed to attest that the network of contracts linking the Chinese company to the WOFE was, in practice, equivalent to control over the Chinese company's equities by the WOFE.[35]

While Sina and Sohu were successfully listed in the USA with this scheme, the collapse of energy giant Enron in 2001 led American authorities to enact stricter accountability standards for VIEs.[36] These provisions were implemented, in light of the Enron experience. Enron, a listed company, had hidden its losses and unprofitable business operations through Special Purpose Entities that were not included in the balance sheet. Since 2002, some minor changes in accountability standards were introduced. The main body of rules set out through FIN-46R, however, have remained mostly unchanged to date.[37]

[33] ibid 3.

[34] K. Johnson, 'Variable Interest Entities: Alibaba's Regulatory Work-Around to China's Foreign Investment Restrictions' 12(2) *Loyola University: Chicago International Law Review*, 249-266, 253 (2015).

[35] P. Gillis, n 30 above, 3.

[36] A. Reinstein et al, 'Consolidation of Variable Interest Entities: Applying the Provisions of FIN 46 (R)' (5) available at https://tinyurl.com/y8l3dekz (last visited 27 December 2018), the authors explain how Enron had set up an elaborate array of Special Purpose Entities (SPEs) to shift debt away from its books, while absorbing substantially all of the risk associated with that debt either through guarantees of the debt or the SPE's assets The stricter accountability was enacted in the form of FASB Interpretation no 46 on Consolidation of Variable Interest Entities - FIN - 46R.

[37] It should be mentioned that Financial Accounting Standards Board (FASB) have been, however, partially reviewed. The latest FASB updates, ASU 2015, 02 and ASU 2017, 02, respectively, impact the following areas of consolidation analysis, most of which apply to the VIE assessment: i. Limited partnerships and similar legal entities; ii. Entities other than limited partnerships and their equivalents; iii. Evaluating fees paid to a decision maker or a service provider as a variable interest; iv. The effect of fee arrangements on the primary beneficiary

The FIN-46R standards further extended pre-existing accountability rules by expanding the provisions of Accounting Research Bulletin (ARB) 51. ARB 51 provided that the 'usual condition for a controlling financial interest' was met upon 'ownership by the company (…) of over fifty percent of the outstanding voting shares of another company'.[38] In addition, FIN-46R recognizes that controlling financial interests may also exist, should a parent company be the primary beneficiary of a Variable Interest Entity. FIN 46-R defines VIEs as all entities subject to at least one of the conditions set forth in FIN 46-R. These conditions are:

a. the entity is unable to rely solely on its capital derived from equity investment at risk, in order to pursue its business activities, as it relies on additional financial support provided by third parties.

b. the holders of the equity investment as a group lack: (1) the direct or indirect ability to make decisions about an entity's activities through voting rights or other rights; (2) 'the obligation to absorb the expected losses of the entity, should they occur'; or (3) 'the right to receive the expected residual returns of the entity, should they occur'.[39]

After defining VIEs, FIN 46-R provides that any company listed on US securities market must consolidate its VIEs in its balance sheet, whenever the parent company has the power to direct activities, absorb losses of the entity, or has the right to receive returns or dividends from the entity.[40] The main purpose of the FIN 46-R standards was to prevent listed companies from using Special Purpose Vehicle/Entity (SPEs) to hide debt or poor performing assets, as Enron did.[41]

Chinese operators, on the other hand, had an interest in falling within the scope of FIN 46-R. Indeed, they needed to consolidate a restricted business operation within the balance of an offshore company that could be listed. In other words, an offshore company would establish a Chinese WOFE, which, as mentioned in the first paragraph, can be legitimately owned by a foreign company. Subsequently, the WOFE would set up a network of contracts with a Chinese company, thus acquiring the ability to make decisions, the obligation to absorb the expected losses, or the right to receive the expected residual profits. If these requirements were met, US regulators would deem the Chinese company to be a VIE controlled by the offshore company. Therefore, they would require the

determination; v. The effect of related parties on the primary beneficiary determination; vi. Certain investment funds. (Accounting Standards Update, ASU 2015, 02) and Non-profit entities (ASU 2015, 02).

[38] M.J. Chapman, 'China's Variable Interest Entities in Context: Past, Present and Future' 4 *University New South Wales Student Series No 16-05*, (22 January 2016), available at https://tinyurl.com/ycdj3vxj (last visited 27 December 2018).

[39] See FIN 46-R, 8.

[40] P. Gillis, n 30 above, 5. See also A. Reinstein et al, n 36 above, 6-7.

[41] J.L. Zhang, 'Economic Consequences of Recognizing Off-Balance Sheet Activities' 5 *AAA 2009 Financial Accounting and Reporting Section (FARS) Paper* (11 September 2008).

offshore company to consolidate the VIE within its balance sheet, notwithstanding that the Chinese company was not directly owned by the offshore company. The original scheme devised by Sina and Sohu is still intact. However, Chinese VIEs listed after the Enron scandal needed to implement a more complex network of contracts, compared to what Sina and Sohu had set up, in order to meet the requirements set out in FIN-46R.[42]

2. The Standard Framework of Contracts

The basic structure of VIEs was essentially similar to what was analyzed in the Sina and Sohu cases. Chinese restrictions on foreign businesses would be worked around by establishing a Chinese company (the OpCo), owned by Chinese nationals, through which it would exercise restricted economic activities. The OpCo is linked through a bundle of contracts to an offshore company (the ListCo), which would then be listed on a major international financial market, usually in the US. However, in addition to mimicking ownership through a bundle of contracts between a WOFE, which was established by the ListCo, and the OpCo, post FIN-46R VIEs developed a standard framework of contracts, which the American regulators treated as having the effect of depriving the Chinese nationals owning the OpCo of their equity rights and to establish a variable interest in favor of the WOFE. The standard contract framework is usually a combination of loan agreements, equity pledge agreements, call option agreements, technical service agreements, and power of attorney.[43]

1. Loan agreements: Through a combination of loan agreements and equity pledge agreements between the WOFE and the natural persons owning the OpCo, it is possible to capitalize business operations, while providing collateral for the WOFE, in the form of equity of the OpCo. The loan agreement is usually RMB denominated, does not provide for any interest and provides for a renewable term.[44] The fact that the loan contract is engaged between a WOFE and Chinese natural persons enables the VIE to circumvent restrictions that limit loans between foreign companies (such as the offshore company) and Chinese companies (such as the OpCo). This type of agreement still encounters some difficulties. Firstly, it is unlikely that performing loans to Chinese citizens can enter within the business scope of a WOFE, although, reportedly, in no case has the validity of a VIE been challenged on this point.[45] Furthermore, the contract might fall within the scope of Art 52, para 3, of the Chinese Contract Law, which, as mentioned above, provides that contracts, which have the purpose of circumventing legal provisions, are invalid. This latter comment can be applied to most of the contracts forming the consolidation of the VIE and represents a major legal risk.

[42] M.J. Chapman, n 38 above, 4.
[43] P. Gillis, n 30 above, 5.
[44] ibid 5.
[45] ibid 5.

2. Equity pledge agreements: As we mentioned above, the equity pledge agreement is designed to establish collateral for the loan. Agreements usually include a one hundred percent rate of pledge on the loan, and a renewable term. Furthermore, it provides the WOFE with a real right over the equities of the OpCo, thus theoretically reducing the risk that they are transferred without permission of the controlling entity.[46] [47] It is important to mention that, while an equity pledge in favor of the WOFE restricts the ability of natural persons owning the Chinese company to autonomously sell the company's equities, these agreements cannot result in the WOFE owning the equities.[48]

3. Call option agreements: Pursuant to call option agreements entered between the WOFE and the owners of the Chinese company, the WOFE is given the right to purchase the Chinese company at the lowest possible price under PRC law. This type of agreement aims to blur the separation line between the two companies, by leaving open the possibility of a future acquisition. It has, however, little or no practical effect. In fact, as mentioned before, under PRC law the type of activity that Chinese companies included under this scheme usually exercise (ie, internet operations, online trading, etc) cannot be owned by a foreign invested entity, such as a WOFE.

4. Technical service agreements: Technical service agreements serve the fundamental role of transferring residual profits of the Chinese company to the WOFE and then to the listed offshore company. The services provided by the WOFE to the Chinese company may vary by company and industry, but often include website maintenance, programming, sales support, fulfillment services, curriculum development, and any other agreement allowing the transfer of funds from the Chinese company to the VIE. Another common way to extract profits is to confer intellectual property or real estate in favor of the WOFE and lease such commodities to the Chinese company, in exchange for a rent that can be unilaterally decided by the WOFE.[49]

5. Power of attorney: Finally, the WOFE is granted a wide set of powers of attorney that allows it to perform all activities connected to shareholders rights, in the name and on behalf of the natural persons owning the Chinese company.

[46] For reference the model of equity pledge agreement available at https://tinyurl.com/y7swe2nn (last visited 27 December 2018).

[47] China adopts a civil law system that identifies the pledge as a real right; see Chapter XVII of the Chinese Real Right Law.

[48] According to Arts 63 and 64 of the 1995 Law on Guaranty of the People's Republic of China, movable property hypothecation (ie pledge), requires the transfer of the hypothecated assets to the pledgee. In case of an equity pledge agreement, this means that the stocks or other securities into which the equity is incorporated, are transferred to the pledgee/creditor (ie the WOFE). Therefore, the ability of the OpCo to transfer the equities is theoretically reduced. At the same time, Art 63 of the 1995 Guaranty Law provides that if the debtor fails to pay off the debt, the pledgee has he right to sell or auction the asset to get paid off preferentially with the proceeds. The pledgee does not, however, have the right to satisfy its credit by acquiring the hypothecated items.

[49] P. Gillis, n 30 above, 6.

In conclusion, the VIE structure is consolidated through a series of agreements aimed at circumventing Chinese regulations while formally satisfying the requirements set out by the SEC. In fact, as mentioned above, the SEC requires the parent company to have the power to direct activities, or absorb losses of the entity, or the right to receive returns or dividends from the entity; the network of contracts exemplified above formally fulfills these requirements. Powers of attorney grant the WOFE, directly controlled by the listed company, the power to direct activities within the restricted business area. Furthermore, call option agreements and equity pledge agreements formally establish a connection between the two companies. Losses are absorbed through loan agreements that compensate for capital contributions. As for dividends, lease agreements and technical service agreements, which enable the WOFE to unilaterally modify the compensation for its services, allow the transfer of profits. Furthermore, Art 19 of the Law on Wholly Foreign Owned Enterprises states that the foreign investor may remit abroad legitimate profits that have been earned from an enterprise with sole foreign investment, other legitimate income, and funds obtained after liquidation of the enterprise.[50] Therefore, once the funds are transferred from the Chinese company to the WOFE, they can be legitimately transferred to the listed company.[51]

3. Risks Involved in the Proliferation of VIE Structures (A Focus on the Governance of the Alibaba Group)

While enabling some of the activities that are usually performed by corporations, VIE structures do not provide for the same level of shareholder protection. In fact, the main business is run by the OpCo, ie a Chinese company owned by Chinese natural persons. Protection of ListCo shareholders and other investors relies solely on the enforceability of Chinese contract law. However, the network of contracts, on which the governance of the VIE structure depends, is hardly enforceable in China, due to the applicability of Art 52 of the Law on Contracts. Furthermore, the main purpose of VIE operations is to circumvent Chinese regulations that aim to protect relevant businesses from foreign influence. This matter is of extreme importance. The People's Liberation Army, in particular,

[50] Art 19, Law of the People's Republic of China Concerning Enterprises with Sole Foreign Investment: The foreign investor may remit, abroad, legitimate profits earned from an enterprise with sole foreign investment, other legitimate income and funds obtained after liquidation of the enterprise.

Wages and other legitimate income of foreign staff and workers of an enterprise with sole foreign investment may be remitted abroad after payment of individual income tax in accordance with the law.

[51] On the purposes of VIE structures see also W. Shen, 'Dark Past, Grey Present or Bright Future? - Foreign Investors' Access to China's Telecommunications Industry and a Political Economy Analysis of Recent Industrial Policy Moves' 13 *Journal World Trade & Investments*, 513, 525 (2013).

has determined that as long as foreign countries maintain a position of informational domination, the openness of Chinese Internet operators will represent a menace to national security.[52]

These risks are well known to American supervisory authorities. Investors are also aware of them, since legal risks connected to VIE operations are included in the prospectus. For instance, Alibaba Group's F1 form for registration on NASDAQ includes detailed information on its structure and on the implied risks.[53] Alibaba Group's prospectus focuses on three types of risks, as follows:

1. Firstly, the prospectus describes risks that are connected to the ability of the investors to nominate directors and, thus, influence company operations. The stocks and other financial instruments available to investors are issued by Alibaba Group Holding Limited, a Company incorporated and existing under the laws of the Cayman Islands.[54] The simple majority of the directors is, however, appointed by Alibaba Partnership, an entity that the prospectus generically defines as an 'entity formed by the founders of Alibaba Group and other partners who are accepted by them, and is led by a Partnership Committee formed by Jack Ma, Joe Tsai, Jonathan Lu, Lucy Peng and Ming Zeng'. One could claim that the Alibaba operation is tolerated by the Chinese government insofar as Chinese citizens maintain direct control of all relevant corporate bodies. Indeed, when American retail giant Walmart attempted the acquisition of Chinese online retailer Yihaodian, the Chinese authorities prescribed that the business activities of Yihaodian be separated, and only allowed Walmart to purchase Yihaodian's logistic framework.[55] On the other hand, most VIEs that have been successfully listed on the US market (such as those listed in Table 1) are actually controlled by Chinese citizens. This impression is strengthened, if we take two additional facts into account. Firstly, according to the Catalogue of Foreign investments, FIEs are actually entitled to operate in the restricted sector of value-added telecommunication services, as long as Chinese entities hold fifty-one percent of the company shares. However, out of twenty-two thousand telecom business licenses that were released to 2008, only seven were granted to FIEs.[56] Secondly, as will be discussed hereinafter, the Draft of the New Chinese Law on Foreign Investments relies on the concept of actual control of the company, in order to determine when a company is foreign owned or foreign invested. In the

[52] D. Cheng, *Cyber Dragon* (Santa Barbara: Praeger, 2017), 12-14.

[53] Alibaba is a major Chinese company, which had a market value of two hundred sixty-four billion USD in 2015, as described at https://tinyurl.com/y7prw7q5 (last visited 27 December 2018).

[54] Amendment no 7 to Form F-1: Registration Statement under the Securities Act Of 1933, Alibaba Group Holding Limited, 230.

[55] H. Freehills, *MOFCOM declaring the use of a VIE (variable interest entity) structure in the internet sector illegal?*, available at https://tinyurl.com/ydynmmuz, 7 August 2012 (last visited 27 December 2018).

[56] W. Shen, n 27 above, 931, provides an in depth analysis on the difficulties that foreign investors must face when entering the Chinese telecommunication industry.

approach of the Chinese legislature, the concept of actual control will replace the current provisions that define the foreign or Chinese nature of a company on the basis of the origin of the conferred capital.[57]

In addition, as far as the managerial aspects of the Alibaba Group are concerned, it should be noted that, as the prospectus states, e-commerce activities performed by the VIE are dependent on the online payment services offered by Alipay. This platform, however, is not part of Alibaba Group, as it is owned by Jack Ma.[58] Given this factor, the power of Alibaba Partnership within the VIE, aside from relying on the control of governance tools, such as the board of directors, is also strengthened by the fact that its members control businesses that are complementary to the exercise of Alibaba's business.

2. The SEC requires the listed parent company to have the power to direct activities of the relevant entity, to absorb its losses and receive its revenues, in order to consolidate a VIE in a parent company's balance sheet. As stated, Chinese operators formally satisfy these requirements by entering into a network of contracts, which mimic corporate governance. Therefore, the actual ability of the parent company (or ListCo) to govern the VIE depends on the enforceability of these contracts. It has already been mentioned how these contracts might theoretically fall within the scope of Art 52, para 3, of the Chinese contract law. This norm declares the invalidity of contracts that aim to circumvent Chinese Law. At the same time, the main purpose of the bundle of contracts, through which VIEs are controlled, is to circumvent restrictions on foreign investments provided by relevant Chinese regulations, ie the Catalogue of Foreign Investments.[59] This major weakness in the set-up of VIE structures is also addressed in the Alibaba prospectus, which states that

> 'there are very few precedents and little formal guidance as to how contractual arrangements in the context of a variable interest entity should be interpreted or enforced under PRC law, and as a result it may be difficult to predict how an arbitration panel or court would view such contractual arrangements. As a result, uncertainties in the PRC legal system could limit the ability to enforce the contractual arrangements'.[60]

It is safe to say that Alibaba's representation of the enforceability of its contract network within the PRC is an understatement. Important cases that have been decided in China show how these networks of contracts are in fact hardly enforceable. Coincidentally, among these, one of the most famous is the

[57] See para 3 of this Art. The provision is contained in Art 18 of the 2015 Draft of a New Foreign Investment Law of the PRC.

[58] Amendment No 7 to Form F-1: Registration Statement under the Securities Act of 1933, Alibaba Group Holding Limited.

[59] Art 52, para 3 of the PRC Contract Law.

[60] Amendment no 7 to Form F-1: Registration Statement under the Securities Act of 1933, Alibaba Group Holding Limited, 51.

case that led Jack Ma to personally own Alipay. The payment system was initially developed under the business operation of a WOFE, which was controlled by an offshore company, in which Jack Ma and Yahoo!, among others, participated. When Chinese regulators stated that business operations, such as third-party payment systems, could not be operated through a WOFE, the first reaction of the group was to establish a VIE, called Zhejiang Alibaba. Zhejiang Alibaba was created and owned by Jack Ma, but, in theory, the former owners of Alipay controlled it through a bundle of contracts. The VIE, however, was not granted the licenses required by the competent authorities. In order to launch the third-party payment business, Jack Ma, acting as legal representative of Zhejiang Alibaba, transferred Alipay to himself; without Yahoo! and other shareholders of the offshore controlling company, the WOFE could do anything, with the exception of settling for compensation.[61] [62]

Regarding the issue of enforceability of VIE agreements, the Supreme People's Court has intervened at least twice. A well-known decision is the Chinachem case of October 2012. Chinachem Financial Services, a Hong Kong company, was relying on a VIE scheme in order to perform banking activities (which are restricted) in China. The scheme relied on a Chinese owned company, Chinachem Small and Medium Enterprise Investment Co. Ltd, to which Chinachem FS lent the investment funds; through this vehicle, Chinachem FS purchased a six point five percent hare quota in China Minsheng Bank. The Hong Kong Company controlled the vehicle via power of attorney and trust agreements. When the parent company and the VIE commenced a dispute, the Supreme People's Court stated that these agreements were entered into with the purpose of circumventing Chinese law and were therefore unenforceable, pursuant to Art 52 of the Chinese contract law.[63] In a second important case that took place in 2015, *Yaxing* v *Anbo*, however, the Supreme People's Court modified its position, deciding that VIE contracts were enforceable.[64] The decision concerned a dispute about a cooperation agreement signed between Anbo – a VIE formally owned by Chinese individuals but linked through a frame of contracts to Nasdaq-listed Ambow Holdings, – and Yaxing RMB. According to the agreement, Ambow was to acquire seventy percent of two schools from Yaxing for the price of one hundred and sixty million RMB, half of which were to be paid in shares of Ambow Holdings.[65] Subsequent to the loss of value of

[61] W. Shen, n 27 above, 933.

[62] P. Gillis, n 30 above, 8.

[63] Charles Comey et al, 'China VIEs: Recent Developments And Observations', available at https://tinyurl.com/y7njuzkc (last visited 27 December 2018).

[64] Supreme People's Court, *Appeal ruling of Beijing Anbo* v *Changsha Yaxin*, 117th decision of the Second civil matters section of 2015.中华人民共和国最高人民法院, 北京师大安博教育科技有限责任公司与长沙亚兴置业发展有限公司二审民事裁定书（民二终字第117号，2015, available at https://tinyurl.com/yad3d29f (last visited 27 December 2018).

[65] In China education is a restricted industry, according to the Catalogue of Foreign Investments and to relevant regulations issued by the Ministry of Education.

Ambow shares, Yaxing sued the VIE, claiming that the cooperation contract was invalid due to the fact that it pursued a purpose contrary to the law. In the first instance, the case was decided by the High People's Court of Hunan Province, which held that the contract was valid because Anbo's shareholders were Chinese natural persons. Anbo had originally been established as a Chinese company and the subsequent stipulation of power of attorney that gave Ambrow Holdings the power to choose the company directors, with the purpose of listing the latter company on the Nasdaq, did not change the fact that it was its Chinese shareholders who controlled it. As Anbo was formally a Chinese company, the cooperation framework agreement was indeed valid. After Yaxing's appeal, the Supreme People's Court upheld the decision of the Hunan High People's Court. The Supreme Court agreed that Anbo could not be deemed to be a foreign company, while also challenging the assumption that any contract signed in violation of the Catalogue of Foreign Investments is invalid. In particular, according to the Supreme People's Court, it was held that the contract could not be treated as be invalid according to Art 52 of the contract law because the Catalogue of Foreign Investments and the relevant provisions issued by the Ministry of Education were mere administrative provisions. This decision could potentially subvert the judicial trend that we described above. However, a few clarifications ought to be made: a) Chinese Courts do not need to follow precedents; b) In this decision the Supreme People Court solicited the opinion of the Department of Policy and Regulations of the Ministry of Education. The competent Ministry agreed that under certain circumstances restrictions to foreign investments (and VIEs) might not be applied to the education industry. However, this exception to the application of the Catalogue of Foreign Investments and of other relevant administrative regulations, released by the Ministry of Education, could not apply to value added telecommunications, which, unlike education, represent a matter of national security; c) as will be discussed shortly hereinafter, a draft of a new Law on Foreign Investments relies on the actual control that shareholders have of companies in order to determine whether such companies are national or foreign owned. As we will further discuss, in future, a company might be deemed to be Chinese regardless of the existence of a network of contracts formally binding it to foreign entities, unless such contracts determine actual control over the Chinese company. In *Anbo* v *Yaxing* the Supreme People's Court determined that Chinese shareholders maintained control over the schools, even if the appointment of the school management was delegated and the profits of the school were transferred to Ambow Holdins, a foreign company. It is, however, important to underline that the Court further argued that the schools had been managed by the physical persons owning Anbo's shares in accordance with all relevant legislation. In other words, the fact that Chinese individuals maintained factual control over company operations, in spite of the presence of a VIE structure did influence the judicial decision.

3. Thirdly, and finally, VIE operations are affected by regulatory risk. In other words, the competent Chinese authorities might at any time explicitly forbid this type of investment.[66] Indeed, it aims to enable foreign capital to flood into sectors of the economy that are deemed to be of vital importance. Chinese government intervention has been mentioned several times, such as in the Walmart and Alipay cases, in which specific operations were not allowed to be executed through VIEs. These interventions underline the acknowledgement of this type of operations on behalf of the Chinese government. The fact that most of these instances ended with a restriction on VIEs is a clear indicator of the government's intention to eventually purge sensitive areas of Chinese economy of this type of investment.

The actual question is how this will happen. Chinese Internet companies are proving to be essential in the transition of China from a manufacturing, export-oriented country to a service-based country that relies on internal consumption.[67] An abrupt interruption of the main source of financing for this industry could have serious consequences on its ability to further develop. Furthermore, considering that the value of the involved investments is in the range of hundreds of billions of US dollars, political repercussions should also be taken into account.

Robin Lee, the founder of Baidu, offered a possible solution, suggesting that future legislation may prohibit VIE structures, while recognising currently existing VIEs.[68] Such an approach could have negative effects, both political and economic. On the one hand, it would be perceived the legislator granting favours to some private enterprises and not others. On the other hand, it would disrupt competition in the Chinese Internet industry, a sector in which giants such as Baidu, Tencent and Alibaba have already been accused of monopolistic tendencies.

III. Towards a New Foreign Investment Law

The MOFCOM has released a draft for a future, more general and all-encompassing Foreign Investment Law, which will supersede the Laws on Equity Joint Ventures, Co-operative Joint Ventures, and WOFEs. In fact, concepts such as EJV, CJV and WOFE will cease to exist. More specifically, the draft of the new Foreign Investment Law introduces the new concept of actual control. This new concept will replace the determination of the foreign or national nature of a company on the basis of the origin of the invested capital.

More precisely, this provision is included in Arts 11, 12 and 14 of the Draft.

[66] Amendment no 7 to Form F-1: Registration Statement under the Securities Act of 1933, Alibaba Group Holding Limited, 51.

[67] W. Ma, n 25 above, 50, 55.

[68] S. Dickinson, 'China VIEs Are Dead. Done. Over. Stick A Fork In Them', available at https://tinyurl.com/yd3oelbb, 22 January 2015 (last visited 27 December 2018).

Art 11 defines Foreign Investors as: (1) Individuals who do not have Chinese nationality; (2) Businesses incorporated under the laws of other countries or regions; (3) Governments of other countries or regions or their subordinate departments or authorities; (4) International organizations; and (5) Domestic businesses controlled by the aforesaid subjects, which shall be deemed as foreign investors. Art 12 contains a complementary norm, defining Chinese investors as Chinese nationals, the Chinese government, and entities controlled by these subjects. Furthermore, Art 14 defines the hybrid category of Foreign invested enterprises as companies partially or wholly owned by foreign investors, incorporated under the laws of the PRC.

It is evident that the definition of actual control of the company will be essential in the distinction between Chinese and Foreign Enterprises. Art 18 of the same law defines this concept, which seems to be an innovation in Chinese company law. According to the norm, the term 'control' refers to any of the situations included in a short list:

(a) A person holds, directly or indirectly, more than fifty percent of the shares, equity, property shares, voting rights or other similar rights on the company;

(b) In a case where directly or indirectly owned share equity, property shares, voting rights or other rights on the company are less than fifty percent, a company is deemed to be controlled under any of the following circumstances:

1. The controlling entity has the right to appoint, directly or indirectly, more than half of the members of the board of directors or similar decision-making bodies;

2. The controlling entity may ensure that its nominee obtains more than half of the seats of the board of directors or similar decision-making bodies;

3. Its voting rights are sufficient to have a significant impact on the resolutions of the decision-making bodies, such as the shareholders' meeting, the shareholders' general meeting or the board of directors;

(c) A person exercises a decisive influence on the business operations, financial strategy, personnel or technology of the enterprise through contracts, trusts, etc.

It seems that Art 18.C explicitly refers to VIE entities, insofar as they allow foreign companies to exercise a decisive influence on business operations, as described in the norm. This does not necessarily mean that all investments imputable to VIEs will be invalidated. Although VIEs gather capital provisions in foreign markets, they do not grant governance powers to foreign investors. As was seen in the Alibaba case, the company's arts of association often provide mechanisms that allow the founders of the company to maintain control, despite subsequent capital investments. In other words, these companies are under the actual control of Chinese investors.[69] According to the new definition provided by Art 12, companies in which Chinese citizens exercise actual control are deemed to be Chinese companies. Therefore, those VIEs that are controlled by Chinese

[69] See above the paras on Alibaba Group's governance structure.

people should be allowed to continue their activity when the New Investment Law will be introduced. Indeed, they will not need to disguise the foreign investments, since, unlike the laws that are currently in force, the Draft of the New Foreign Investment Law does not take capital investments into account, as long as these capital investments do not exceed the fifty percent quota set out by Art 18.A. It is worth mentioning that this limitation could be easily circumvented by only offering shares that are not granted voting rights to foreign subjects.

IV. Conclusions

As many authors have observed, the introduction of the New Foreign Investment Law will probably end the proliferation of VIE schemes in China, but it will not exclude foreign investments in Chinese Internet economy, as long as the corporate structures underlying these investments preserve control by Chinese citizens or companies.[70] The main purpose of Chinese limitations to foreign investments is, in fact, to prevent sensitive sectors of the economy from falling under the control of overseas entities. This is confirmed not only by the provisions of the Draft regarding actual control by foreign investors, but also by the MOFCOM 2011 announcement no 53, pursuant to the Security Review Circular ('M&A Rule'); Art 9 of the M&A Rule reads:

> 'With regard to the merger and acquisition of domestic enterprises undertaken by foreign investors, the authorities should judge whether such a transaction is subject to the security review based on the essential content and actual impact of the transaction. Foreign investors shall not avoid M&A security review through any means, including but not limited to commissioned shareholdings, trusts, multi-level investments, leases, loans, contractual control, and overseas transactions'.

In other words, this MOFCOM circular instructs authorities controlling Sino-Foreign M&A operations to evaluate the 'actual impact' of an operation, that is, whether it results in foreign investors obtaining 'actual control' of the PRC business by engaging in 'overseas transactions' and exercising 'contractual control'.[71] This implies the intention to differentiate between foreign invested businesses that are still controlled by Chinese entities and those actually falling under the influence of foreign investors. The first category will likely be considered to be a Chinese company and will therefore be allowed to operate in restricted business areas.

On the other hand, entities that are subject to the actual control of foreign

[70] I.E. Brown, 'China's Leaked CSRC Report Five Years Later: Baseline for VIE Trajectory' 39 *Houston Journal of International Law*, 197, 214 (2017).

[71] S.Y. Shi, 'Dragon's House of Cards: Perils of Investing in Variable Interest Entities Domiciled in the People's Republic of China and Listed in the United States' 37 *Fordham International Law Journal*, 1281 (2014).

investors have always been restricted (see Alipay and Walmart cases) and will likely continue to be. Some authors have argued that since Arts 25 and 26 replace the catalogue of foreign investments with shorter Negative lists, they might liberalize the Chinese Internet economy sector.[72] This prediction may be accurate, but it fails to take into consideration the statistical data gathered from 2001 until today. These clearly show how foreign invested Internet companies have been basically excluded, despite the fact that, according to the Catalogue of Foreign Investments, they should have already been allowed, as long as Chinese shareholders were holding the majority of shares.[73] Nor does it take into account recent publications that clearly highlight the strategic importance that the People's Liberation Army attributes to excluding foreign influence from the Chinese Internet economy.[74]

In conclusion, while a clear overview will not be possible until the New Investment Law is actually promulgated, it seems that the Chinese system maintains a clear distinction between foreign and domestic businesses. The main innovation will be the parameter under which the foreign or domestic nature of a company is evaluated, since the draft, as well as recent regulations, such as MOFCOM announcement no 53 of 2011, seem to take into account actual influence, and not only equity shares. This innovation will allow Chinese companies to openly gather foreign financial provisions, as long as they manage to maintain control of the company's governance.

[72] M.J. Chapman, n 38 above, 4.
[73] D.J. Elliot and K. Yan, n 22 above.
[74] P. Gillis, n 30 above, 6.