



Ca' Foscari
University
of Venice

Master's Degree programme
in Language and Management to China

Final Thesis

China's Foreign Investment Law and its impact on VIE operations

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Academic Year

2023 / 2024

Abstract

The legal framework regulating foreign investment in China has been subject to enormous changes during the past four and a half decades, all of which have recently culminated in the rather quick approval of a new comprehensive law on foreign investment in 2019. There have always been some industries in which foreign investment was more welcomed and encouraged and others, considered more sensitive for the country, in which foreign investment was restricted. Starting in the early 2000s, investors have utilized complex structures called special purpose vehicles (SPVs) or variable interest entities (VIEs) in particular, to ‘exploit’, to a certain extent, existing regulatory loopholes and ultimately obtain profits from entities operating in strategic industries.

This thesis discusses the topic of the new China’s Foreign Investment Law (China FIL) and the impact it has on the operations involving VIE structures. Firstly, an analysis on the legal and political context in which the FIL was adopted is provided, together with an overview of the aims of the Law, and its structure and contents. Secondly, VIE structures and the regulatory loopholes ‘allowing’ their practice are briefly discussed, as well as the needs behind the decision to take part in such operations and the risks that they imply for investors and the market. Finally, the aim of this work is to identify in which ways China’s new Foreign Investment Law impacts on VIEs operations in China in the context of changed geopolitical dynamics; the matters of domestic VIE listings on the Shanghai Stock Exchange and the establishment of the SSE STAR Board are tackled, and selected famous cases are presented for explanatory reasons. The final part concludes.

Acknowledgements

Words cannot express my gratitude towards my supervisor and assistant supervisor for their precious advice on this thesis work and their knowledge and expertise; this endeavor would not have been possible without their guidance throughout the process.

I would also like to take the time to thank our faculty's professors and teachers of Chinese language for guiding us during this degree programme and enabling us to also base our research on Chinese sources.

I am grateful to my family for supporting me during my university years, to my partner, my friends and classmates for becoming my support network and to my first ever teacher of Chinese for sparking my interest in the Chinese language and culture.

Thanks should also go to my Chinese host family for letting me in as their own relative and for gifting me with the invaluable opportunity of learning different sides of the Chinese culture. Additionally, I must thank AFS-Intercultura for their efforts in promoting interculturality and in offering young people the immense opportunity of "connecting lives – sharing cultures". You changed my life for the better and helped me broaden my horizons on a different, beautiful world. I probably would not be writing this thesis right now had I not lived the experiences that made me passionate about the 'Chinese world'.

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前言

外国投资者一直对开拓中国市场感兴趣，特别是改革开放后，中国开始吸引了越来越多的外国投资者。在过去的四十五年里，中国规范外商投资的法律框架经历了巨大的变化，一直到如今，新的外商投资综合法于 2019 年迅速获得批准，将所有这些变化推向了高潮。中国新的《外商投资法》及《外商投资法实施条例》于 2020 年 1 月 1 日生效。

在中国外商投资一直采用目录制度为依据，可最近已转变为负面清单制度；因此，在中国经济的一些行业里，外商投资一直受到更多欢迎和鼓励，而在另一些行业里，因为被认为对国家更为敏感，所以外商投资受到限制。在 2000 年代初，投资者开始利用复杂财务结构，以便通过中国外商投资法律框架现有的监管漏洞的“利用”从在战略行业里经营的实体中获取利润。该财务结构被称为“特殊目的机构”（SPV）或“可变利益实体”（VIE）。

新《外商投资法》已有助于为外国投资者提供更明确的指导，并被认为是全面地改变了中国整个外国投资法律框架。然而，它并未就可变利益实体问题提供明确的指示，也未说明中国政府在这一问题上的立场如何。

本论文讨论的主要议题是新《中华人民共和国外商投资法》（China FIL）及该法对涉及可变利益实体结构的业务产生的影响，同时也将考虑到此法的目的、内容和限制、可变利益实体对投资者具有的主要风险和利益，以及《外商投资法》对上述财务结构的影响。

本论文分为三章，内容安排如下。首先，本文对《外商投资法》的法律和政治背景以及该法的目的、结构和内容进行分析；此外，第一部分还谈到该法条款的一些限制和问题。其次，本文讲的是 VIE 架构的基本特征和“允许”其实践的监管漏洞、决定参与此类业务背后的原因和需求，以及其对投资者和市场意味着的风险；第二部分还对几个案例以及中国对 VIE 架构的看法这两个主体进行分析。最终，本论文的主要目标是指在最近地缘政治关系改变的背景下中国新《外商投资法》如何影响了中国的 VIE 结构：因而，第三章针对该法的条例对 VIE

结构具有何后果以及可变利益实体保持含糊不清的合法性的问题。再说，第三章还谈论国内 VIE 在上海证券交易所上市以及上海证券交易所科创板（SSE STAR Board）的设立这些题目。最后一部分是总结。

本论文的研究以学术文章、报刊文章和中华人民共和国的官方报告和法律为基础；“西方 ”专家和中国专家的观点都被参考，并本文在出现差异时对两个不同观点进行比较。在本论文的最后一部分也提供一个词汇表，其中包含了文中最有意义的中文词汇。

Preface

Foreign investors have always been interested in exploring the Chinese market and, after its opening up, China has been attracting more and more foreign investors. The legal framework regulating foreign investment in the country has been subject to enormous changes during the past four and a half decades, all of which have recently culminated in the rather quick approval of a new comprehensive law on foreign investment in 2019. China's new Foreign Investment Law (FIL) came into force on January 1st, 2020, together with the more detailed Regulation on its Implementation.

Foreign investment in China has always been based on a system of catalogues, which has recently been transformed into a negative list system; as a result, there have always been some industries in which foreign investment was more welcomed and encouraged and others, considered more sensitive for the country, in which foreign investment was restricted. Starting in the early 2000s, investors have utilized complex structures called special purpose vehicles (SPVs) or variable interest entities (VIEs) in particular, to 'exploit', to a certain extent, existing regulatory loopholes and ultimately obtain profits from entities operating in said strategic industries.

The new FIL was expected to provide clearer guidance to foreign investors and drastically changed the entire legal framework for foreign investment. However, it does not provide clear indications on the matter of variable interest entities, nor does it share the Chinese government's position on the subject.

This thesis discusses the topic of the new China's Foreign Investment Law (China FIL) and the impact it has had and still has on the operations involving VIE structures, taking into account the aims, contents and limits of the law, as well as the risks and benefits of VIE operations for investors, and the implications of the FIL on said operations.

This thesis work is outlined into three chapters, which are organized as follows. Firstly, an analysis on the legal and political context in which the FIL was adopted is provided, together with an overview of the aims of the Law, and its structure and contents; the first part also touches on what are considered a few limits and issues regarding its provisions. Secondly, VIE structures and the regulatory loopholes 'allowing' their practice are briefly

discussed, as well as the needs behind the decision to take part into such operations and the risks that they imply for investors and the market; a few explanatory cases are analyzed and China's perspective on their regulation is presented. Finally, the aim of this work is to identify in which ways China's new Foreign Investment Law impacts on VIE operations in China in the context of changed geopolitical dynamics, thus the third chapter focuses on the subject of China's new FIL's consequences on VIE operations and the ambiguous legality that they maintain; in addition, the matters of domestic VIE listings on the Shanghai Stock Exchange and the establishment of the SSE STAR Board are tackled, and selected famous cases are presented for explanatory reasons. The final part concludes.

This thesis bases its research on academic articles, newspaper articles and official reports and laws of the People's Republic of China; the points of view of both 'western' and Chinese experts are considered and a comparison of the two is presented when differences emerge. At the end of this thesis work, a glossary of the most relevant Chinese terms encountered in the text is presented as well.

1. Chapter I, Foreign investments in China: a new regulatory framework

1.1. Introduction on China's Foreign Investment Law and its background

After the start of the “reform and opening up”¹ period in the late 1970s, the Chinese government enacted reforms which started opening up the country's market to foreign investors. Since then, foreign investment into the country has been vital in sustaining the efforts to modernize China and vitalize its economy, as well as in connecting a once closed market to the rest of the world.² In the 1980s, a proper legal system³ to regulate foreign investment was formally put in place, forming the basis for attracting foreign investments and aiding the country's economic growth.⁴

¹ The “reform and opening-up” policy (改革开放) was announced by Deng Xiaoping in 1978 and was a first milestone for the opening up of the Chinese market towards foreigners. See Wall, D. (1993). China's economic reform and opening-up process: The role of the special economic zones. *Development Policy Review*, 11(3), 243-260.

² See Zhang, M. (2020). Change of Regulatory Scheme: China's New Foreign Investment Law and Reshaped Legal Landscape. *UCLA Pacific Basin Law Journal*, 37(1), UCLA Pacific Basin law journal, 2020, Vol.37 (1).

³ To better understand the evolution of Chinese laws on foreign investment, taking into account the concept of Chinese specificities (中国特色), see Cavalieri, R. (2022). Evoluzioni e involuzioni del diritto cinese degli investimenti esteri: dalla prima legge sulle joint ventures alla pandemia. *Journal: ANNUARIO DI DIRITTO COMPARATO E DI STUDI LEGISLATIVI*.

⁴ The system in the beginning was based on the Law of the People's Republic of China on Joint Ventures Using Chinese-Foreign Investment (also called EJV Law), the Wholly Foreign Owned Enterprises Law (WFOEs Law) and the Contractual Joint Venture Law (CJV Law). See Bush, C. (2024). Critical analysis of the new Chinese foreign investment law in the prism of China-EU CAI and China-US bit negotiations. *Sociology International Journal*, 8(2), 61–76.

China began attracting more and more foreign investors, and soon became the largest developing country in the world to attract foreign investment in 1993, ultimately surpassing even the United States as the top host country of foreign investment in 2002, reaching the amount of USD 134.97 billion in use of foreign capital.⁵ Many argue that Foreign Direct Investment (FDI) has constituted the main source of capital for Chinese economic development over the past forty years.⁶ However, to keep up with said growth, the legal framework regulating foreign investment in the country has been subject to enormous changes during the past four and a half decades, all of which ultimately culminated in the publishing and approval of China's new Foreign Investment Law (*Zhonghua Renmin Gongheguo Waishang Touzifa* 中华人民共和国外商投资法)⁷ in 2019, aimed at diving into a less restricted and more transparent legal environment.⁸

According to Chinese scholars, the new Foreign Investment Law is a helpful tool for foreign investors to navigate the Chinese legal system and its publication symbolizes the determination of the country to open up its market even more, serving as a sort of reassurance for foreign investors in the country; furthermore, it serves as a legal tool that provides protection and support to foreign investors, aiding the People's Republic of China in the process of becoming the world's most promising land for investment (全球投资热土 *quanqiu touzi retu*).⁹ Conversely, it seems interesting to note that many in the West have instead perceived the new law and its quick approval merely as a tool of the

⁵ Zhang, M. (2020), p. 181.

⁶ Zheng, Y. (2019). Foreign direct investment in China. *Handbook on the international political economy of China*, 61-75.

⁷ *Zhonghua Renmin Gongheguo Waishang Touzifa* 中华人民共和国外商投资法 (Law of the People's Republic of China on Foreign Investment), published on March 15th, 2019 by the National People's Congress (*Quanguo Renmin Daibiao Dahui* 全国人民代表大会). See: <https://www.pkulaw.com/chl/6a88714068b3724dbdfb.html?keyword=%E5%A4%96%E5%95%86%E6%8A%95%E8%B5%84%E6%B3%95&way=listView>

⁸ Zheng, Y. (2021). China's New Foreign Investment Law and Its Contribution Towards the Country's Development Goals. *The Journal of World Investment & Trade*, 22(3), 388–428.

⁹ HUANG Jin 黄晋, “*Waishang touzifa*” *zhongzai cujin he baohu* 《外商投资法》重在促进和保护 (The Foreign Investment Law Focuses on Promotion and Protection), *Dazhong ribao* 大众日报 [Dazhong Daily], 2019. Available at: <https://article.chinalawinfo.com/ArticleFullText.aspx?ArticleId=106966&listType=0>

Chinese government to face the escalation of the China-US trade war and thus provide parity conditions for foreign direct investments in the world's second economy.¹⁰

Despite not being very long, the new FIL encompasses provisions on a wide range of topics such as negative lists, examination, approval and put into record of investment projects, industry permits, corporate form and put into operation of the manufacturing processes, mergers and participations, information report, examination of investments' safety and more.¹¹ Not only this, but the new law also renovates the Chinese legal system regulating the protection of intellectual property rights for foreign-invested enterprises, following the trend towards an evermore stringent protection of international intellectual property.¹² Overall, the FIL is perceived in China as the embodiment of the efforts of the government towards developing the country's economy and expanding companies, in spite of more efforts being certainly needed in the near future to improve the relation 'national security-foreign investment'.¹³

The provisions Iled in the Foreign Investment Law apply to all foreign investments taking place within the territory of the People's Republic, excluding the special administrative regions (SARs, 特别行政区 *tebie xingzhengqu*) of Hong Kong and Macau, which are considered 'foreign' for what concerns the application of law¹⁴, and are aimed at reformulating the legal environment for foreign investment in China and making it more

¹⁰ For more, see: Li, X. (2021). The Durability of China's Lawmaking Process under Xi Jinping: A Tale of Two Foreign Investment Laws. *Issues and Studies - Institute of International Relations*, 57(1). DOI: 10.1142/S1013251121500016.

¹¹ HUANG Jin 黄晋 (2019).

¹² LUO Ying 罗迎, "Waishang touzifa" zhishi chanquan baohu de fazhizhua: jiben jiaogou, dongyin yu boyi luoli 《外商投资法》知识产权保护的法治化: 基本架构、动因与博弈逻辑 (Rule of Law for Intellectual Property Protection under the Foreign Investment Law: Basic Structure, Motivation and Game Logic), *Guoji shangwu yanjiu 国际商务研究 [International Trade Research]*, 2022 (05), 61-74. doi:10.13680/j.cnki.ibr.2022.05.006

¹³ ZHANG Jin 张进, *Waishang touzifa shijian jiazhi tanjiu 外商投资法实践价值探究 (Enquiry on the Practical Value of the Foreign Investment Law)*, *Caijing guancha 财经观察 [Financial Observation]*, 2023 (01), 58-60. doi:CNKI:SUN:ZWQW.0.2023-01-019.

¹⁴ To deepen this topic, refer to: Zhang, M. (2012). Codified Choice of Law in China: Rules, Processes and Theoretic Underpinnings. *North Carolina Journal of International Law and Commercial Regulation*, Vol. 37, No. 1, p. 83, 2011, *Temple University Legal Studies Research Paper* No. 2012-07, Available at SSRN: <https://ssrn.com/abstract=1960717>

open, fair and transparent.¹⁵ Furthermore, the passing of the Foreign Investment Law provides a legal basis for the further enhancement of the reporting system for information on foreign investment, promotes correct legal practices, and thus provides more support for foreign investors operating in China as compared to previous regulations.¹⁶

However, it is mainly the introduction of the pre-entry national treatment on one hand and the negative list system on the other that can be said to constitute the key factors revolutionizing China's regulatory scheme of foreign investment. At the same time, a few doubts about the enforcement of the FIL are still present, especially considering that the provisions in it are quite vague and leave certain issues unanswered.¹⁷

It is anyhow relevant to point out that, after the entry into force of the FIL in 2020, China surpassed once again the United States as the world's largest host State of new foreign investments, receiving USD 163 billion in new foreign direct investment, which highlights the growing importance of China in the global economy and its success in attracting foreign investment.¹⁸ Although China does not seem to need foreign capital as much as it did in the early stages of its economic reforms, the approval of the Foreign Investment Law demonstrates that the market's opening-up and the encouragement of inward foreign investments are still two very pursued national strategies, which are very appreciated by foreign investors as well, who still view the Chinese people's consumption power as utterly appealing.¹⁹

In light of all that has been mentioned above, the topic of China's new Foreign Investment Law as well as its innovative traits and apparent limits appear worth to tackle at the beginning of this thesis work, in order to lay the basis for understanding its implications on the phenomenon of variable interest entities. The following paragraphs mainly focus on giving an overview of the legal and political context in which the Foreign Investment

¹⁵ Zhang, M. (2020), p. 188.

¹⁶ HUANG Jin 黄晋 (2019).

¹⁷ Zhang, M. (2020), p. 187.

¹⁸ China Takes New Foreign Investment Top Spot from US (2021). *BBC*. Available at: www.bbc.co.uk/news/business-55791634

¹⁹ Zhang, X. (2020). China's New Foreign Investment Law: An Open-and-Shut Case for Foreign Investors? *Amicus Curiae (Bicester, England)*, 2(1), 79–94.

Law was introduced, on the goals of the FIL in relation to the nation's goals, on the structure and contents of the FIL and Regulation on its implementation as compared to the previous draft of the law, on the issue of national security and finally on limits regarding the provisions of the FIL. The points of view of both Chinese and western scholars and think tanks are taken into account.

1.2. Changes in Chinese laws on foreign investment after China's entry into the WTO and the legal context in which the FIL was introduced.

The legal framework regulating foreign investment in China has been ever-evolving, but this paragraph will mainly focus on defining the legal context that has been regulating foreign investment in the country in the past twenty years. The goal is to outline the context in which the Foreign Investment Law was introduced in order to better grasp what implications it has as compared to past regulations.

Economic globalization and China's entry into the WTO increased the needs of China's legal, administrative and judicial systems to adapt to a new interconnected world.²⁰ As a matter of fact, China's will to enter the World Trade Organization implied that Chinese Laws regulating different areas including foreign investment had to be revised to meet the requirements for the entry into the WTO²¹, overall leading to the creation of a more liberalized business environment. Major changes in the country's foreign trade and

²⁰ GUO Jian'an, ZHA Qingjiu 郭建安、查庆九, *Zhongguo fazhi yu jingji fazhan* 中国法治与经济发展 (Rule of Law in China and Economic Development), *Zhongguo falü* 中国法律 [Chinese Law], 2008, (1: 17), 322. Available at: http://www.pkulaw.cn/fulltext_form.aspx/pay/fulltext_form.aspx?Db=qikan&Gid=1510090192

²¹ The RPC ended up entering the WTO on the 11th of December of 2001. For more on the subject, see: Agarwal, J. and Wu, T. (2004), "China's entry to WTO: global marketing issues, impact, and implications for China", *International Marketing Review*, Vol. 21 No. 3, pp. 279-300. <https://doi.org/10.1108/02651330410539620>

investment regime thus took place during the first years of the XXI century and concerned areas such as legal transparency, market access and treatment equality.²²

Being a WTO member, China is subject to various obligations concerning transparency, regulatory independence and competition to cite a few; some of these obligations apply to all members of the GATS (General Agreement on Trade in Services), while others are member-specific.²³ A few of the major improvements that followed China's entry into the WTO are named below.

The law on Wholly Foreign Owned Enterprises (WFOE) and its Implementing Regulation were subject to changes in the years 2000 and 2001, implying that, for the first time, wholly foreign owned subsidiaries could be set up in any business industry, as long as it was not a prohibited or restricted industry according to law.²⁴ However, all foreign invested enterprises (FIEs) still had to undergo a complex and onerous approval and registration process by the Ministry of Foreign Trade and Economic Cooperation (MOFTEC).²⁵ The Economic Joint Venture Law (EJV Law) was amended too in 2001, allowing FIEs to purchase insurance, materials and goods from international providers, and stating their right to litigate in the PRC's Courts when no arbitration agreement was in place; such changes represented the expansion of foreign economic cooperation and technological exchange.²⁶ Moreover, the Investment Catalogue, which divided investment projects in China based on the nature of the industrial sector into three categories (encouraged, restricted and prohibited), was modified in 2002, reducing the

²² Qin, J. Y. (May 9, 2007). The Impact of WTO Accession on China's Legal System: Trade, Investment and Beyond. Wayne State University Law School Research Paper No. 07-15, Available at <http://dx.doi.org/10.2139/ssrn.985321>

²³ Such as the Telecommunication Reference Paper, see: Fawn T., Mitchell, A, Pendray, *Shangye kaifang? Zhongguo dianxin fuwu shichang yu WTO* 商业开放? 中国电信服务市场与 WTO (Commercial Openness? China's telecommunication services market and the WTO), *Jiaoda faxue* 交大法学 [Jiaotong University Law Journal], 2012, (02), 68. Available at: <https://www.pkulaw.com/qikan/32f6d506209a58f5d605189356864c2fbdfb.html?keyword=variable%20interest%20entity&way=listView>

²⁴ Cavalieri (2022), pp. 154-155.

²⁵ Bush (2024), p. 63.

²⁶ For a more detailed outlook on the evolution of Chinese Foreign Direct Investment Law throughout the decades, see: Wang, Y. (2002). *Chinese Legal Reform* (1st ed.). Routledge. <https://doi.org/10.4324/9780203164273>

list of prohibited industries²⁷: for instance, following China's commitment to open up sectors within five years of its accession to the WTO in 2001, many service sectors were moved from the prohibited category to the restricted category.²⁸

In 2003 and 2006 new provisions on mergers and acquisitions were enacted and for the first time foreigners were allowed to not only take part into greenfield investments through the establishment of foreign invested enterprises (FIE), but also to participate in brownfield investments, via the acquisition of public or private Chinese companies or their merger with foreign enterprises. Said provisions were revised in 2009 and today are still applicable.²⁹

In the following decade, complaints were made by foreign investors due to the unfavorable treatment received by the Chinese administration, for instance regarding the preferential treatment of state owned enterprises (SOEs), local protectionism to local SOEs and policies supporting national champions; this resulted in the Chinese State showing commitment in the developing of a more open economic system and modern market system, and therefore in amendments to Chinese laws.³⁰

It is to be noted that Chinese laws regulating foreign Investment had been prioritized over China's other laws, considering that the Chinese legal system was still quite limited at the time of their promulgation: the goal was to create a legal environment that provided safeguards to investors, to ultimately make the Chinese market even more attractive and this way sustaining growth of the country's economy.³¹

Anyways, after 2010, the development of laws on FDI followed the principles of establishing a unified, open, competitive and transparent market system for a mixed economy, by means of removing market barriers and allowing all investors to enter

²⁷ The Foreign Investment Industrial Guidance Catalogue was first jointly published in 1995 by the National Development and Reform Commission (NDRC) and the Ministry of Commerce (MOFCOM) and was subject to various amendments, the most recent one being in 2017. See Zhang, M. (2020), p. 183.

²⁸ Li, X. (2021), pp. 6-7.

²⁹ Cavalieri (2022), p. 155.

³⁰ Bush (2024), pp. 63-64.

³¹ Zhang, X. (2020), pp. 84-87.

industries which were not on the negative list on an equal basis. The first experiment was carried out in Shanghai Free Trade Zone in 2013: for the first time China adopted the “Negative List” approach as opposed to the Positive List approach contained in the Catalogue system.³²

To sum up, until the Foreign Investment Law was enacted in 2020, foreign investments entered China in three major forms, which were all collectively called Foreign Invested Enterprises or FIEs (外资企业, as an abbreviation of the complete term 外商投资企业), and were in fact regulated by three separate laws: the Sino-Foreign Equity Joint Venture Law, which regulated the most common form of investment (equity joint ventures or EJV) ³³ ; the Foreign Capital Enterprises Law regulating wholly foreign owned enterprises (WFOEs)³⁴; and the Sino-Foreign Cooperative Joint Venture Law governing contractual joint ventures (CJVs)³⁵. ³⁶

The abovementioned laws were commonly labeled as FIE Laws and constituted an actual “tripartite system of laws”, which defined an era of governance of foreign investment in China.³⁷ Hence, a few characteristics proper of this statutory regime well describe the legal context in which the FIL was introduced. First and foremost, it must be pointed out

³² Bush (2024), pp. 63-64.

³³ Refer to: *Zhonghua Renmin Gongheguo Waizi qiyefa* 中华人民共和国中外合资经营企业法 (Law of the People's Republic of China on Chinese-Foreign Equity Joint Ventures), available at <https://www.pkulaw.com/chl/44fe519756440da6bdfb.html?keyword=%E4%B8%AD%E5%A4%96%E5%90%88%E8%B5%84%E7%BB%8F%E8%90%A5%E4%BC%81%E4%B8%9A%E6%B3%95&way=listView>

³⁴ Refer to: *Zhonghua Renmin Gongheguo Waizi qiyefa* 中华人民共和国外资企业法 (Law of the People's Republic of China on Foreign-Capital Enterprises), available at <https://www.pkulaw.com/chl/2301cdee64b97477bdfb.html>

³⁵ Refer to: *Zhonghua Renmin Gongheguo Zhongwai hezuo jingying qiyefa* 中华人民共和国中外合作经营企业法 (2017 修正), (Law of the People's Republic of China on Chinese-Foreign Contractual Joint Ventures (2017 Amendment)), available at <https://www.pkulaw.com/chl/8d5ccc9a6f18e937bdfb.html>

³⁶ Zhang, S. (2022). Protection of foreign investment in China: the Foreign Investment Law and the changing landscape. *European Business Organization Law Review*, 23(4), 1049-1076.

³⁷ See the Foreign Investment Guide of the People's Republic of China (2024 Edition). The Legal System for Foreign Investment, issued by the MOFCOM in 2024. Available at <https://fdi.mofcom.gov.cn/en/come-newzonghe.html?parentId=125&name=The%20Legal%20System%20for%20Foreign%20Investment&comeID=4#:~:text=In%20the%20early%20stage%20of,on%20Chinese%2DForeign%20Contractual%20Joint>

that foreign investment and domestic investment have always been subject to different treatments, meaning that individuals with Chinese nationality were excluded from FIEs. Also, the registration of FIEs required government review and approval, without which, the right of the FIE to operate was hindered.³⁸ Such a distinct legal system for foreign investors was noticeably in contrast with legal frameworks in place in many Western states, which prescribe the same requirements on foreign investors as well as domestic investors in company and partnership law; at the same time, it reflected the *ad hoc* approach of Chinese legislators for regulating economic reforms and foreign investment.³⁹

The Three Laws (外资三法) contained a wide range of provisions including contents on modifications to and establishment of the corporate form of FIEs and on the business operations of FIEs; overall, they helped China make progress following the development of international business as well as strengthen and improve the position of China in the global business environment.⁴⁰

Since the FIE Laws were each promulgated at different times and individually, the regulatory regime lacked uniformity. For this reason, this system of separate regulations often implied bureaucratic complexity and confusion for investors willing to enter the Chinese market, not even mentioning the conflicts existing between FIE Laws and China's Company Law.⁴¹ Being fully aware of these issues, one of the most ambitious economic reform programs since 'Deng era' was thus launched by China's Communist Party after the 18th Party Congress in November 2012: one of its major goals were to broaden foreign investment access to China.⁴²

As some Chinese scholars stated, we could draw the conclusion that the issues pervading the tripartite system of laws on foreign investment, considering the evolution of epochs, consisted in the following: first, in the process of transition from a planned economy to a

³⁸ Zhang, M. (2020), pp. 193-194.

³⁹ Zhang, S. (2022), pp. 1063-1064.

⁴⁰ HUANG Jin 黄晋 (2019).

⁴¹ Zhang, M. (2020), p. 184.

⁴² Li, X. (2021), p. 8.

socialist market economy, the “three laws” on foreign investment oriented to greenfield investment could not cope with the emergence of new investment patterns; second, the ambiguity in the application of the law in individual cases due to different treatment of domestic and foreign investors meant the principle of competitive neutrality could not be respected; third, the whole process for administrative approval of foreign investment projects was too onerous.⁴³

This legal framework was almost entirely swept away by the implementation of the new Foreign Investment Law 2020.

1.3. Political context in which the new FIL was introduced: Xi Jinping era

A few clarifications should also be made on the political context in which the FIL was implemented, especially regarding the so-called ‘Xi Jinping era’. After Xi Jinping took the leadership of China’s ruling party (the Communist Party of China CPC) in 2012, along with economic reforms, political transformations took place as well and shaped China’s most recent political context, a major one being the development and promotion of the rule of law.⁴⁴

Xi’s style has been that of operating based on the principle of “ruling the country according to law” (依法治国 *yifazhiguo*): for him, this meant that law should be clear and complete and that it should be applied consistently by the public administration. For this reason, despite it being clear that judicial power is still subordinated to political power, Xi’s administration has put huge efforts in eradicating certain phenomena among the

⁴³ REN Hongda 任宏达, *Waishang touzifa shishi jizhi de tedian yu wanshan* 外商投资法实施机制的特点与完善 (Characteristics and Improvements for the Implementation Mechanism of the Foreign Investment Law), *Zhongguo fazhan guan cha* 中国发展观察 [China Development Observation], 2020 (7-8). Available at: <https://article.chinalawinfo.com/ArticleFullText.aspx?ArticleId=113991&listType=0>

⁴⁴ For more on political reforms refer to: Womack, B. (2017). Xi Jinping and continuing political reform in China. *Journal of Chinese Political Science*, 22(3), 393-406.

public administration such as corruption and illegal or immoral practices.⁴⁵ Hence, it is said that Xi greatly reduced the gap between ‘law in the books’ and ‘law in action’.⁴⁶

It must be highlighted that, from 2013 onwards, the presidency of Xi Jinping led to the decision of the Central Committee of the Communist Party of China to adopt a new round of reform called ‘Reform 2.0’, which aimed at giving a leading role to the economic system reform and deepening reforms in order to set up fair and transparent market rules, create a business environment by the rule of law and promote modernization of the national governance system.⁴⁷

To fully understand the importance of such a decision, it must be taken into account that both democratic and authoritarian leaders meet difficulties in the policymaking process, being constraints mainly represented by key stakeholders within the ruling coalition or ‘selectorate’ in the case of China. This implies that, on the one hand, bureaucratic competition and bargaining can delay the time before a draft law can be voted on at the National People’s Congress, resulting in the majority of draft laws taking years just to reach the voting stage.⁴⁸

Concrete applications of Xi’s policy can be found in the adoption of the negative list system to optimize market access and liberalize China’s investment legal regime (which will be discussed later in this chapter), in the establishment of pilot free trade zones (FTZs) to conduct experimental economic reform, and in the adoption of other economic and political measures.⁴⁹

On the other hand, it has been proven that the legislative process can be sped up if urgent domestic or international threats to regime stability occur, which many have argued was exactly the case for the quick approval of the Foreign Investment Law.⁵⁰

⁴⁵ Garrick, J., & Bennett, Y. C. (Eds.). (2016). *China's socialist rule of law reforms under Xi Jinping*. London and New York: Routledge.

⁴⁶ Cavalieri, R. (2022), p. 158.

⁴⁷ Zhang, S. (2022), pp. 1052-1053.

⁴⁸ Li, X. (2021), pp. 4-5.

⁴⁹ Zhang, S. (2022), pp. 1067-1070.

⁵⁰ See, generally: Bush (2024).

1.4. Aims of the FIL

The Chinese legal and political contexts presented in the previous paragraphs already give a few hints on the causes that led to the approval of the Foreign Investment Law in 2019. This paragraph will focus on expressing the actual goals that the implementation of the new law has.

First of all, it must be clear that most reforms in China, of which the FIL is certainly part, are planned in accordance with specific national goals, which are, in our case, expressed in the 14th Five-Year Plan for National Economic and Social Development.⁵¹ The mission behind this is that of improving the quality of China's development and the abovementioned goals can be enumerated as follows: building technological capacity, deepening integration into the global economy, promoting green development, protecting public security and participating in global economic governance and rule-making. We could conclude that the approval of the new FIL directly or indirectly responds to almost all of the needs implied by said development goals.⁵²

The Foreign Investment Law is aimed at setting general principles governing FDI in the country and providing unified provisions on market access, investment promotion, as well as investment management, this way ending confusion and complexity linked to the previous use of separate regulations.⁵³ Its enactment, in fact, embodies a shift in regulations from micro to macro management of foreign investment.⁵⁴

⁵¹ See Major targets in RPC's 14th Five-Year Plan, available at <https://english.www.gov.cn/w/14thfiveyearplan/>

⁵² Zheng, Y. (2021), pp. 389-390.

⁵³ Zhang, S. (2022), pp. 1050-1052.

⁵⁴ Zhang, M. (2020), p. 187.

Some Chinese scholars consider the FIL as a sort of ‘law on promotion’ (促进法 *cujinfa*) and ‘law on protection’ (保护法 *baohufa*) at the same time, implying that promoting and protecting foreign investment in the country is one of the crucial aims of the law.⁵⁵

Additionally, a main goal of the FIL is to open up the Chinese market to foreign investment through the rule of law⁵⁶, given that, before its adoption, many industries in China were still partially or completely closed, due to their political, strategic, economic or cultural importance⁵⁷: in 2012, China was in fact ranked the second most restrictive country against FDI out of 62 countries considered.⁵⁸ This critical goal can be achieved through the creation of a more welcoming investment climate both from an economic and a political point of view.⁵⁹

The Foreign Investment Law aims to simplify the pre-establishment administrative procedure by establishing a new reporting mechanism, which eliminates the pre-entry approval by Chinese authorities for investments in sectors not covered by the negative lists, thus making the bureaucratic burden lighter for foreign investors.⁶⁰ In fact, the submission of the report together with the registration procedure includes fewer documents and can be carried out online.⁶¹

While doing so, another relevant objective of the FIL is obviously that of continuing to protect national security; for this purpose and for that of creating a stable market environment, the National Security Review System of foreign investments (外资安全审

⁵⁵ DENG Tingting, CHEN Meiyu 邓婷婷、陈美玉, *Youhua waiziyingshang huanjing beijingxia “Waishang touzifa” guize shiyong wenti yanjiu* 优化外资营商环境背景下《外商投资法》规则适用问题研究 (Research on the Application of the Rules of the Foreign Investment Law under the Background of Optimizing the Foreign Capital Business Environment), *Dalian daxue xuebao* 大连大学学报, 2022, (03),58-65. doi:CNKI:SUN:DALI.0.2022-03-009

⁵⁶ Zhang, S. (2022), pp. 1053-1054.

⁵⁷ Li, X. (2021), p. 7.

⁵⁸ According to the OECD FDI Regulatory Restrictiveness Index, available at: <https://goingdigital.oecd.org/en/indicator/74>

⁵⁹ Zhang, S. (2022), pp. 1051-1052.

⁶⁰ Zheng, Y. (2021), pp. 397-399.

⁶¹ *Ibid*, 406-408.

查制度 *waizi 24nquan shencha zhidu*) was put into place.⁶² This topic will be discussed in more detail further in the chapter.

Another aim of the Law is that of levelling the playing field between foreign and domestic investors while, as previously mentioned, strengthening investment promotion and protection.⁶³ Chinese sources confirm as well that the FIL was in fact implemented with the aim of promoting and protecting inward foreign investment in China firstly by means of “creating a more equal, stable and predictable business environment” (打造更加公平、稳定、可预期的市场环境 *dazao gengjia gongping, keyuqi de shichang huanjing*).⁶⁴ The FIL is seen in China as a milestone that grants to both foreign invested enterprises and domestic enterprises a field for equal development opportunities, in the meantime being a strong legal step towards the country’s need for becoming more open, fair and protective with respect to foreign investment.⁶⁵

Overall, China’s new FIL can be considered as a tool for surpassing obstacles present in the previous legal environment regulating foreign investment in the country, such as difficulties in meeting approval requirements during the pre-entry and even post-entry phases of investment or the lack of effective supervision by competent authorities due to gaps in the regulatory regime for post-establishment regulatory supervision.⁶⁶

Lastly, it is imperative to highlight that the Foreign Investment Law’s core mission can be identified in the reformulation of the entire regulatory regime governing foreign investment in China, also following the trend of reforms in the country initiated in 2013, and especially the strategic initiative called NOES -which stands for building a “new open economic system”-, already aimed at encouraging China’s opening-up to the outside world.⁶⁷

⁶² DENG Tingting, CHEN Meiyu 邓婷婷、陈美玉 (2022), pp. 60-61.

⁶³ Zheng, Y. (2021), pp. 401-406.

⁶⁴ HUANG Jin 黄晋 (2019).

⁶⁵ ZHANG Jin 张进 (2023), pp. 59-60.

⁶⁶ Zheng, Y. (2021), pp. 391-399.

⁶⁷ Zhang, M. (2020), pp. 185-188.

1.5. From the 2015 draft to the final version of 2019

According to Chinese scholars, the promulgation of the FIL can be considered as a reflection of China's need for development in a new era; in fact, it serves the purposes of attracting foreign investment, enhancing the economic system of the Chinese market, and speeding up the transition of the Chinese economy towards a new level of development.⁶⁸ The first drafts of a new law on foreign investment by the Ministry of Commerce can be dated back to as early as 2011, when loopholes in the FIE Laws started to become evident as well as a need for a new foreign investment legal system, which could actually support investors in a new globalized world.⁶⁹

However, a first relevant draft of the FIL was published by MOFCOM for public comment in 2015 and is often compared to the actual FIL that passed approval in 2019: the 2015 draft contained 11 chapters and a total of 170 articles, being longer than the actual FIL.⁷⁰ The draft and the actual law differ in a series of points, one of the main being the definition of foreign investment, which will be discussed later in this chapter: in the 2015 draft 'foreign investment' was worded as 外国投资 *waiguo touzi*⁷¹, meaning 'investments from foreign countries', which implicated the geographic source of investment.⁷² Anyways, when first published, the 2015 draft was perceived in the country as an ambitious move that would radically change the system regulating foreign

⁶⁸ ZHANG Jin 张进 (2023), p. 60.

⁶⁹ Zhang, M. (2020), p. 185.

⁷⁰ Refer to the text of the draft: *Shangwubu jiu "Zhonghua Renmin Gongheguo Waiguo touzifa (cao'an zhengqiu yijian gao)" gongkai zhengqiu yijian* 商务部就《中华人民共和国外国投资法(草案征求意见稿)》公开征求意见 (The Ministry of Commerce solicits public opinions on a Draft of the Foreign Investment Law of the PRC (Draft for Soliciting Comments)), 2015, available at <https://www.pkulaw.com/protocol/34f464f7f59e91758268e3d0d1a72ef7bdfb.html?keyword=%E5%A4%96%E5%9B%BD%E6%8A%95%E8%B5%84%E6%B3%95&way=listView>

⁷¹ *Ibid.* This wording differs from the text of the FIL 2020, in which 'foreign investment' is referred to as 外商投资 *waishang touzi*. See the Glossary of Chinese Terms at the end of this thesis work.

⁷² Zhang, M. (2020), pp. 185-187.

investment. Three key points in the detailed draft stood out more than others: the unification of the Three Laws (三法合一 *sanfa heyi*), the adoption of a negative list system and the control via the National Security Review System (NSRS).⁷³ The 2015 draft was comprehensive and covered a wide range of topics since it was intended to overrule the entire regulatory framework on foreign investment; for this reason, though, many governmental agencies and departments disagreed on its implementation, fearing it would jeopardize their own interests. This could be said to be the main reason for the draft not reaching consensus back in 2015.⁷⁴ One of its contents were some provisions on the national security review system, which will be tackled afterwards in this chapter: the draft stated that China will apply a NSRS (国家安全审查制度 *Guojia 26nquan shencha zhidu*) to all foreign investment that infringes or may infringe upon national security.⁷⁵ If the draft had passed, this system would have been a great contribution to the creation of a business environment with greater legal certainty and predictability.⁷⁶

Another draft, a shorter one, was published nationwide in 2018 by the National People's Congress for comments: this time the draft was intended to establish a basic institutional framework for foreign investment which could leave room for further deepening reforms and it was based on the notion of “performing a new pattern of comprehensive opening up” with a “focus on promotion and protection of investment”.⁷⁷

A final draft was published in 2019 by the NPC with twelve additional articles, this version was passed relatively fast in the annual assembly meeting in March 2019,

⁷³ See REN Qing 任清, “*Waiguo touzifa (cao'an)*” *zhong de san ge guanjianci* 《外国投资法(草案)》中的三个关键词 (Three Keywords in the Foreign Investment Law (Draft)), *Zhongguo falü pinglun* 中国法律评论 [China Law Review], 2015 (1). Available at: <https://article.chinalawinfo.com/ArticleFullText.aspx?ArticleId=99205&listType=0>

⁷⁴ Li, X. (2021), pp. 10-13.

⁷⁵ Shangwubu 商务部, “*Zhonghua Renmin Gongheguo Waiguo touzifa (cao'an zhengqiu yijian gao)*” 《中华人民共和国外国投资法(草案征求意见稿)》 (Draft of the Foreign Investment Law of the PRC (Draft for Soliciting Comments), 第四十八条 article 48.

⁷⁶ To learn more on the topic of China's NSRS, see: Li, Y., & Bian, C. (2016). A new dimension of foreign investment law in China - evolution and impacts of the national security review system. *Asia Pacific Law Review*, 24(2), 149–175.

⁷⁷ Zhang, M. (2020), p. 186.

resulting in many people viewing it as a move to respond to China-U.S. trade war and finally addressing the issues of foreign businesses investing in China.⁷⁸

For many, the adoption of the FIL can be seen as the unsurprising consequence of different factors that contributed to the integration of much of the content of the Three Laws into China company law, partnership law, civil law, property law and contract law.⁷⁹ Internal factors include the willingness to create a more welcoming investment climate which can benefit China from an economic point of view and the political issue of opening up more to FDI, whereas external factors can be identified in the negotiations for bilateral investment treaties with the US and EU.⁸⁰

1.6. Contents of the new FIL and the Regulation on its implementation

China's new Foreign Investment Law is structured in six chapters and 42 articles and applies to all foreign investments within China, excluding the special administrative regions of Hong Kong and Macau.⁸¹ The Regulation on Implementation is instead formed by six chapters and 49 articles and consists of provisions aiding the implementation of the Law by focusing on promoting foreign investment, protecting legal rights of foreign investors, regulating the management of foreign investment, continuing to optimize the investment environment and finally pushing a higher level of opening up. Both the Law and the Regulation have entered into force on January 1st, 2020.⁸²

⁷⁸ *Ibid*, p. 186.

⁷⁹ Zhang, S. (2022), p. 1051.

⁸⁰ *Ibid*, pp. 1051-1056.

⁸¹ Refer to the text of the law: Quanguo renmin daibiao dahui 全国人民代表大会 (National People's Congress), *Zhonghua renmin gongheguo Waishang touzifa* 中华人民共和国外商投资法 (Foreign Investment Law of the People's Republic of China), 2019. Available at: <https://www.pkulaw.com/chl/6a88714068b3724dbdfb.html?keyword=%E5%A4%96%E5%95%86%E6%8A%95%E8%B5%84%E6%B3%95&way=listView>

⁸² Refer to the text of the regulation: Guowuyuan 国务院 (State Council), *Zhonghua renmin gongheguo Waishang touzifa shishi tiaoli* 中华人民共和国外商投资法实施条例 (Regulation

Taking the distance from both the previous Three Laws, which were extremely prescriptive, and from the 2015 draft, the new FIL seems to be rather generic and some scholars even described it as content-neutral.⁸³ The following section focuses on giving an overview of the main characteristics and contents typical of the new Law.

Articles in the Law are about general provisions, investment promotion, investment protection, investment management, legal liability and others. National security is kept as a core value in its provisions, as well as equal treatment of domestic and foreign investment during its implementation (执行过程中做到内外一致 *zhixing guochengzhong zuodao neiwai yizhi*), resulting in the FIL being considered by Chinese nationals as a law based on investment equality (一部平等投资的法 *yibu pingdeng touzi de fa*) and not on privileged approaches (特权法 *tequanfa*).⁸⁴

1.6.1. The definition of foreign investors

Foreign investment enterprises are now defined as “firms registered in China under Chinese law wholly or partially capitalized by foreign investors” and they must all “directly or indirectly conduct business activities in China” (直接或间接在中国境内进行投资活动 *zhijie huo jianjie zai zhongguo jingnei jinxing touzi huodong*). Foreign investors can be of three kinds:

- 1) Foreign natural persons (外国的自然人 *waiguo de ziranren*)
- 2) Foreign firms (外国的企业 *waiguo de qiye*)

for Implementing the Foreign Investment Law of the People's Republic of China), 2019. Available at:

<https://www.pkulaw.com/chl/bb7e08ee6f9a35f4bdfb.html?keyword=%E5%A4%96%E5%95%86%E6%8A%95%E8%B5%84%E6%B3%95&way=listView>

⁸³ Zhang, M. (2020), p. 187.

⁸⁴ ZHANG Jin 张进 (2023), p. 59.

3) Other organizations (其他组织 *qita zuzhi*).⁸⁵

As previously discussed, it is imperative to note that, unlike previous drafts, the FIL describes foreign investment as ‘foreign business investment’⁸⁶ and therefore eliminates the concept of geographic location of the investors, switching the focus more towards businesses.⁸⁷ However, it is important to note that the Law does not provide a very clear definition on how investors can be considered foreign, given the fact that it leaves room for interpretation in the third point.⁸⁸

1.6.2. The concept of negative list as opposed to the previous system of ‘catalogues’

The Foreign Investment Law formally incorporates the Negative List Management System (负面清单管理制度 *fumian qingdan guanli zhidu*) into China’s basic foreign investment regime⁸⁹, meaning that admission of foreign investment in specific areas is controlled via special measures, which started being used in Free Trade Pilot Zones in 2015 already. Measures contained in the Negative List are divided into two categories: prohibitive or restrictive measures, the former indicating completely off-limits sectors, and the latter implying the need for permission from the authorities before market entry. Industries that are not on the negative list do not require approval for market entry.⁹⁰ A Market Access Negative List was then introduced nationwide in 2018 and was shortened

⁸⁵ *Zhonghua renmin gongheguo Waishang touzifa* 中华人民共和国外商投资法 (Foreign Investment Law of the People’s Republic of China), 2019, 第二条 Article 2.

⁸⁶ Instead of “investment from foreign countries”, which was the case of the 2015 draft of the law. See paragraph 1.5 and note 71 on the difference in wording between the draft and FIL2020.

⁸⁷ Zhang, M. (2020), pp. 185-187.

⁸⁸ Zhang, X. (2020), pp. 82-84.

⁸⁹ *Zhonghua renmin gongheguo Waishang touzifa* 中华人民共和国外商投资法 (Foreign Investment Law of the People’s Republic of China), 2019, 第四条 Article 4.

⁹⁰ Zhang, M. (2020), pp. 199-201.

in 2019, with the number of Special Management Measures SMMs listed being reduced from 93 in the first trials in 2015 to only 20 in 2019.⁹¹

The introduction of the system of negative lists has proved to be essential in enhancing the degree of freedom for foreign investors operating in China; some Chinese scholars point out that, together with the new reporting mechanism, the negative list system has been of vital importance and clear effectiveness in improving China's foreign investment environment, since it aids to gradually open the market to foreign investors.⁹² At the same time though, prohibited and restricted-access industries have obviously also been quite attractive to foreign investors, who have, since two decades, found intricate ways of overcoming regulations' restrictions: a prominent example is that of VIE operations, which will be the focus of discussion in the second chapter of this work thesis. Subsequently, the third chapter will present how the FIL impacted on said VIE operations, therefore the subject of negative lists will be discussed again.

However, many others have been skeptical towards China resorting to a negative list approach, mainly because it is thought that this is only a tool for leaving room to Chinese authorities to operate freely and change rules when needed.⁹³ Other scholars have even pointed out that the Negative List System involves a few issues such as lack of clarity and transparency of the legal basis or the opaque and imperfect legal supervision mechanism.⁹⁴

On the contrary, it cannot be ignored that the Negative List Management System is a major change in China's foreign investment management model and one of the biggest highlights of this Foreign Investment Law, since it abolishes the existing case-by-case approval system for foreign investment (对外商投资的逐案审批体制 *dui waishang touzi de zhu'an shenpi tizhi*), drastically reduces the restrictive measures for foreign

⁹¹ 2019 Notice of the NDRC and the MOFCOM on issuing the Market Access Negative List (2019 Revision).

⁹² DENG Tingting, CHEN Meiyu 邓婷婷、陈美玉 (2022), pp. 59-60.

⁹³ Zhang, X. (2020), pp. 87-89.

⁹⁴ Nuo, W. (2022). Problems and Solutions of Negative List System of Foreign Investment Access in China. *Journal of Sociology and Ethnology* (2022), *Clausius Scientific Press, Canada*. DOI: 10.23977/jsoc.2022.040613

investment, and liberalizes the access of foreign investment.⁹⁵ Overall, it could be stated that this system definitely improves China's integration into the global market and encourages more investment flows, especially with the opening of high-end sectors like aviation, shipping or pharmaceutical, which also contribute to the goal of building technological capacity.⁹⁶

Anyhow, despite many domestic sources highlighting the Negative List as a major innovation, and except for its tendency to get shortened every year, the new law does not clearly explain in which terms the negative list system represents a drastic improvement with respect to the previous system of catalogues, therefore future analysis on this topic could be useful. It is, however, worth to note that the negative list is being used by the Chinese government as a tool not only to encourage FDI inflow in desired industries, but also for addressing geographical inequalities by channeling investments in less developed regions.⁹⁷

1.6.3. How FIL enhanced investors' freedom and protection: equal treatment of foreign and domestic investors

One of the most significant features of the FIL is the creation of a completely new market access mechanism for foreign investment, which eliminates the previous three-step process of application, governmental approval and post-approval filing, and is based on the combination of pre-entry national treatment plus negative list.⁹⁸

⁹⁵ ZHAO Jinxia 赵金霞, "Waishang touzifa" san da liangdian jiedu 《外商投资法》三大亮点解读 (An Interpretation of Three Major Highlights of the Foreign Investment Law), Weixin gongzhonghao: JinNuoLü 微信公众号: 金诺律 [Official Wechat Account: JinNuoLü], 2019. Available at: <https://article.chinalawinfo.com/ArticleFullText.aspx?ArticleId=107975&listType=0>

⁹⁶ Zheng, Y. (2021), pp. 399-401.

⁹⁷ See: Jakubczak, J. (2020). China's Foreign Investment Encouraged Catalogue and Negative Lists as a Tool of Foreign Direct Investment Attraction. *Annales Universitatis Mariae Curie-Skłodowska*, sectio H – Oeconomia, Vol. 54, No. 2.

⁹⁸ Zhang, M. (2020), p. 194.

Pre-Entry National Treatment (准入前国民待遇 *zhunruqian guomin daiyu*) refers to the treatment given to foreign investors and their investments at the stage of investment access, which, according to the FIL, is no less favorable than that given to domestic investors and their investments. Useful explorations of the Pre-Access National Treatment in addition to the Negative List System have been previously carried out in Pilot Free Trade Zones (PFTZs) and resulted in policy guidelines for China to promote the “pre-access national treatment plus negative list management system” nationwide.⁹⁹

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A key characteristic of the pre-entry national treatment can be found in the equal competition among all investors, both domestic and foreign, and maintaining equality can ultimately serve as an incentive to attract more foreign investment¹⁰¹, which is also one of China’s interests considering that high-quality domestic supply of investments is insufficient and needs opening up on a deeper level.¹⁰² The combination with the Negative List System implies that national treatment is granted to foreign investments only in sectors that are not included in the negative list at the moment of entry.

The Foreign Investment Law can be said to have enhanced both investor’s freedom and protection by, on one hand, promoting foreign investment and supporting the development of enterprises, and, on the other hand, setting out a list of measures aimed at protecting foreign investment in five different areas: provisions against expropriation, about free transfer of funds in and out of China, enhanced protection of intellectual property, rule of law and a complaint mechanism.¹⁰³ It’s worth to mention a few other relevant provisions of the law on investment protection, among which it is stated that investors that are not satisfied with authorities’ decisions are free to apply for

⁹⁹ In Chinese this is referred to as: *zai quanguo fanweinei tuiguang “zhunruqian guomin daiyu jia fumian qingdan zhidu”* 在全国范围内推广“准入前国民待遇加负面清单管理制度” (to promote the “pre-access national treatment plus negative list management system” nationwide).

¹⁰⁰ See HUANG Jin 黄晋 (2019).

¹⁰¹ Zhang, M. (2020), pp. 225-226.

¹⁰² Zhang, S. (2022), p. 1072.

¹⁰³ See the section of the FIL on investment protection (chapter 3): *Zhonghua renmin gongheguo Waishang touzifa* 中华人民共和国外商投资法 (Foreign Investment Law of the People’s Republic of China), 2019, 第二十二-二十六条 Articles 20 to 26.

administrative reconsideration or bring an administrative lawsuit in accordance with the law, a proper system for foreign-invested enterprises to file complaints is thus set up (外商投资企业投诉工作机制 *waishang touzi qiye tousu gongzuo jizhi*)¹⁰⁴; the law also stipulates that the government and its relevant departments shall review the legality of the regulatory documents involving foreign investment in accordance with the provisions of the State Council, and foreign investors and foreign-invested enterprises may request a review of the regulatory documents when applying for a litigation.¹⁰⁵

Given all of the above, it can be concluded that protecting foreign investment has been a key goal for the implementation of the new FIL, which contains specific provisions regarding investors' protection, consisting essentially in rules against the expropriation of privately owned property by the government, rules that prohibit forced technology transfer, rules against commercial theft, and finally rules on the validity of foreign investment contracts.¹⁰⁶

1.6.4. A new type of corporate form: How FIL affected existing foreign-invested enterprises (FIE)

Another relevant aspect of China's FIL and its Implementing Regulation consists in the management of the transition for existing foreign investments in order to comply with the new provisions contained in the new regulatory framework.

¹⁰⁴ Ibid, 第二十六条 Article 26.

¹⁰⁵ For more on promotion and protection of foreign investment in China, refer to: LIAO Fan 廖凡, *Cujin he baohu waishang touzi de xin pianzhang - "Waishang touzifa shishi tiaoli" jiedu* 促进和保护外商投资的新篇章 ——《外商投资法实施条例》解读 (A New Chapter on the Promotion and Protection of Foreign Investment – an Interpretation of the “Foreign Investment Law Implementing Regulation”), *Jingji cankao bao* 经济参考报 [Economic Information Daily] 2020. Available at: <https://article.chinalawinfo.com/ArticleFullText.aspx?ArticleId=110870&listType=0>

¹⁰⁶ Zhang, M. (2020), pp. 210-225.

After the enforcement of China's FIL, the previous FIE Laws were all repealed (废止 *feizhi*)¹⁰⁷, implying that the organizational form, corporate structure and operating rules of new FIEs mostly became subject to China's Company Law and Partnership Enterprise Law, meaning that existing FIEs will have to adapt to them.¹⁰⁸ The FIL and its Implementing Regulation, however, even comprise provisions on the corporate form and organizational structure for foreign investments, and existing foreign invested enterprises are given a transitional period of five years since the enactment of the Law to adapt their legal form to the new requirements. This measure has the goal of providing legal protection and a smooth transition to all foreign investors.¹⁰⁹ Regulating this matter are articles 44 and 45 of the Regulation for the Implementation of the FIL¹¹⁰, which prescribe that, during the transitional or grace period, an existing foreign invested enterprise shall choose to transform its business form and organization structure under the Company Law or the Law of Partnership Enterprises and change its business registration accordingly, or, more rarely, to maintain its original business form or organization structures.¹¹¹

In practice, the FIL prescribes that the organizational form of foreign-invested legal person-type enterprises (including limited liability companies and joint stock companies) and partnerships need not be changed, whereas other foreign-invested enterprises that do not have legal person status may apply for restructuring into partnerships during the transitional period.¹¹² The FIL has therefore had a major impact mainly on the governance

¹⁰⁷ As stated in: *Zhonghua renmin gongheguo Waishang touzifa* 中华人民共和国外商投资法 (Foreign Investment Law of the People's Republic of China), 2019, 第四十二条 article 42.

¹⁰⁸ Schaub, M., Zhao, A., Dai, X. And Zheng, W. (2019, June, 3rd). China Foreign Investment Law: How Will It Impact the Existing FIEs? *China Law Insight*. Available at <https://www.chinalawinsight.com/2019/06/articles/foreign-investment/china-foreign-investment-law-how-will-it-impact-the-existing-fies/>

¹⁰⁹ Refer to: CHI Zheng 迟政, "Waishang touzi fa" guoduqi tiaokuan de qiye yingdui yu tiaozheng 《外商投资法》过渡期条款的企业应对与调整 (Enterprises Responses and Adjustments to the Provisions of the Foreign Investment Law on the Transition Period), *Zhongguo Waizi* 中国外资, 2024, (03),99-101. doi:CNKI:SUN:WQZG.0.2024-03-035

¹¹⁰ *Zhonghua renmin gongheguo Waishang touzifa shishi tiaoli* 中华人民共和国外商投资法实施条例 (Regulation for Implementing the Foreign Investment Law of the People's Republic of China), 2019, 第四十四-四十五条 articles 44-45.

¹¹¹ Zhang, M. (2020), pp. 236-237.

¹¹² CHI Zheng 迟政, 2019.

of existing joint ventures, since organizational form and corporate structure under JV Laws are extremely different from those under China Company Law and this change can greatly impact on the interests of joint ventures' shareholders, including areas such as share transfer, dividend distribution scheme or voting rules and quorum.¹¹³

One amongst different issues relating to the transitional period regards which can be considered the applicable law during these five years, given that the former FIE Laws are already repealed but existing FIEs can still maintain their previous status.¹¹⁴

1.7. The issues of intellectual property and national security: the National Security Review System

Issues in regulating intellectual property have long been part of China's regulatory framework of foreign investment, and the protection of intellectual property rights (知识产权 *zhishi chanquan*) for foreign-invested enterprises, instead, has only lately been addressed by becoming a core value of the new FIL, also due to external pressure from foreign countries.¹¹⁵ Hand in hand with the protection of intellectual property rights goes the issue of national security (国家安全问题 *guojia anquan wenti*), since it must be compared that, while protecting foreign investment, Chinese authorities always keep national interests in mind. As a matter of fact, Chinese nationals perceive that, if foreign investment is not strictly scrutinized, it may threaten the interests of national security and development and jeopardize the sovereignty of the country.¹¹⁶

Therefore, it is for the abovementioned reasons that China established a proper security review system for foreign investment, in order to actively safeguard the global multilateral trade free system, while at the same time ensuring its own national security

¹¹³ Schaub, M., Zhao, A., Dai, X., Zheng, W. (2019).

¹¹⁴ Zhang, M. (2020), p. 237.

¹¹⁵ For more on the economic logic behind protection of intellectual property rights, refer to: LUO Ying 罗迎 (2022).

¹¹⁶ ZHANG Jin 张进 (2023), p. 60.

and the security of development.¹¹⁷ In addition, the new Foreign Investment Law promotes the creation of regulations for the establishment of an improved and refined National Security Review System, and prescribes that security review be carried out on foreign investment projects that have or may have an impact on national security.¹¹⁸

After more than a decade of legal construction of China's NSRS, a State Security Law was actually promulgated as soon as 2015 by the standing committee of the National People's Congress (NPC): it comprised the definition of state security and the establishment of a state security framework among other contents and is relevant to mention in that, for the first time, it proposed to establish a state security review and oversight mechanism even with regard to foreign investment.¹¹⁹

The regulatory system has then evolved towards a specific system that requires review only towards those foreign investment projects that may pose a threat to national security, thanks to the new information-reporting obligations prescribed by the FIL. However, some scholars have argued that the current national security review system remains somewhat vague and that it is based on the protection of China's economic security and cultural nationalism, instead of just national security.¹²⁰

The new NSRS also applies outside the scope of traditional national security, in the Internet field, and has the goal of protecting national security and prevent domestic key Internet technologies from being manipulated or utilized by foreign countries for cultural infiltration: some Chinese scholars perceive that the NSRS constitutes an important manifestation of the exercise of national sovereignty and protection of national security interests.¹²¹

¹¹⁷ *Ibid*

¹¹⁸ HUANG Jin 黄晋 (2019).

¹¹⁹ Li, Y., & Bian, C. (2016), p. 150.

¹²⁰ Bian, C. (2022). National Security Review of Foreign Investment in China: Rule of Law in Ambiguity. *Erasmus Law Review*, 15(4), 278–289.

¹²¹ SHI Hua, WANG Huaqian 师华、王华倩, *Waizi xieyi kongzhi moshi Guojia Anquan Shencha Shijian caozuo tanxi* 外资协议控制模式国家安全审查实践操作探析 (Analysis of Practical Operability of the National Security Review System of Foreign Contractual Control), Tongji daxue Guoji shangwu yanjiu 同济大学国际商务研究 [Tongji University International Business

Considering that the issue of national security is highly relevant for what concerns variable interest entities as well, it will be mentioned again in the third chapter, when the impact of the FIL on VIEs will be presented.

1.8. Limits and issues regarding the provisions of the FIL

To conclude the first chapter of this thesis work, the topic of limits regarding the new FIL is tackled.

Being quite concise, the FIL noticeably presents a few unresolved issues, which many attempted to describe. Some suggestions were made around the need to clarify issues on provisions regarding IP rights protection, the National Security Review, the length of the negative list and regulatory transparency among others.¹²² First, the law has a flexible approach in defining foreign investment¹²³, ultimately providing an unclear definition which leaves out the concept of indirect foreign investment, including the form of agreement control called variable interest entities (which will be discussed in depth in the following chapter); second, Chinese scholars also reckon that the negative list system presents a lack of stability and that constant modifications to the list undermine the confidence of investors to invest in China; third, the security review system presents a lack of transparency, since the factors to be considered for security review are not specified in the law.¹²⁴

Research], Shanghai, 2022 (2), 48. Available at: <https://www.pkulaw.com/qikan/da4bf9390908e05e58baa782baa1d17fbdfb.html?keyword=%E5%8F%AF%E5%8F%98%E5%88%A9%E7%9B%8A%E5%AE%9E%E4%BD%93&way=listView>

¹²² Zhang, S. (2022), pp. 1066-1071.

¹²³ See paragraph 1.6.1.

¹²⁴ DENG Tingting, CHEN Meiyu 邓婷婷、陈美玉 (2022), pp. 61-62.

Just like the National Security Review System, the FIL seems to revolve around the concept of strategic ambiguities, which can be defined as the art of using language that avoids being specific to then being able to define the law based on the circumstances.¹²⁵

Many have argued that addressing said issues could dramatically improve the effectiveness of the new Law and help China attract more foreign investments, especially considering that investors are recently beginning to leave the country, reflecting a sort of pessimism around China's economy¹²⁶. However, the conservative attitude of the FIL, which only solves a part of the issues encountered by foreign investors in China, results quite understandable, especially considering the scale of China's economy and the number of investments affected by the recent regulatory change.¹²⁷

It is paramount to keep in mind these limits regarding the Foreign Investment Law for the purpose of this thesis work, in that they are of most relevance in understanding the impact of the Law on the day-to-day economic practice, especially on what have been called VIE operations and how they are regulated, which will be the focus of the third chapter.

¹²⁵ Zhang, S. (2022), p. 1069.

¹²⁶ Sebastian, D. (2023), The Big Risk Causing Investors to Shun China, The Wall Street Journal. Available at: <https://www.wsj.com/finance/investing/the-big-risk-causing-investors-to-shun-china-c0710fdd?mod=djem10point>

¹²⁷ Zheng, Y. (2021), pp. 425-426.

2. Chapter II, Variable Interest Entities in China: benefits, risks and regulatory responses.

2.1 Introduction on VIEs

As a much-debated subject which has raised worries and doubts amongst foreign investors and experts, Variable Interest Entities (VIEs) appear to be one of, if not the most interesting phenomenon related to foreign investment in China, especially at the present moment, when regulatory changes around the area of foreign investment have finally been implemented.

Variable interest entities are complex financial structures used to ultimately attract foreign capital and circumnavigate Chinese restrictions in certain industries. It can be said that they are used by Chinese companies to issue securities on international stock exchanges and raise capital for financing further development.¹ VIEs have been widely accepted structures for decades, however, they have been defined by many as a sort of grey area within the Chinese legal system.² Considering the risks involved, many have called for an improved regulation on such practices and what is interesting to note, for the purpose of this thesis work, is the debate around the new Foreign Investment Law relating to a possible improved regulatory framework on VIEs, which will be outlined in the third chapter.

¹ Cieřlik, S. (2021). Variable Interest Entity Structure as a Form of Investment Undertaken by Chinese Companies on Foreign Stock Exchanges. *Finanse i Prawo Finansowe*, 3(31), 7–23.

² Eales, J. (2015). The future of Chinese Foreign investments: An exploration of the Perils and consequences of investing in variable interest entities. *Kent Law Review*, 2.

Thanks to these unusual corporate structures, which involve a contractual type of control of companies instead of an equity-based control, many Chinese companies have been able to get listed on U.S. stock exchanges, for instance, and circumvent Chinese regulatory restrictions on foreign investment.³ To fully comprehend the relevance of this phenomenon, it is imperative to highlight the fact that, according to experts, over half of the companies domiciled in the People's Republic of China (PRC) that are listed on the U.S. stock exchange are part of this kind of operations called VIEs, including China's largest and most renowned Internet companies, operating in the industries of e-commerce, telecommunications, education and media to cite a few examples.⁴

This section is therefore intended to present the basic features regarding this typical phenomenon, including the reasons behind the creation of such structures and thus the benefits stemming from participating in them, their basic functioning, the self-evident and the more subtle risks they involve, and, above all, the regulatory response that followed their use. This chapter hence serves as a basis for understanding the debate around the FIL on the regulation of said operations and its actual impact on their use, which will be discussed in the following chapter. A few specific cases will be mentioned to provide a clearer analysis of the phenomenon and the point of view of Chinese scholars and experts will also be presented for developing a more complete picture of the topic.

2.2 Reasons for and benefits of creating a VIE structure: establishing regulatory workarounds

One of the most relevant issues consists in learning the reasons that lead to the creation of VIE structures and thus what the benefits of taking part in such risky operations are.

³ Gillis, P., & Lowry, M. R. (2014). Son of Enron: Investors Weigh the Risks of Chinese Variable Interest Entities. *JOURNAL OF APPLIED CORPORATE FINANCE*, 26(3), 61–66.

⁴ Johnson, K. (2015). Variable Interest Entities: Alibaba's Regulatory Work-Around to China's Foreign Investment Restrictions. *Loy. U. Chi. Int'l L. Rev.*, 12, 249.

Given the contents presented in the first chapter of this thesis, it is now well known that China has used a differentiated-sectors system for management of inward foreign investments both before and after the enactment of the new Foreign Investment Law; this implies that both foreign investors and Chinese companies have long felt the need to find a way in order to respectively invest and raise capital while operating in restricted business sectors of the Chinese economy. As a matter of fact, China implemented the “negative list approach” in inward foreign investment even after its entry into the WTO, and continues to do so, which means that Chinese companies operating businesses in restricted or prohibited sectors cannot seek foreign investment by going public on foreign stock markets, since the ownership of equity in these sensitive sectors by non-Chinese individuals is not allowed.⁵

The possibility to transfer profits from a Chinese Operating Company to a Wholly Foreign Owned Enterprise (WFOE) and ultimately to an offshore listed company is the essential motive behind the creation of a VIE structure, which is also considered by many experts a tax loophole and a way to exploit regulatory loopholes. For this reason, VIE structures are considered regulatory workarounds that avoid the restrictions posed by Chinese regulations for an economic purpose.⁶

When they first appeared in the beginning of the 2000s, VIEs were therefore intended as a workaround to circumvent the Catalogue (Catalogue for the Guidance of Foreign Investment Industries) restrictions on investment in specific industries: it can be said that they were, more or less legally, born as a ‘necessary’ consequence to the legal environment of foreign investment in China, as their widespread adoption demonstrates.⁷ Variable Interest Entity operations have not only been well-accepted for foreign investors in industries subject to restrictions or prohibition, but they have also been used as a means by which Chinese domestic companies can list on overseas capital markets for quite a

⁵ Li, Y. (2022). Variable Interest Entity Risks and Governance. *The Journal of Corporation Law*, 48(1), 145–164.

⁶ Larson, M. (2018). Alibaba's VIE structure and erosion of beps goals in China's e-commerce industry. *Temp. Int'l & Comp. LJ*, 33, 201.

⁷ Ziegler, S. F. (2016). China's variable interest entity problem: How Americans have illegally invested billions in China and How to fix it. *Geo. Wash. L. Rev.*, 84, 539.

long time now, which could be due to the adoption by Chinese authorities of policies oriented more towards economic liberalism.⁸

Obtaining the necessary authorizations from Chinese authorities to invest in restricted sensitive industries such as the technology, telecommunications and media sector was, in fact, time-consuming to say the least and approval was not granted, hence VIEs were created as a type of special purpose vehicle (SPV) whose main goal was to allow private Chinese companies operating in said sectors to issue securities on international stock exchanges and thus raise much-needed capital for further development.⁹ Chinese firms including tech giants and State-Owned Enterprises (SOEs) have specifically been able to raise large sums of capital from foreign investors in global tax havens by establishing offshore affiliates, also via VIE structures.¹⁰

The phenomenon of VIEs can be considered as an innovation of corporate and financial systems (一种公司制度与金融制度的创新 *yizhong gongsizhidu yu jinrongzhidu de chuangxin*). The VIE model (VIE 模式 *VIE moshi*) refers to the separation of the overseas listed entity and the domestic business operating entity¹¹ and, according to Chinese scholars as well, presents different advantages: firstly, it is favorable to obtain more financing when participating in such operations (获得更多的融资 *huode gengduo de rongzi*); secondly, the ability to avoid industrial policy investment restrictions is key (规避产业政策投资限制 *guibi chanye zhengce touzi xianzhi*); thirdly, the popularity and visibility of the enterprise is enhanced (提升企业知名度 *tisheng qiye zhimingdu*), which can in return strengthen its competitiveness.¹² VIE structures (VIE 架构 *VIE jiagou*) have

⁸ Eales, J. (2015).

⁹ Cieřlik, S. (2021), p. 8.

¹⁰ Clayton, C., Coppola, A., Dos Santos, A., Maggiori, M., & Schreger, J. (2023, May). China in tax havens. In AEA Papers and Proceedings (Vol. 113, pp. 114-119). 2014 Broadway, Suite 305, Nashville, TN 37203: American Economic Association.

¹¹ This concept is often referred to in Chinese as: 境外的上市主体与境内的业务运营实体相分离 *jingwai de shangshi zhuti yu jingnei de yewu yunying shiti xiangfenli*, meaning ‘the separation of the overseas listed entity and the domestic business operating entity’.

¹² WANG Zhenkai, SHEN Chuan 王振凯、沈川, *VIE moshi qiye de zhishi chanquan celiie goujian* VIE 模式企业的知识产权策略构建 (Construction of Intellectual Property Strategy for

become popular among enterprises because of their ability to avoid government regulation (规避政策管制 *guibi zhengce guan zhi*) and “legal” tax avoidance (“合法避税” *hefa bishui*): other Chinese scholars, in fact, suggested that VIEs’ multiple benefits include increasing the competitiveness of domestic enterprises, increasing employment opportunities, and a sort of “legal” evasion of corporate income tax (合法逃避企业所得税 *hefa taobi qiye suodeshui*), due to the various preferential policies for wholly foreign-owned enterprises and the signing of the tax policies with Hong Kong.¹³

2.3 Structural background: VIEs and their functioning worldwide and in China

This thesis work is not aimed at discussing in detail the technical specificities of VIE operations, however, a few characteristics are presented to serve as a basis for better understanding their functioning and implications.

VIE solutions are designed so that, on one hand, Chinese regulators will view the operations of the company as owned by Chinese investors, while, on the other hand, foreign investors will view them as structures owned by a foreign corporation in which they can buy shares and thanks to which they can ‘own’ an interest in companies operating in restricted sectors.¹⁴ The VIE structure is also known as the Sina-model structure, due to the fact that Sina Corporation was the first Chinese company to acquire an offshore public listing via a VIE structure in 2000, and is made of at least three entities, namely: the offshore holding company listed on a foreign stock exchange (often on the US stock

VIE Model Enterprises), *Dianzi zhishi chanquan 电子知识产权* [Electronic Intellectual Property Journal], 2017 (9). Text available at: <https://www.pkulaw.com/qikan/ea4637a9235efbbfee14d3eee2557a59bdfb.html?keyword=variable%20interest%20entity&way=listView>

¹³ ZHANG Ying & SUN Ciyi 张英 & 孙次宜, *Jiyu VIE jigou de fanbishui wenti yanjiu 基于 VIE 架构的反避税问题研究* (Research on Anti-Tax Avoidance in VIE Structures), *Caikuai yanjiu 财会研究* [Financial and Accounting Research], 2024 (02), 9-18. doi:CNKI:SUN:LKHL.0.2024-02-002.

¹⁴ Gillis, P., & Lowry, M. R. (2014), p. 62.

exchange), a wholly foreign-owned enterprise (WFOE) domiciled in China, and an operating enterprise also based in the PRC.¹⁵

This kind of structure is based on a bundle of contracts instead of direct ownership, which entails that the offshore company shall obtain future benefits from the onshore operating company, based on the agreements contained in such contracts, the nature of which will be presented in the following paragraphs. Said benefits, however, usually include “variable interest”, hence the term “variable interest entity”.¹⁶ Anyhow, it is imperative to highlight the fact that this series of contracts are concluded between the Chinese operating company and the China-based WFOE, with the goal of mimicking property rights of the WFOE over the actual operating business in the restricted sector, which is the key step to achieving the benefits of a VIE structure.¹⁷

Considering that a crucial aim of the VIE structure is to get listed on the US stock exchange and that many companies achieved this goal since the phenomenon took place, it does not seem strange that the term Variable Interest Entity (which translates in Chinese as 可变利益实体 *kebian liyi shiti*) was actually given to said structures by the US Securities and Exchange Commission, which categorized them as a type of Special Purpose Vehicles (SPV) (特殊目的机构 *teshu mudi jigou*).¹⁸

The trend among Chinese companies operating in restricted business sectors that take part into VIE-style operations has historically been that of listing on non-Chinese exchanges, especially in the United States, due to their inability to obtain sufficient capital domestically for their expansion; one of the reasons appeared to be linked to the fact that China’s state-owned banking system tends to favor state-owned enterprises more. VIEs are essentially holding companies that link foreign investors and Chinese firms via a set

¹⁵ Johnson, K. (2015), p. 253.

¹⁶ Larson, M. (2018), p. 209.

¹⁷ Santoni, G. (2018). Foreign capital in Chinese telecommunication companies: from the Variable Interest Entity model to the draft of the new Chinese Foreign Investment Law. *Italian LJ*, 4, 589.

¹⁸ ZHANG Ming 张鸣, *Qianxi “xieyi kongzhi + VIE” moshi xiangguan falü wenti* 浅析“协议控制+VIE”模式相关法律问题 (A brief analysis of legal issues related to the "agreement control + VIE" model), *benwang shoufa* 本网首发 [China Law Info first issue], 2013. Available at: <https://article.chinalawinfo.com/ArticleFullText.aspx?ArticleId=76442&listType=0>

of complex legal contracts, which should theoretically guarantee that economic benefits flow to foreign investors, while operating control of the business remains with the Chinese firm, however enormous risks are entailed and will be explained later in the chapter.¹⁹

Before analyzing other characteristics of the VIE structure, it is worth to mention once again that said corporate structures have been designed by securities lawyers with the aim of satisfying two clearly inconsistent needs: assuring Chinese regulators that ‘actual control’ of the structures resides with Chinese nationals and convincing foreign investors that they own control rights.²⁰ This surely constitutes the basis for understanding the risks involved in such structures.

2.3.1 The four-tier structure

An essential feature of the VIE structure is that of separating operation and control and different levels can be identified in the structure: an offshore holding company, which is public and listed overseas, sets up a subsidiary in China in the form of a WFOE; and the WFOE ‘controls’ a Chinese domestic operating company via a series of contractual agreements. The Chinese company usually owns all operating licenses and is considered the Variable Interest Entity, meanwhile the WFOE is a subsidiary of the offshore holding company and is considered as its Special Purpose Vehicle that facilitates the listing process.²¹ In addition to these three entities, a fourth one is often involved too and consists in an indirect Hong Kong-based company – owned by the offshore holding entity –, whose purpose is solely that of functioning as an additional collateral in the structure in order to minimize tax deductions on dividends paid from China. It can thus be said that

¹⁹ Rosier, K. (2014). The risks of China’s Internet companies on US stock exchanges. *US-China Economic and Security Review Commission Staff Report*, 18.

²⁰ Hopkins, J., Lang, M. H., & Zhao, J. D. (2018). The Rise of US-Listed VIEs from China: Balancing State Control and Access to Foreign Capital.

²¹ See: Li, Y. (2022), p. 149-150.

the typical VIE structure presents two separate segments, one of which is characterized by domestic ownership, and the other one which is characterized by foreign investments. The crucial part of the VIE-style operation is that in which the WFOE, after receiving payment from the Chinese operating entity, transfers part of the profits offshore to the holding company.²² Therefore, a key part of the structure links the Chinese operating entity and the China-based WFOE, meanwhile another part of the structure is that which links the China-based WFOE and the offshore public company: due to its outline, VIE structures are sometimes described through the metaphor of bridges, which are supposed to link entities based in different countries.²³

The offshore parent company is normally created by the Chinese legal persons that own the VIE, namely the domestic operating entity, and the financial statements of every tier of the VIE structure are consolidated into the group's overall financial statements by the offshore holding company, in compliance with current U.S. General Accepted Accounting Principles.²⁴

For summarizing purposes, the entities forming part of the four-tier structure can be outlined as follows:

- 1) a tax-haven-incorporated company which is responsible for capital raising
- 2) a conduit company based in Hong Kong
- 3) a wholly foreign owned enterprise domiciled in China
- 4) a Chinese entity operating in a restricted industry which is responsible for business operation.²⁵

The process for the creation of a VIE structure has been outlined by many experts, some Chinese scholars described it in four main steps: firstly, a company is established in a tax haven such as the British Virgin Islands; secondly, said company is listed offshore; then,

²² Cieřlik, S. (2021), pp. 10-11.

²³ Ziegler, S. F. (2016).

²⁴ Eales, J. (2015).

²⁵ For more details and for figures explaining the VIE structure, refer to: Fa, C. (2021). Variable interest entity structures in China: are legal uncertainties and risks to foreign investors part of China's regulatory policy? *Asia Pacific Law Review*, 29(1), 1–24. <https://doi.org/10.1080/10192557.2021.1995229>

a WFOE is established; finally, the domestic operating company is either established or reorganized.²⁶

2.3.2 The foundation of VIE structures: the indirect non-equity relationship between the WFOE and the operating company

From what has been previously mentioned, it is not hard to draw the conclusion that the VIE structure lays its foundations in a series of contracts between the offshore company and the onshore operating company, via the WFOE: shareholders, in fact, own equity in the offshore holding company and, this way, they have what can be considered ‘de facto control’ over the onshore operating company.²⁷ However, two groups of shareholders can actually be identified, the first one comprising Chinese shareholders, who have ownership interests in the domestic operating company as well as in the offshore holding company, and the other one including foreign investors, who only hold securities of the offshore company.²⁸

The relationships that result from the bundle of agreements typical of the VIE structure aim to mimic the control based on equity ownership, but instead are indirect and contract-based, which highlights their inherent fragility.²⁹ This dynamic, according to which corporate control relations are based upon agreements contained in a series of contracts instead of on equity ownership is called “agreement control” (协议控制 *xieyi kongzhi*) and is opposed to the usual “equity control” (股权控制 *guquan kongzhi*).³⁰

The VIE structure implies that the operating control remains within the China-based operating company, which complies with Chinese laws, whereas foreign investors derive economic benefits merely from the contractual agreements.³¹ As a consequence of the

²⁶ WANG Zhenkai, SHEN Chuan 王振凯、沈川 (2017).

²⁷ Larson, M. (2018), p. 209.

²⁸ Cieřlik, S. (2021), pp. 11-12.

²⁹ Ziegler, S. F. (2016), p. 547.

³⁰ ZHANG Ming 张鸣 (2013).

³¹ Johnson, K. (2015), p. 253.

VIE structure, restricted business operations are conducted in the VIE (namely the domestic operating company), while the WFOE obtains control over the VIE through contractual arrangements instead of through equity ownership.³²

2.3.3 The nature of contractual arrangements: essential elements

Given all that has been discussed above, scholars tend to distinguish between two essential groups of agreements:

- a) Contractual agreements between Chinese shareholders and the WFOE company, which are aimed at defining the rights of Chinese shareholders in voting of company matters;
- b) Contractual agreements concluded between the onshore operating company and the WFOE, which prescribe that the WFOE is obliged to provide services to the Chinese operating entity and that the latter is obliged to transfer its profits to the WFOE in the form of payment for said services.³³

It can be stated that contractual arrangements are at the core of the VIE structure and Chinese scholars attempted to organize them in different categories, which include operational control agreements (运营控制类协议 *yunying kongzhilei xieyi*), profit transfer agreements (利润转移类协议 *lirun zhuanylei xieyi*), exclusive option agreements (独家期权协议 *dujia qiquan xieyi*) and borrowing agreements (借款协议 *jiemkuan xieyi*).³⁴ Said agreements then practically translate into: a “*technical cooperation agreement*” that makes the WFOE the provider of services, technologies and property rights to the operating company as well as the recipient of the Chinese operating company’s revenue and profits; a “*loan agreement*” that allows the operating entity to borrow interest-free funds from the WFOE; a “*voting proxy agreement*”, according to which the holding company can choose board members for the onshore operating

³² Gillis, P., & Lowry, M. R. (2014), p. 63.

³³ Refer to: Cieřlik, S. (2021), p. 12.

³⁴ WANG Zhenkai, SHEN Chuan 王振凯、沈川 (2017).

company; an “*equity pledge agreement*” that grants the WFOE first-priority security interests; a “*call option agreement*” or “*purchase option agreement*” designed to cover future decisions in the remote case in which Chinese authorities would remove foreign investment restrictions³⁵; and, finally, “*power of attorney*” agreements, which gives the WFOE almost normal shareholder rights, voting and attending shareholders meetings included.³⁶

However, not all VIE structures are identical, in fact, many WFOEs do not extract all of the operating company’s profits through service agreements or, in some cases, additional asset licensing agreements are used, typically for intellectual property. To sum up, it can be stated that ‘ownership’ and control are achieved through contracts.³⁷

In light of what has just been discussed, it is absolutely necessary to tackle the topic of preferential stock structures. Despite the above-mentioned agreements, it must be clear that, also in VIE structures, share ownership (or the contractual agreements that try to mimic it) does not always equal voting right or decision-making power: VIE structures, in fact, also employ a so-called ‘dual-class share structure’ or DCSS, which usually allows the Chinese founders of the structure to keep more voting power, despite lowering their equity stake due to the presence of foreign investors.³⁸

2.4 Capital flows to China: Chinese companies as issuers in tax havens

It appears valuable to note that the offshore holding company is most often registered in what are called tax havens, being the Cayman Islands, the British Virgin Islands and the United States among the most popular ones, which denotes the significance of foreign investors. Said holding company’s main function is that of appearing on foreign stock

³⁵ To deepen the topic, refer to: Zhao, C. (2022). Variable Interest Entity, Offshore Domesticated Foreign Finance, and the Political Economy of China’s Internet Firms: The Case of Alibaba. *Social Sciences (Basel)*, 11(3), 99.

³⁶ Fa, C. (2021).

³⁷ Li, G. (2014). Chinese style VIEs: Continuing to sneak under smog. *Cornell Int’l LJ*, 47, 569.

³⁸ Fa, C. (2021), p. 13.

exchanges, while it does not operate any practical business activity. Similarly, the China-based WFOE has the main goal of transferring profits made by the Chinese operating business abroad and both are, in fact, also considered shell companies.³⁹

Although we should be mindful of the various risks implied by VIE structures, it still cannot be denied that, from a perspective of benefits, VIEs have helped the growth of Chinese emerging enterprises and have had a positive effect, in fact many Chinese enterprises still choose the VIE structure to obtain foreign funds while meeting regulatory requirements.⁴⁰ As a matter of fact, tax havens and offshore financial centers have allowed an increasing number of emerging market firms, especially Chinese enterprises, to raise large sums of capital from foreign investors, with China quickly becoming one of the largest issuers of securities in said offshore centers, which see the Cayman Islands, the British Virgin Islands and the Bermuda at the top. It seems interesting to note that, according to some studies, the growth of investments in securities directly issued by Chinese entities took an even quicker pace during the recent years 2016-2020 and that the majority of securities issued via tax havens are in foreign currency (mainly US dollars and Euros).⁴¹

It has been argued that the VIE structure represents a new type of cross-border capital movement that allows China-based Internet firms to fundraise from international financial markets and retain corporate control despite minority shareholding and to camouflage as foreign entities thanks to the adoption of special purpose vehicles and complex structures in offshore financial centers (OFCs). Considering that the concept of “foreignness” has proved to be malleable, this, as a consequence, represents one of the risks for foreign investors, who might not know where they are really investing their money.⁴² Considering that many VIEs are getting listed on the US exchange, the SEC has a prime

³⁹ Cieřlik, S. (2021), p. 9.

⁴⁰ PAN Yuanyuan 潘圆圆, *VIE jia gou: gainian, libi he zhengce hanyi* VIE 架构: 概念、利弊和政策含义 (VIE structures: concepts, advantages and disadvantages, and policy implications), *Guoji jinrong 国际金融* [International Finance], 2023 (07),74-80. doi:10.16474/j.cnki.1673-8489.2023.07.008.

⁴¹ For reference and graphs on the topic, see: Clayton, C., Coppola, A., Dos Santos, A., Maggiori, M., & Schreger, J. (2023).

⁴² Zhao, C. (2022).

role in attempting to regulate VIE structures: it prescribes that companies shall warn investors of the potential risks and disclosure on potential risks of investing in VIEs is required. However, it has been suggested by many experts that the US and the SEC should require a more thorough disclosure in order to properly inform US investors and the general public.⁴³

The use of structures that are as complex as VIEs unfortunately often implies the issue of tax avoidance, including harmful tax practices in advantageous jurisdictions, which also means that VIEs are able to in a way escape tax liability in China and to direct considerable amounts of value outside the country.⁴⁴ This, however, causes unfairness to the development of other domestic enterprises and may have a serious impact on China's tax base, thus other Chinese scholars even suggested that an "intelligent regulatory system" with the support of big data technology be established, as well as a tax regime for VIE-structured companies, based on the criteria of actual control.⁴⁵

After 2010, the phenomenon of VIEs was growing and an actual wave of Chinese Internet companies started launching initial public offerings (IPOs) on U.S. exchanges, which started raising concerns among U.S. regulators; among said companies were giants such as Alibaba, China's leading e-commerce website, JD.com, a Chinese retailing website, and Weibo, a Chinese microblog with hundreds of millions of users. But also companies from other business sectors and SOEs decided to adopt a VIE-style structure and get listed abroad, among which we can find: Tencent and Baidu, State Grid Corporation of China, China National Overseas Offshore Oil (CNOOC) or Sinopec.⁴⁶

While discussing about the geography of foreign investment, it appears interesting to mention that some scholar have debated around the concept of extraterritorial application of the law, which stems from the principle of "putting the interests of the country first" and the application of a so-called "long-arm jurisdiction". It refers to the process of the state applying the its law to people, objects and behaviors outside its jurisdiction, a

⁴³ Johnson, K. (2015), p. 266.

⁴⁴ Refer to: Larson, M. (2018), p. 222.

⁴⁵ ZHANG Ying & SUN Ciyi 张英 & 孙次宜 (2024).

⁴⁶ Rosier, K. (2014), p. 3.

phenomenon which could occur for what concerns the new Foreign Investment Law, especially taking into account the increase of China's comprehensive international influence.⁴⁷

2.5 Legal risks of Chinese VIE Structures to foreign investors

Foreign investors that participate in VIE operations also include quite navigated individuals such as venture capitalists (VC) and private equity (PE) firms, nevertheless, they are still subject to a various range of risks, which many experts attempted to analyze. Some distinguished among horizontal risks of VIEs, which are based on the intrinsic nature of the contracts, and vertical risks, which can stem from both domestic causes (including regulatory uncertainty and selective enforcement) and offshore factors (including the risks of invalidation and delisting of the company and taxation issues).⁴⁸

The most important and potentially harmful issue, however, is that very few investors are aware that the Chinese companies they invest in are actually shell companies based in tax havens with no standard equity ownership of the listed company: moreover, even when informed, many investors are quite unlikely to fully comprehend the risks involved, given the unique legal status of the structures.⁴⁹ Therefore, the basic feature of variable interest entities is that they do not provide an adequate level of shareholder protection, given that they uniquely rely on the enforceability of Chinese contract law: difficulties in enforcing said network of contracts in China are often present.⁵⁰

⁴⁷ FU Yuxing 傅宇星, *Waishang touzifa de yuwai shiyong zhidu yanjiu* 外商投资法的域外适用制度研究 (Research on the Extraterritorial Application System of the Foreign Investment Law), *Suihua xueyuan xuebao* 绥化学院学报 [Journal of Suihua University], 2023 (05), 25-29. doi: CNKI:SUN:SHSZ.0.2023-05-008

⁴⁸ See: Eales, J. (2015).

⁴⁹ For more on the issues regarding VIE disclosure, refer to: Mainous, R. W. (2022). The SEC's VIE Problems: Why the Agency's Approach Contradicts Its Rhetoric. *Colum. Bus. L. Rev.*, 1066.

⁵⁰ Santoni, G. (2018), p. 601.

Chinese scholars as well have identified various risks, among which the issue around the validity and legality of the structures (VIE 架构合法性 *VIE jiagou hefaxing*) and the tax issue (税务问题 *shuiwu wenti*) stand out.⁵¹ The issue of legality refers to the fact that VIEs have always been in a sort of ‘grey area’ under the Chinese legal framework and there has been no clear regulation on the legality of the model in domestic laws and policies; other key risks include uncertainty in the realization of claims of rights and interests, the fact that the agreement-based mode of control of the enterprise is not as strong as equity, technical difficulties in reporting, taxation and foreign exchange and, ultimately, moral risk (meaning that once a greater temptation of interest arises, the management of the VIE company may no longer follow the orders of the foreign enterprise, and will no longer simply “act according to the agreement” and be controlled by it).⁵² Hence, while the VIE arrangement may eventually be declared legal, valid, and enforceable by the PRC government, a huge risk lays in the fact that the validity of this structure is solely presumed and not certain, hence VIE investments could become worthless.⁵³

In addition to the abovementioned findings, other scholars conducted empirical analysis and came to the conclusion that the main risks of variable interest entity operations involve: government or political intervention in the operations, which is due to the fact that VIEs ultimately violate the intent of Chinese law; managerial expropriation, given that explicit control ultimately resides in the hands of Chinese managers; and the risk regarding the distribution of dividends, which carries uncertain tax consequences since investors are not formally shareholders of the VIE.⁵⁴ Moreover, the low level of internal

⁵¹ LI Bing, ZHAO Chong, YU Rui 李冰、赵冲、余瑞, *VIE jiagouxia, minban gaoxiao shoubinggou falü ji shuiwu fengxian jiexi* VIE 架构下, 民办高校收并购法律及税务风险解析 (Legal and Tax Risks in Mergers and Acquisitions of Private Universities under the VIE Structure), Han Sheng lüshi 汉盛律师 [Han Sheng Lawyers], 2020. Available at: <https://article.chinalawinfo.com/ArticleFullText.aspx?ArticleId=113675&listType=0>

⁵² ZHANG Ming 张鸣 (2013).

⁵³ Shi, S. Y. (2013). 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. *Fordham Int'l LJ*, 37, 1265.

⁵⁴ For empirical evidence regarding the growth of Chinese VIEs, see generally: Hopkins, J., Lang, M. H., & Zhao, J. D. (2018).

disclosure and external monitoring of such companies can easily lead to insider trading, accounting fraud, and corporate governance violations.⁵⁵ Another Chinese empirical study based on a range of judgements points out that investors face the legal risk of non-performance of repurchase obligations (回购义务不履行的法律风险 *huigou yiwu bu lüxing de falü fengxian*), while small shareholders face the risk of information disclosure (信息披露的风险 *xinxi pilu de fengxian*) and proposed listed companies face the risk of insufficient funds (投资款不到位的风险 *touzikuān bu daowei de fengxian*).⁵⁶

Other scholars dived even deeper into the subject and discovered even more risks involved in VIE structures, one of them even being personal issues such as divorces or passing away of the VIE's Chinese shareholders, which could, for example, delay the listing on offshore capital markets.⁵⁷

What are considered to be the major risks are singularly presented in the following paragraphs.

2.5.1 The contractual risk: control power collapse and insider misappropriation

Among many risks, a crucial one is posed by the contractual foundation of VIEs, which might collapse under manipulation by non-government parties, which, for example, is exactly what happened in the Alibaba vs. Yahoo dispute. While the VIE structure already stands on a precarious basis in terms of its legality, at the same time, it is paramount to keep in mind that PRC courts are unlikely to uphold the validity of VIE contracts in the case of disputes, because contracts that effectively circumvent PRC laws are obviously

⁵⁵ SHI Hua, WANG Huaqian 师华、王华倩 (2022), p. 50.

⁵⁶ YAN Jinqiang 颜金强, *Kuajing shangshi VIE jiagou fengxian de shizheng fenxi* 跨境上市 VIE 架构风险的实证分析 (An Empirical Analysis of the Risks of VIE Structures in Cross-border Listings), *Hebeiqiye* 河北企业 [Hebei enterprises], 2023 (04), 158-160. doi:10.19885/j.cnki.hbqy.2023.04.019.

⁵⁷ Mainous, R. W. (2022).

considered unlawful under the PRC contract law. As a consequence, it has often been stated that the value of any VIE investment is ultimately dependent on the integrity and goodwill of the PRC partners.⁵⁸ Considering the appeal of high returns in the short-term, U.S. investors have kept investing in VIEs and Chinese firms kept listing on U.S. exchanges for decades. However, it is not clear whether the advantages actually outweigh the risks of these operations, one of the main being the fragility of the legal contracts that serve as their foundation. The contracts in question are concluded between the wholly foreign-owned subsidiary and the VIE, both of which are established in China, thus they are only binding and enforceable if Chinese courts are willing to uphold them. As previously mentioned, many scholars highlight the point that, since the entire VIE structure consists of a workaround of Chinese government regulations, relying on Chinese courts to uphold the VIE contracts in court is clearly highly risky.⁵⁹

Considering that, as seen in previous paragraphs, in VIE operations control is established through contractual agreements instead of ownership, and that the VIE model presents a very complex structure in which interests of different entities may collide, the listed holding company might even lose control power over the Chinese VIE, especially due to the fact that voting rights are disproportionate and mainly held by the Chinese shareholders of the VIE, who own so-called ‘super-voting shares’. The difficulty in enforcing control as per what is established in the contracts for the reason that parties may breach the contract itself is thus referred to as *contractual risk* and may result in a control power collapse.⁶⁰ The possibility that the owner of the VIE will ignore VIE contracts and keep all profits and assets is also referred to as ‘*agency risk*’ and basically involves a conflict of interest among different agents of the structure.⁶¹

In contrast with what has been presented above, it seems interesting to note that a few scholars are of the opinion that VIEs themselves are not inherently risky, but rather the true source of the problem lies in Chinese government policies, specifically in a lack of

⁵⁸ Shi, S. Y. (2013), pp. 1290-1295.

⁵⁹ Rosier, K. (2014), pp. 5-7.

⁶⁰ See: Li, Y. (2022), pp. 154-155.

⁶¹ Gillis, P., & Lowry, M. R. (2014), p. 64.

enforceability in Chinese courts.⁶² However, from what has emerged from all of the sources consulted for this thesis, it seems that the most widespread opinion still views VIEs main advantage as one of their weaknesses: when business is prosperous VIEs produce a win-win situation, whereas, when it begins to slow down, disputes emerge between beneficial and legal owners of the VIE and the underlying contractual basis of the structure starts looking precarious.⁶³

Therefore, if and when the Chinese party of the contract decides to breach it, the related risk faced by investors is that of *insider misappropriation*, which is also called ‘misappropriation of foreign assets’; when this occurs, as previously seen, Chinese courts do not protect shareholders’ interests, especially given that they actually own shares in the holding company based in a tax haven and not directly in the Chinese VIE.⁶⁴

2.5.2 Policy risks and regulatory risks: pursuing “illegal goals under the disguise of legitimate forms” according to the Chinese Contract Law

VIE operations in restricted sectors of the Chinese economy surely represent a menace for national security, an issue of which American regulators are also aware⁶⁵. Especially considering that these structures do not operate within the bounds of the law, but rather within its limits, it is not hard to see why the risks they entail are so numerous.⁶⁶

Due to the special characteristics of VIE structure itself, such as that of operating on the basis of agreements and the introduction of foreign capital into restricted sectors of the Chinese economy, VIE structures have great risks of legitimacy, which may lead to the

⁶² Rosier, K. (2014), pp. 9.

⁶³ Eales, J. (2015).

⁶⁴ Ziegler, S. F. (2016), pp. 548-549.

⁶⁵ Santoni, G. (2018), p. 602.

⁶⁶ Cieřlik, S. (2021), p. 21.

invalidation of the structures overall.⁶⁷ As a result, VIEs face the risk of hostile state action and the threat of a Chinese government crackdown at any moment, risk which would involve enormous difficulties for shareholders in pursuing relief from the losses.⁶⁸ Moreover, it should be highlighted that no effective legal remedy is available against invalidation, which implies that, in light of China's Contract Law, invalidation can cause the mandatory reorganization of the company's structure or even the withdrawal of the business license granted to the Chinese VIE. This constitutes what is referred to as *regulatory risk*.⁶⁹

In addition, various Chinese experts consider control agreements of VIE structures 'a shortcut for the illegal transfer of property' (为非法转移财产提供捷径 *wei feifa zhuan yi caichan tigong jiejing*), viewing them as unfair because they violate the economic laws of market transactions and 'hide the real purpose of transferring property abroad' (隐藏向境外转移财产的真实目的 *yincang xiang jingwai zhuan yi caichan de zhenshi mudì*), threatening, in some cases, the security of domestic information networks.⁷⁰ Hence, the VIE structure is legally problematic and constantly present the risk of being declared invalid for 'pursuing illegal goals under the disguise of legitimate forms', which is a major cause of contracts becoming null according to the Contract Law (CL).⁷¹

It should be taken into account that, during the long period in which VIE structures have been used, the Chinese government has not explicitly expressed its attitude towards their validity, which can be considered the main issue related to variable interest entities and which will be discussed in the following paragraphs. This key issue therefore creates the perfect environment for regulatory uncertainty regarding possible and *sudden policy changes*, which definitely have the potential to affect the VIE's business and that of the

⁶⁷ LIN Zihang 林子杭, *Neidi qiye caiyong VIE jiagou fugang shangshi de linguan jianyi* 内地企业采用 VIE 架构赴港上市的监管建议 (Regulatory Recommendations for Mainland Enterprises Listing in Hong Kong Using the VIE Structure), *Guoji shangwu caihui* 国际商务财会 [International Business Accounting and Finance], 2023 (01),53-56+71. doi:CNKI:SUN:CWJC.0.2023-01-009.

⁶⁸ Ziegler, S. F. (2016), p. 552-553.

⁶⁹ Fa, C. (2021), pp. 15-17.

⁷⁰ SHI Hua, WANG Huaqian 师华、王华倩 (2022), pp. 49-50.

⁷¹ Fa, C. (2021), p. 22.

entire operation.⁷² In other words, since VIEs comply with investment restriction on foreign ownership only in form, but not in substance, they are in danger of being pronounced illegal or invalid for public policy reasons. Even when this does not happen, regulatory inconsistency or ‘selective enforcement’ represents another related risk, which occurs when law enforcers digress from established principles and enforce regulations by discretion, treating similar issues with different attitudes.⁷³

Anyways, many experts, including Chinese scholars, reckon that, until a serious policy change occurs, VIE use will continue to be widespread, or at least this was their opinion before the implementation of the new Foreign Investment Law.⁷⁴

2.5.3 Risks of de-listing and taxation issues

Risks not only lie in the Chinese regulatory framework but can also arise from offshore jurisdictions in which the company is listed, the main one being the risk of the VIE getting de-listed from that offshore market due to different reasons, such as unfulfillment of relevant accounting principles related to consolidation for instance (in the U.S. being the FASB Interpretation no. 46).⁷⁵ Chinese VIEs are, in fact, facing the perilous risk of de-listing from US exchanges, due to laws amended by the US that aim at protecting investors from these structures’ inherent risks.⁷⁶

Since profits are usually taken out of the Chinese operating entity and passed to the WFOE in the form of service charges, tax concerns are present due to China charging a variable percentage of tax and may lead to the choice of accumulating profits in the VIE, which is obviously in conflict with public shareholders’ interests. Moreover, other uncertain tax consequences of taking profits out of the VIE may be encountered, and, as a result, various companies have provided deferred taxes due to the cause of potential tax

⁷² See: Li, Y. (2022), p. 155.

⁷³ See: Eales, J. (2015).

⁷⁴ WANG Zhenkai, SHEN Chuan 王振凯、沈川 (2017).

⁷⁵ Eales, J. (2015).

⁷⁶ PAN Yuanyuan 潘圆圆 (2023).

costs.⁷⁷ The fact that the State Tax Administration of China (SAT) has not implemented clear regulations regarding the taxation of VIE structures shall also be taken into account: in fact, VIEs are able to transfer all or almost all profits offshore disguised as a service fee, despite the fact that this triggers the issue of transfer pricing. However, there is always the possibility of Chinese tax authorities initiating an investigation if activities such as an abusive use of tax incentives or especially tax avoidance through tax havens are suspected, which often constitutes a risk.⁷⁸ The issue of malicious tax avoidance, in fact, is often present in VIE operations and has caused instability in China's economy and society as well as a loss of tax sources. Therefore, many Chinese experts believe that it is necessary to strengthen supervision from both legal and tax dimensions, in order to promote the long-term and stable development of China's enterprises and capital markets.⁷⁹ Thanks to tax policies signed between the PRC and Hong Kong and their complex structure, enterprises adopting the VIE structure often 'legally' evade corporate income tax and other taxes, which is considered unfair by many Chinese experts who believe improvements in China's regulatory system are necessary.⁸⁰

2.6 China's perspective and regulation on VIEs before 2020: the "substance rather than form" principle.

Both foreign and Chinese scholars investigated whether VIE structures are legally approved (VIE 协议法律是否认可 *VIE xieyi falü shifou renke*) and whether they have what is called a legal effect (是否有法律效应 *shifou you falü xiaoying*); considering what has been discussed in the previous paragraphs, it is clear that VIE operations pose risks not only for foreign investors, but also for China itself.⁸¹ This paragraph is aimed at

⁷⁷ Gillis, P., & Lowry, M. R. (2014), p. 65.

⁷⁸ For more on tax implications for VIEs and loopholes in Chinese regulations, refer to: Larson, M. (2018), pp. 234-236.

⁷⁹ See: LIN Zihang 林子杭 (2023).

⁸⁰ ZHANG Ying & SUN Ciyi 张英 & 孙次宜 (2024).

⁸¹ LI Bing, ZHAO Chong, YU Rui 李冰、赵冲、余瑞 (2020).

showing the attitude of Chinese authorities towards VIEs before the enactment of the FIL in 2020.

First and foremost, it is to be highlighted that the structure of VIEs itself has actually never been approved by the PRC's authorities.⁸² Thus, the regulatory attitude of the domestic regulatory authorities towards the "agreement control + VIE" model is unclear and, in some occasions, there has been the tangible risk of VIEs getting finally considered illegal, such as in 2014, when news was spread that the Securities and Futures Commission (SFC) of Hong Kong recommended the PRC's State Council to outlaw the agreement-controlled company structure.⁸³ By never formally confirming it, the Chinese government has, in fact, left the validity of the VIE structure in question: in addition, in 2011, a few regulations of China's State Council and MOFCOM imposed an increased number of requirements on foreign investors and seemed to specifically target VIEs, which raised worries related to how much longer VIEs could survive⁸⁴; in 2013, the Supreme People's Court of China even defined the contractual arrangements in VIEs as equivalent to "*concealing illegal intention with a lawful form*". This, however, did not translate into any formal banning of these structures.⁸⁵

It seems that Chinese regulators clearly knew that VIEs are widely used, but have always been reluctant to challenge these structures directly since, on one hand, the potential for undesirable widespread disruption is high and, on the other hand, the ambiguity of the situation can serve the country's interests: keeping the threat of invalidating VIEs anytime is a strong weapon and, meanwhile, Chinese companies operating in restricted sectors are able to raise capital and become strong and competitive worldwide.⁸⁶ The vague wording of rules around VIEs can, in fact, give Chinese regulators more discretionary powers in the future.⁸⁷ For example, China's Supreme Court had to express its opinion on the matter in a few instances, such as the case Yaxing-Ambow, which involved the industry of

⁸² Mainous, R. W. (2022), p. 1073.

⁸³ ZHANG Ming 张鸣 (2013).

⁸⁴ Shi, S. Y. (2013), pp. 1280-1284.

⁸⁵ Johnson, K. (2015), pp. 256-258.

⁸⁶ Gillis, P., & Lowry, M. R. (2014), p. 63.

⁸⁷ Johnson, K. (2015), p. 258.

compulsory education: it clearly did not want to recognize the VIE structure as a legal form to cover up an illegal purpose, thus rendering the VIE invalid, nor did it want to give the VIE too much judicial protection and somehow left the matter in the hands of the PRC's Ministry of Education.⁸⁸

Many affirmed that Chinese law on VIE-model enterprises is non-existent. In fact, before 2020, VIEs were not explicitly defined throughout the legal system and their identification relied on the Contract Law of China (CL) to identify its control agreement as a civil and commercial contract between equal subjects, in accordance with the principle of autonomy of will and the relevant provisions of the contracts involved.⁸⁹ In some other cases, such as the Chinachem lawsuit in 2013, VIE contracts were considered null based on the provisions of the Contract Law since they deliberately helped foreign investors enter a sensitive sector (banking), and Chinese regulators at that time adopted what some scholars call a “*substance rather than form*” approach. Yet, these cases can be considered quite isolated, since, in practice, the Chinese government did not officially condemn the VIE model; this attitude posed many risks to investors who took part into VIE operations and translated into an unclear position that created unpredictability.⁹⁰

2.7 Regulatory practice and dispute settlement in China: cases.

⁸⁸ SUN Binbin & WEN Han 孙彬彬、温晗, *VIE hefa? Zuigaoyuan zheme kan VIE hefa? 最高院这么看* (China Supreme Court's view on the legality of VIEs), Zhonglun shijie 中伦视界 [Zhonglun Law Firm], 2020. Available at: <https://article.chinalawinfo.com/ArticleFullText.aspx?ArticleId=112668&listType=0>

⁸⁹ Yang, Y., & Zhu, K. (2018, October). On the foreign legal supervision of the Variable Interest Entity. In *2018 3rd International Conference on Politics, Economics and Law (ICPEL 2018)* (pp. 176-179). Atlantis Press.

⁹⁰ Fa, C. (2021), pp. 6-8.

In less and more recent years, different companies that form part of a VIE operation have been involved in disputes with their foreign counterpart due to different reasons; a few cases will be mentioned in this paragraph for explanatory purposes.

As previously mentioned, a key case was that of Chinachem Financial Services, a Hong Kong company which fought in court for more than ten years due to a shareholding dispute, which ended with contractual arrangements deemed unenforceable due to their illegal objectives of entering restricted sectors of the Chinese economy.⁹¹ Another interesting case is that concerning Buddha Steel, a Delaware-incorporated company which planned to acquire a HK company who owned assets in a Chinese VIE operating in the Hebei province steel industry: Buddha Steel was obligated to withdraw its IPO application after Hebei local authorities invalidated the VIE's business due to public policy reasons.⁹²

In the case of Walmart, instead, the acquisition of a Chinese e-commerce company was brought to court because it would allow Walmart to obtain more equity than the allowed limit of foreign shareholding in the sector: MOFCOM did not deny the legality of the structure but instead resorted to the Anti-trust Law of China and put restrictions on the ground of a potential monopoly. Another case that highlighted ambiguity is the 2009 litigation between the Chinese company Yaxing and the VIE-structured Ambow Beijing over their business in the industry of education: in this case, the VIE structure was not considered illegitimate.⁹³

Gigamedia Limited encountered issues with its Chinese partners due to the problem of insider misappropriation back in 2010, meanwhile similar problems developed during the Alibaba-Yahoo dispute, due to the spin-off of Alipay (which will be discussed further in the chapter). Despite the losses involved, it can be seen, however, that the company often prefers to settle the issue autonomously rather than going to court and risking being declared entirely illegal.⁹⁴ As a result, many scholars point out that, as cases prove, when

⁹¹ Eales, J. (2015).

⁹² Refer to: Fa, C. (2021), p. 8.

⁹³ For more examples, refer to: *ibid.*

⁹⁴ Ziegler, S. F. (2016), pp. 549-552.

disputes arise over control of the Chinese VIE, foreign investors have very limited legal recourse options, meaning that, if VIE fails, by means of either PRC government action, managerial rift, or other operational or governance decision, it is enormously difficult for US investors to use judicial means to recover their investment losses⁹⁵

What's more, after analyzing different disputes related to VIE structures, many scholars came to the conclusion that inconsistency between opinions from administrative authorities and decisions from judicial authorities regarding the legality of the structures is present. The Supreme Court, for instance, relied on contract principles and avoided expressing any type of confirmation regarding the legitimacy VIE operations themselves.⁹⁶ According to the PRC Contract Law (article 52), for example, a contract is considered null and void due to different reasons, such as if it is concluded to damage the interests of the State or if it conceals an illegitimate purpose under the guise of legitimate acts or, also, if it violates the compulsory provisions of laws and administrative regulations: this obviously creates worries concerning VIE contracts and their performance.⁹⁷

One of the most explanatory cases concerning VIEs involves Alibaba, the Chinese giant that operates a conglomerate of e-commerce sites and is listed on the New York Stock Exchange, which was involved in a dispute with Yahoo, its major foreign investor, over the Alipay case.⁹⁸ Alibaba utilized the VIE structure to circumnavigate PRC government restriction on foreign investment and, in addition, also used the preferential stock structure which leaves decision-making power in the hands of the company's founders in China. After developing Alipay, which is a very widespread Chinese online payment service, Alibaba decided to split Alipay into a separate entity controlled by the owner Jack Ma, thereby terminating Alipay's VIE contracts in 2010⁹⁹; however, it did so without even informing Yahoo, who would have benefitted largely from Alipay's business and who actually had decision-making powers based on the VIE contractual arrangements.

⁹⁵ Shi, S. Y. (2013), pp. 1296-1300.

⁹⁶ See: Li, Y. (2022), p. 156.

⁹⁷ Li, G. (2014), p. 592.

⁹⁸ For more details see: Larson, M. (2018).

⁹⁹ Ziegler, S. F. (2016), pp. 551-552.

The reason behind Alibaba's unilateral decision seems to be that a specific license was required by Chinese authorities to make the online payment platform operating, and that said license could not be granted if Alipay were to be part of a VIE operation. However, this does not fully justify the incident, which looks like a reminder of the risks that VIEs entail.¹⁰⁰ After the incident, Yahoo and Alibaba Group were actually able to reach an agreement to compensate for the potential losses of Yahoo, but preferred to autonomously solve the dispute. The Alipay incident, however, was an actual scandal that caused great concern among investors. Some scholars suggested that the contractual risk of the VIE structure could be mitigated by maximizing business activities in the WFOE and minimizing those conducted in the Chinese VIE.¹⁰¹

To conclude, what seems interesting to highlight, however, is the decision-making mechanism behind Alibaba Group as one of the most successful Internet companies in China. On top of the VIE structure itself, in fact, Alibaba used an even less transparent decision-making mechanism which granted the company's effective controllers great discretionary power in making key decisions even behind the backs of board members. Said mechanism involved a top-down approach which took the name of Lakeside Partnership (湖畔合伙人 *Hupan Hehuoren*): it was a proper selectorate of around thirty people which included the company's founders and managers and which admitted new members each year. This murky mechanism allowed Alibaba to maintain Chinese control over the complex VIE structure and constituted an innovative organization superior to the board of directors.¹⁰²

¹⁰⁰ Johnson, K. (2015), pp. 254-256.

¹⁰¹ Gillis, P., & Lowry, M. R. (2014), p. 64.

¹⁰² Refer to: Zhao, C. (2022), pp. 108-112.

3. Chapter III, VIEs in China in the legal background of the FIL: the expectations around the new law compared to its actual impact on this kind of foreign investment operations

3.1. Introduction: implications of VIE operations for global markets

In order to better grasp the expectations that were born around China's new Foreign Investment Law, which is one of the crucial topics of this chapter, it seems necessary to introduce the implications that variable interest entities have not only on the Chinese economy, which have been tackled previously in this work thesis, but also on global capital markets.

As seen in the previous chapter, by allowing foreign investment in Chinese companies operating in restricted economic sectors basically in violation of the law and even without the requisite approval process, VIEs create an enormous number of perils for the American and Chinese government and for investors and businesses as well, to the extent that some scholars even proposed the implementation of a bilateral investment treaty (BIT) between the US and China in order to govern investment-related disputes.¹

Moreover, it is relevant to note that VIEs also have implications for global markets, which primarily consist in the issue of *financial stability*: considering the prevalence of issuance of corporate debt in tax havens, uncertainties arise around how both offshore and onshore creditors are treated in the case of bankruptcy, which constitutes another enormous risk for foreign investors. In order to mitigate risks, scholars have suggested that global efforts

¹ Ziegler, S. F. (2016), pp. 554-560.

to regulate tax havens be carried out, even though geopolitical tensions are in the way of a necessary cooperation among the major players (US and China).²

In order to mitigate the many risks inherent to VIEs, the SEC has adopted the strategy of basically relying on a system of disclosure that does not dictate corporate action but instead allows investors to choose for themselves what they deem acceptable; the goal is that of eliminating abuse and retaining investor confidence.³

In light of what has been mentioned above, it appears crystal clear why both foreign and Chinese market players, stakeholders and the public were eager to learn more around China's new foreign investment law.

3.2. Expectations on the Foreign Investment Law and how it could provide better indications relative to VIEs: the debate in and outside China

It must be noted that, before the publication of China's Foreign Investment Law, true expectations were born among the community of experts and investors, who practically all hoped for an improved regulatory system that would reduce uncertainty in the field of foreign investment in China. In light of the characteristics of the FIL that are discussed in the first chapter of this thesis, this paragraph focuses on presenting expectations around the FIL and especially around the regulation of variable interest entities.

As a matter of fact, experts have always hoped for the creation of a more level playing field for investment in China and for an improved rule-of-law environment for all market players in order to prevent further uncertainty in the foreign investment sector; some suggested that these goals, if reached, would surely benefit China and would make the economic reform effective, consequently making the VIE structure somewhat redundant and less necessary.⁴ Because of the fact that China's regulatory environment has remained quite rudimentary according to some scholars, foreign investors face incredible risks

² Clayton, C., Coppola, A., Dos Santos, A., Maggiori, M., & Schreger, J. (2023), pp. 5-6.

³ Mainous, R. W. (2022), p. 1076.

⁴ Eales, J. (2015).

stemming from the complexity of the VIE structure (as shown in the second chapter of this thesis). This explains why the process of creation of the new FIL has been so relevant to all investors and especially to those engaging in VIE operations and why concerns were widespread; in fact, the new law had the potential to drastically change the entire foreign investment environment and to impact on VIE structures either in a positive or negative way, namely by means of validating the structure or by means of declaring it completely illegal. As a result, it is clear that the hopes of investors and experts translated into true expectations when changes in China's regulatory framework were announced and when news was spread that a new law on foreign investment was to be enacted.⁵

As previously stated in chapter I, initial expectations can be dated back to 2015, when the draft of the Law was published: at that time, hopes were high given that specific references to the regulation of variable interest entities seemed to be included in the text of the law. According to the Draft, a clear distinction was to be maintained between foreign and domestic businesses and the actual influence of corporate control seemed to be taken into account on top of equity shares, thereby allowing Chinese companies to gather foreign capital provided that control remains in the hands of Chinese owners.⁶ The proposed FIL, at that time, promised to tighten the administration of contractual arrangement between foreign investors and the onshore operating VIE, thereby leading many companies listed in the U.S. with VIE structures to face legal difficulties, also considering that it defined foreign investment as "any form of arrangement that exerts foreign actual control over a PRC domiciled business". Consequently, investors did not exactly know what kind of impact the new law could have on VIE operations until the final text would be published, which undoubtedly translated into various forms of expectations around it.⁷

Foreign investors involved in such operations certainly hoped for their legalization in China while American governmental agencies, with the goal of protecting foreign investors' interests, hoped for an improved regulation of the phenomenon in China. The

⁵ See generally: Johnson, K. (2015).

⁶ Santoni, G. (2018), pp. 606-608.

⁷ Johnson, K. (2015), p. 262.

issue of national security and China's National Security Review System, however, constituted a concern among the public, given that, as previously seen in chapter I, Chinese nationals perceive that, if foreign investment is not strictly scrutinized, it may threaten the interests of national security and development and jeopardize the sovereignty of the country.⁸ Some experts in China, in fact, considered VIEs as a threat to national security and thus hoped for a switch towards a more 'de facto' control by Chinese investors, even though this would implicate that companies adopting the VIE structure would be inhibited, thereby causing their industry to suffer due to the lack of foreign capital (such as the Internet sector). All, however, definitely hoped for more clarity on the subject, which would help eliminate issues due to an uncertain regulatory climate in China.⁹ Moreover, considering that, as previously stated in the first chapter of the thesis, the draft of the new Foreign Investment Law also promoted the creation of regulations for the establishment of an improved and refined National Security Review System, prescribing that security review be carried out on foreign investment projects that have or may have an impact on national security, it is easy to see how VIEs risked being declared illegal.¹⁰ It appears, therefore, that the key point to look for in the new FIL was the definition of foreign investment, which would determine whether VIE-based companies would be considered as such or not.

Some scholars, however, pointed out that, even if China was to validate the VIE structure, some issues, such as those on tax avoidance, will unlikely be solved.¹¹

The negative list system, which determines which business sectors are prohibited for foreign investors and which are restricted, represents another aspect on which everyone expected the FIL to give more clarity.¹² As seen before, the Negative List Management System of the FIL together with a simpler reporting mechanism, in fact, had the potential to improve the freedom of foreign investors operating in China; expectations were put on

⁸ See paragraph 1.7 and refer to: ZHANG Jin 张进 (2023), p. 60.

⁹ Johnson, K. (2015), p. 263.

¹⁰ Refer to paragraph 1.7 and HUANG Jin 黄晋 (2019).

¹¹ Larson, M. (2018), pp. 239-241.

¹² Refer to paragraph 1.6.2 for more on the topic.

a potential gradual opening of the Chinese market to foreign investors.¹³ In addition to it, it is mandatory to understand that, on one hand, if the business sector in which the Chinese VIE is operating remains restricted, the VIE structure likely remains in place and useful, whereas, on the other hand, if the industry in which the Chinese VIE operates is magically removed from the negative list, there is a possibility that the VIE structure in place would no longer serve its purpose and that benefits be outweighed by risks.¹⁴ This would entail changes in the structures and consequences for investors and the entities involved would be certain.

3.3. The ambiguous legality of variable interest entity structures in China after the enactment of the FIL.

Compared to the text of the 2015 draft, which contained interesting and clear provisions also regarding variable interest entities¹⁵, the actual text of the FIL 2020 was, surprisingly, quite a different story.

What is mandatory to note is that, in contrast with the long draft published in 2015, which actually contained prescriptions on VIEs and their legality, the FIL cuts out the content regarding “actual control” of foreign invested companies (which in Chinese is referred to as “实际控制” *shiji kongzhi*). As previously mentioned, in fact, the legislative focus of the new law is on setting general provisions with the aim of opening up even more towards the outside world, setting a negative list management system or creating a more level playing field for investors, whereas the determination of foreign investment based on lineage rather than place of incorporation (外资认定看血统而非注册地 *waizi rending kan xuetong er fei zhucedi*) (the “actual control” idea put forward by the 2015 Exposure Draft) have been temporarily shelved and left to be resolved later through legislative authorization. Anyway, according to some Chinese scholars, VIE structures

¹³ DENG Tingting, CHEN Meiyu 邓婷婷、陈美玉 (2022), pp. 59-60.

¹⁴ See Zhang, M. (2020), pp. 199-201 and paragraph 1.6.2 generally.

¹⁵ Refer to paragraph 1.5 of this thesis.

may still be included in the regulatory scope of “foreign investment” in the future by way of other separate laws, administrative regulations and even normative documents formulated by the State Council.¹⁶

The investor nationality issue, as already mentioned in the previous paragraph, is crucial in determining the validity and the future of variable interest entities. The 2015 Draft, on this matter, provided specific prescriptions that specifically defined who are considered foreign investors, which roughly included: natural persons without Chinese nationality, companies incorporated under the laws of countries other than China, the governments of countries other than China and international organizations.¹⁷ The Draft also defined contractual control as a form of foreign investment, therefore, according to it, VIEs operating in prohibited sectors would be illegal, whereas VIEs operating in restricted sectors, if the tax-haven based entity was actually under the control of Chinese investors, would be allowed (as a form of foreign investment conducted by Chinese investors, which would be legitimate).¹⁸ In contrast with this, however, as discussed in the first chapter of this thesis, the FIL 2020 was published containing more vague provisions, which would not clearly define terms such as ‘indirect investment activities’ or ‘other forms of investment’.¹⁹ The key legal problem of VIEs therefore is whether contractual control is actually a real form of foreign investment and, according to the new Law and in contrast with every expectation on the matter, it remains unresolved and once again uncertain.²⁰

From this research, it appears evident that the new Foreign Investment Law did not actually succeed in solving previous issues related to the legal environment and the adoption of risky shortcuts to economic benefits.

Despite praising the new FIL as a revolutionary milestone in innovating the regulatory framework of foreign investment in China and in enhancing the level of liberalization,

¹⁶ Please refer to: LI Bing, ZHAO Chong, YU Rui 李冰、赵冲、余瑞 (2020).

¹⁷ Shangwubu 商务部, “*Zhonghua Renmin Gongheguo Waiguo touzifa (cao'an zhengqiu yijian gao)*” 《中华人民共和国外国投资法(草案征求意见稿)》 (Draft of the Foreign Investment Law of the PRC (Draft for Soliciting Comments), 第十一条 article 11.

¹⁸ Fa, C. (2021), p. 11.

¹⁹ Refer to paragraphs 1.6 and 1.6.1 of this thesis.

²⁰ Fa, C. (2021), p. 12.

even Chinese scholars have admitted that there are still some legal ‘white spaces’ in China’s legislation on the matter.²¹ Some others stated that, even after the enactment of the FIL 2020, there is no law that can be cited to directly negate VIE structures, nor has any regulatory authority issued clear rules that explicitly prohibit or recognize the VIE model, hence risks of being declared invalid by judicial or arbitration authorities remain in the case disputes land in court.²²

Therefore, the point of view of some Chinese scholars is also interesting to say the least: in short, they believe that China’s supervision of the VIE structure has been increasingly strengthened and that their legal status has been shaken, nevertheless they admit that the legal effect of VIEs and their contractual agreements should be further clarified, especially because they perceive VIEs as a cause of instability in China's economy and society and loss of tax sources.²³

Hence, it might be due to quite opposite reasons, however, both Chinese and foreign scholars seem to admit that, as for now, variable interest entities still possess a sort of ambiguous legality and both feel the need of improved regulatory clarifications. Strengthening the supervision of VIE companies listed overseas through the use of negative lists and security reviews has been proposed as a feasible solution.²⁴

3.3.1. Strategic ambiguity: focus on interests rather than rules

As per what the time has proved until now, many experts reckon that VIE operations are highly unlikely to be deemed illegal and their application will not be directly prohibited

²¹ JIANG Liangpeng 江良鹏, *Woguo waishang touxi xingshi falü wenti yanjiu* 我国外商投资形式法律问题研究 (Research on Legal Issues Concerning Foreign Investment Forms in China), *Jingji yanjiu daokan* 经济研究导刊 [Economic Research Guide], 2024 (14), 158-161. doi: CNKI:SUN:JJYD.0.2024-14-039

²² SUN Binbin & WEN Han (2020).

²³ See: LIN Zihang 林子杭 (2023).

²⁴ PAN Yuanyuan 潘圆圆 (2023).

or sanctioned: this is mainly due to the fact that Chinese companies involved in such operations receive huge financial benefits, which, for now, cannot be provided by the Chinese market alone. As a result, Chinese authorities have kept a sort of silent consent regarding the matter, in order to allow Chinese private companies to exploit the opportunity and attain good financial results²⁵, even if this involves, in a way, compromising the integrity of the country's regulatory principles. However, it can be stated that the main motive behind this ultimately lies in the country's national development goals and in its aspirations to achieve a dominant position in the world economy.²⁶

As a matter of fact, after the new Foreign Investment Law was enacted in 2020, the perception of the public and of the vast majority of experts on the topic has been that the Law was yet another proof that Chinese authorities are still unwilling to clarify the VIE legality issue. This phenomenon can be defined as strategic ambiguity and consists in a focus on interests rather than rules, which also means that risks for foreign investors engaging in VIE operations remain present. The blurred legality of VIEs therefore seems to be a weapon in the hands of Chinese authorities, leading companies involved in the structures to follow their instructions very precisely.²⁷

At present, there are still no clear regulatory provisions on the VIE model of foreign investment, which, in Chinese experts' eyes, mainly means that foreign investors can easily take advantage of loopholes in the system to circumvent the restrictions on entry into China.²⁸

3.4. The phenomenon of VIE operations at present: the impact of the FIL and the geopolitical factor.

²⁵ Cieřlik, S. (2021), p. 22.

²⁶ *Ibid.*

²⁷ Fa, C. (2021), p. 12.

²⁸ JIANG Liangpeng 江良鹏 (2024).

Many scholars reckon that the legalization of VIEs or the entire abolition of restrictions on foreign investment in restricted industries constitute the most acceptable future scenario; according to them, Chinese regulators are unlikely to directly prohibit the application of VIEs or impose sanctions, primarily due to the fact that Chinese enterprises still gain huge financial benefits from participating in these structures.²⁹

After the implementation of the new FIL, which prescribes that even foreign-funded enterprises are allowed to raise funds legally through the public issuance of stocks and bonds, the negative list system for the management and restriction of foreign-funded investment is adopted, therefore the crucial motive for adopting a VIE-style structure is still present.³⁰

Compared with the relatively high expectations around the regulation on the matter of variable interest entities, it can be stated that the Foreign Investment Law, as seen above, has not quite met the hopes of investors, leaving the matter vague and uncertain. Even so, a key factor should be taken into account: the fact that China entered the era of negative list, which caused investment restrictions to be eased like never before.³¹ In this environment, many believe that, instead of maintaining strategic ambiguity around VIEs, Chinese legislators should clarify the supervision on such structures, as well as crucial concepts like that of “*control*”; some even suggested that ‘control agreement’ should not be equated mechanically with ‘foreign investment’ and that flexible concepts such as ‘substantive control’ be introduced.³²

In addition, in order to understand the phenomenon of variable interest entities in China at present, the geopolitical issue should be taken into account: the recent trade war among the two giants (U.S. and China) has definitely impacted the relationship between the two

²⁹ Cieřlik, S. (2021), p. 22.

³⁰ FU Yuxing 傅宇星 (2023).

³¹ See paragraph 1.6.2 and consult: DENG Tingting, CHEN Meiyu 邓婷婷、陈美玉 (2022).

³² GUO Yuan 郭远, *VIE jiagou de jianguan gai hequhecong – fumian qingdan shidai xia de zaishenshi* VIE 架构的监管该何去何从——负面清单时代下的再审视 (What Is the Future of VIE Structure Supervision: A Reexamination in the Era of Negative Lists), *Dongbei daxue xuebao (shehui kexueban)* 东北大学学报 (社会科学版) [Journal of Northeastern University, Social Science], 2023 (05),99-106. doi:10.15936/j.cnki.1008-3758.2023.05.011.

countries, and, in a way, has also influenced the course of foreign investment.³³ Considering the Sino-US market competition and the enhanced requirements for listing on the U.S. market due to the goal of protecting American investors, scholars have doubts on whether companies will still be listed on the US stock market in the future. For instance, a study shows how, while still being mainly listed on the American and Hong Kong stock exchanges, VIE-structured companies are starting to expand in Europe as well.³⁴ In fact, due to a few regulatory issues on accounting practices, the SEC even risked being required to halt trading in various China-based companies in 2024. Despite these challenges, however, it seems that China-based operating companies are still seeking capital from U.S. investors.³⁵

Related to the above-mentioned issue of competitiveness between China and the U.S., considerations on the matter of national security are also necessary: the concept of “national security” seems to have expanded under President Trump’s “America First” doctrine to include ensuring that the U.S. maintains its economic and trade pole positions in all industries, meanwhile the recent expansion of national security interests to encompass economic well-being has coincided with China’s rise as a global power. This rationale resulted in an enormous number of trade actions promulgated as “national security”-based and other defensive measures, such as tariffs on products from China, extensive new sanctions on Chinese companies, restricting Chinese companies from buying American technology, and barring investments in Chinese firms with military ties. This certainly enhanced the already existing frictions between the two countries.³⁶

On the other hand, as previously seen, Chinese experts also tend to view VIEs as a threat to their national security: therefore, for example, the recent China’s Data Security Law was adopted in 2019 with the aim of imposing stricter scrutiny on large companies which

³³ For more on the U.S.-China trade war, see: Itakura, K. (2020). Evaluating the impact of the US–China trade war. *Asian Economic Policy Review*, 15(1), 77-93.

³⁴ Refer to: Cieřlik, S. (2021).

³⁵ Mainous, R. W. (2022), p. 1079.

³⁶ Refer to: Kho, S., & McNamara, Y. K. (2022). Focus on China: the expansive use of national security measures to address economic competitiveness concerns. *U. Pa. Asian L. Rev.*, 17, 368.

seek to circumvent Chinese regulations.³⁷ As a result of the present geopolitical circumstances, it has thus emerged from this research that VIE companies are viewing listing themselves on domestic stock exchanges as a viable option, which will be discussed in the next paragraph. This could also be perceived as a representation of stricter policies by the Chinese government in recent years, which has the potential to lead towards a more radical transformation of the regulatory approach towards VIEs in the future.

To conclude, according to some experts, despite the VIE model was created by market players, its success and survival must definitely be attributed to Chinese regulatory policy and its strategic ambiguity.³⁸ Hence, it can be stated that, while the FIL 2020 seems to have improved the regulatory framework of foreign investment in China overall, the matter of variable interest entities has not yet been comprehensively and clearly addressed and investors are still left with a need for certainty.

3.5. The SSE STAR Board is established: red-chip companies.

Despite the adoption of a strategic ambiguity approach by the Chinese government towards investment regulation on VIE usage, VIE companies were actually banned from listing on Chinese capital markets, which might be a clue that their legality was not recognized and which lead to the entire purpose of listing overseas; it has been proved, however, that this undermined the competitiveness of domestic capital markets³⁹ to a certain extent.

³⁷ See: Li, Y. (2022), p. 158.

³⁸ Fa, C. (2021), p. 15.

³⁹ To deepen the topic of China's financial system, see: Amighini, A., Il sistema finanziario cinese: sviluppi e implicazioni internazionali (10 febbraio 2023), *ISPI*. Available online at: <https://www.ispionline.it/it/pubblicazione/il-sistema-finanziario-cinese-sviluppi-e-implicazioni-internazionali-112780>

Consequently, the establishment of the so-called SSE STAR Board in 2019 by Chinese authorities seems another relevant topic to tackle at the end of this thesis work, given its rather permissive policy on VIE listings. Variable interest entity-structured companies are not directly and specifically admitted, but instead it appears interesting to note that a different name is employed: “red-chip companies”, which are defined as companies incorporated overseas, but with their main business operation in China. In this case, some scholars pointed out that the definition of investment according to the concept of ‘actual control’ is still being employed, as well as the concept according to which foreign shareholding does not necessarily equal voting rights.⁴⁰ The creation of the SSE STAR Board has provided an alternative to Chinese VIEs other than the American Exchanges or the Hong Kong Exchange, meeting the needs of some Chinese VIE issuers, even though the legality of the VIE model is not endorsed by the rules of the Board.⁴¹

The name SSE STAR Board stands for Shanghai Stock Exchange Science and Technology Innovation Board (上海证券交易所STAR版 *Shanghai zhengquan jiaoyisuo STAR ban* or 上海证券交易所科创板 *Shanghai zhengquan jiaoyisuo kechuangban*), in fact, China’s STAR market mainly targets high-tech industries and strategic emerging industries such as new-generation information technology, high-end equipment, new materials, energy conservation & environmental protection, and biomedicine. While promoting the deep integration of the internet, big data, cloud computing, artificial intelligence, and manufacturing, it is also aimed at encouraging reforms on quality and efficiency.⁴²

Ninebot, a producer and seller of electronic scooters and robotics, was the first Chinese entity employing a VIE-style structure to go public on the STAR market in October 2020. Given that it was exactly the same year in which the FIL was enacted, timing should be

⁴⁰ Fa, C. (2021), pp. 12-13.

⁴¹ *Ibid.*

⁴² Liu, K. (2023). Shanghai Stock Exchange's Science and Technology Innovation Board: A Review. *Financial Markets, Institutions and Risks*, 7(1), 1-15. [http://doi.org/10.21272/fmir.7\(1\).1-15.2023](http://doi.org/10.21272/fmir.7(1).1-15.2023)

considered, meaning that the approval of an IPO from a VIE could be interpreted as a policy hint regarding their validity.⁴³

What happened after the SSE STAR Board was established is that different companies listed on American exchanges were suddenly delisted in order to get listed on the STAR market, which was exactly the case of China's biggest chipmaker, Semiconductor Manufacturing International Corp (SMIC) in July 2020.⁴⁴

The discussion on China's STAR Board could be food for thought for what concerns shifts in the regulatory scheme of variable interest entities in the PRC; notwithstanding, it remains clear that no official endorsement on their validity is available yet.

DIDI Global Inc., another Chinese company using a VIE-modeled structure, was eligible to list on the SSE STAR Board, but, in 2021, decided to go public on the NYSE; unfortunately, it did so without previously informing Chinese regulators, who immediately launched a cyber-security investigation out of the concern that Didi's US flotation under the SEC's information disclosure requirements may have caused harm to China's national data security.⁴⁵ This affected the company's share price, which started falling, causing investors to suffer losses. This IPO fallout case (2021) represents an interesting example of the risks that still arise from a lack of certainty around VIEs regulation.⁴⁶

3.6. The regulatory reaction of global capital markets to Chinese VIE structures

To conclude the discussion on VIEs, it seems relevant to mention how global capital markets reacted to these operations. The crucial point that has emerged from this research is the key role of American financial regulatory agencies, primarily that of the Securities and Exchange Commission (SEC), in trying to shed light on variable interest entity

⁴³ Fa, C. (2021), pp. 12-13.

⁴⁴ Liu, K. (2023), p. 2.

⁴⁵ Fa, C. (2021), p. 22.

⁴⁶ For more information and a visual representation of the contractual agreements of Didi's VIE structure, see: Li, Y. (2022), pp. 151-152

structures and mitigate the risks they involve, considered that the American stock markets have long been Chinese companies' favorite to try go public. It must be highlighted that investor protection is central to securities regulation in the U.S., and that the SEC often initiated investigations to ensure that financial results of Chinese operating entities were consolidated correctly; at the same time, the SEC has also enhanced disclosure obligations.⁴⁷ Specifically, the SEC has adopted what has been defined as a pure disclosure approach (as opposed to a substantive approach), meaning that it merely requires risks be disclosed by VIE companies listing on the NYSE or NASDAQ: this system is supposed to allow investors to choose for themselves whether investing into a VIE is acceptable, however, the information is usually 'hidden' within dense and complicated disclosure documents.⁴⁸

Surprisingly, due to the risks involved, specifically due to that of interference of the Chinese government in businesses and the regulatory risk, at the end of July 2021, the SEC paused new offerings of Chinese operating companies on American capital markets, until they fully explained their legal structures and disclosed risks.⁴⁹ Shortly after, the SEC prescribed that all VIE issuers shall specifically disclose that investors are not buying shares of a Chinese company, but rather of a shell company, and the uncertainty risk shall be specified accordingly.⁵⁰

Some scholars, anyway, pointed out that current disclosure rules in the U.S. are inadequate, but highlighted that increased disclosure risks being counterproductive and might prevent investors from truly understanding VIE's risks.⁵¹

Even though it is not the main concern among investors, it is interesting to note that the Hong Kong Exchanges and Clearing Limited (HKEx) also issued its opinion on the matter of VIEs (as early as the early 2000s): however, despite approving the listing of VIE-

⁴⁷ Fa, C. (2021), p. 21.

⁴⁸ For more information on the SEC's role, refer to: Mainous, R. W. (2022), pp. 1075-1080.

⁴⁹ Bain, B., SEC Chief Blocks Chinese IPOs Until Risks Better Disclosed (2021, July 30th), *Bloomberg*. Available at: <https://www.bloomberg.com/news/articles/2021-07-30/sec-stops-processing-ipo-filings-for-chinese-firms-reuters-says>

⁵⁰ Mainous, R. W. (2022), p. 1078.

⁵¹ *Ibid.*, pp. 1083-1089.

structured companies, recently, its attitude has become increasingly cautious, and frequent amendments, additional disclosure and other requirements have been attached to VIEs⁵²: in fact, after the issuance of the 2015 Draft of the FIL, more disclosure requirements on the risks related to the Chinese legal form were added here as well.⁵³

⁵² Li, G. (2014), p. 595.

⁵³ Fa, C. (2021), p. 22.

Concluding remarks: Suggestions for future developments in China's foreign investments' legal framework

The new Foreign Investment Law is perceived by experts in China as a drastic improvement on the matter of inward foreign investment, or at least this is what emerges from the consulted sources, meanwhile it seems that, according to foreign experts, the Law is not as revolutionary, especially for what concerns the regulation of the interesting matter of variable interest entities. However, it has emerged that even Chinese scholars feel the necessity to further develop the foreign investment regulatory system in the country. Some even suggested that in the process of future development of China's Foreign Investment Law, it is necessary to comprehensively consider foreign investment under the present situation and investigate the various forms of foreign economic activities in China, including variable interest entities.⁵⁴ Others, recognizing that the FIL approaches the issue of authenticity of a foreign investor on vague terms, find that the establishment of a new management system for foreign investment is necessary for China, not exactly with the goal of protecting foreign investors but rather in order to prevent the setting up of VIEs altogether.⁵⁵

⁵⁴ Refer to: JIANG Liangpeng 江良鹏 (2024).

⁵⁵ XING Gang 邢钢, *Xujia waiguo gongsi falü zhidu de Zhongguo goujian: yuwai jingji yu bentu gouzao* 虚假外国公司法律制度的中国构建：域外经验与本土构造 (The Construction of the Legal System of Fake Foreign Companies in China: Overseas Experience and Local Construction), *Dangdai faxue*, Beijing Shifan daxue faxueyuan 当代法学, 北京师范大学法学院 [Contemporary Jurisprudence, Beijing Normal University Law School], 2023 (5), 147. Available at: [https://www.pkulaw.com/qikan/9ec225439910091874e8feae98b95f73bdfb.html?keyword=%E5%8F%AF%E5%8F%98%E5%88%A9%E7%9B%8A%E5%AE%9E%E4%BD%93&way=listV](https://www.pkulaw.com/qikan/9ec225439910091874e8feae98b95f73bdfb.html?keyword=%E5%8F%AF%E5%8F%98%E5%88%A9%E7%9B%8A%E5%AE%9E%E4%BD%93&way=listView)

Some scholars suggested the implementation of a bilateral investment treaty with an international arbitration commission as a solution that would resolve the threats and uncertainty surrounding VIEs and that would make foreign investment in China thrive, while effectively protecting Chinese sensitive industries.⁵⁶ Others suggested that a genuinely level playing field be created in China's foreign investment environment⁵⁷, or recommended that improved transparency in the regulatory framework be granted and that a policy risk alert mechanism that would combine different sources of information available to regulators be established, in order to help offshore markets better assess investment risk.⁵⁸

According to a few other scholars, developments in China's foreign investment legal framework should entail strengthened supervision under a legal and tax perspective too⁵⁹, and, according to China's perspective, said supervision of VIEs should take into account both development and security.⁶⁰ Meanwhile, according to others, a suggestion could be that negative lists and Chinese domestic financing procedures be improved.⁶¹

In the author of this thesis' opinion, conducting this research by means of comparing 'Western' and Chinese sources has been one of the most difficult but stimulating and interesting parts of this entire thesis work.

To conclude, what has emerged is that (as it has been shown in the final chapter), despite the divergence in motivations between Chinese scholars and foreign experts around the interesting phenomenon of VIEs, enhanced regulation on the subject is needed by both.

After consulting as many sources as possible, a few areas for future research, based on the future changes in China's regulatory practice around foreign investment, have become evident: further research on future improvements on the transparency of the FIL with a

⁵⁶ Ziegler, S. F. (2016), pp. 554-560.

⁵⁷ Eales, J. (2015).

⁵⁸ Li, Y. (2022), pp. 161-163.

⁵⁹ LIN Zihang 林子杭 (2023).

⁶⁰ PAN Yuanyuan 潘圆圆 (2023).

⁶¹ GUO Yuan 郭远 (2023).

stricter regulatory framework seems necessary, as well as research on future changes on the regulatory approach towards VIEs and the future of VIEs on the Chinese stock market.

Hence, the key questions of whether variable interest entities will finally be explicitly adopted as legal structures and whether the Chinese authorities' standpoint based on strategic ambiguity will finally be ditched in favor of a clearer approach, thereby reducing risks for investors, remain open.

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Glossary of Chinese terms

Terms related to China's Foreign Investment Law

负面清单管理制度 vs. 逐案审批体制	<i>fumian qingdan guanli zhidu</i>	Negative List Management System
	<i>zhu'an shenpi tizhi</i>	Case-by-case approval system (for foreign investment)
国家安全审查制度 or 外资安全审查制度	<i>Guojia anquan shencha zhidu</i>	National Security Review System (NSRS)
	<i>Waizi anquan shencha zhidu</i>	National Security Review System of foreign investments
全国人民代表大会	<i>Quanguo Renmin Daibiao Dahui</i>	National People's Congress
三法合一	<i>Sanfa heyi</i>	Unification of the Three Laws
特别行政区	<i>Tebie xingzhengqu</i>	Special Administrative Regions (SARs)
投诉工作机制	<i>tousu gongzuo jizhi</i>	Complaint mechanism (for foreign-invested enterprises)
外国投资 vs. 外商投资	<i>Waiguo touzi</i>	Foreign Investment, investments from foreign countries
	<i>Waishang touzi</i>	Foreign Investment, investments from foreign investors
外资企业, 外商投资企业	<i>Waizi qiye, Waishang touzi qiye</i>	Foreign Invested Enterprises (FIEs)
外资三法	<i>Waizi sanfa</i>	The Three Laws (on foreign investment)
依法治国	<i>Yifa zhiguo</i>	Principle of "ruling the country according to law"
做到内外一致	<i>zuodao neiwai yizhi</i>	Equal treatment of domestic and foreign (investment)
《中华人民共和国外商投资法》	<i>Zhonghua Renmin Gongheguo Waishang Touzifa</i>	Law of the People's Republic of China on Foreign Investment, Foreign Investment Law (FIL).
准入前国民待遇	<i>Zhunruqian guomin daiyu</i>	Pre-Entry National Treatment, Pre-Access National Treatment

Terms related to Variable Interest Entities

产业政策投资限制	<i>chanye zhengce touzi xianzhi</i>	industrial policy investment restrictions
法律认可 有法律效应	<i>falü renke</i>	legal approval
	<i>you falü xiaoying</i>	have legal effect
法律风险	<i>falü fengxian</i>	legal risk
回购义务不履行的风险	<i>huigou yiwu bu lüxing de fengxian</i>	risk of non-performance of repurchase obligations
信息披露的风险)	<i>xinxi pilu de fengxian</i>	risk of information disclosure
投资款不到位的风险	<i>touzikuan bu daowei de fengxian</i>	risk of insufficient funds
“合法” 避税	<i>“hefa” bishui</i>	“legal” tax avoidance
合法逃避企业所得税	<i>“hefa” taobi qiye suodeshui</i>	“legal” evasion of corporate income tax
可变利益实体 VIE 模式 VIE 架构	<i>kebian liyi shiti</i>	Variable Interest Entity (VIE)
	<i>VIE moshi</i>	VIE model
	<i>VIE jiagou</i>	VIE structure
上海证券交易所	<i>Shanghai zhengquan jiaoyisuo</i>	Shanghai Stock Exchange (SSE)
上海证券交易所科创板, 上海证券交易所 STAR 版	<i>Shanghai zhengquan jiaoyisuo kechuangban, Shanghai zhengquan jiaoyisuo STARban</i>	SSE Science and Technology Innovation Board, SSE STAR Market, SSE STAR Board
特殊目的机构	<i>teshu mudi jigou</i>	Special Purpose Vehicle (SPV)
VIE 架构合法性	<i>VIE jiagou hefaxing</i>	legality of the VIE structure
为非法转移财产提供 捷径	<i>wei feifa zhuanyi caichan tigong jiejing</i>	shortcut for the illegal transfer of property
协议控制 vs. 股权控制	<i>xieyi kongzhi</i>	agreement control
	<i>guquan kongzhi</i>	equity control
运营控制类协议	<i>yunying kongzhilei xieyi</i>	operational control agreements
利润转移类协议	<i>lirun zhuanyilei xieyi</i>	profit transfer agreements
独家期权协议	<i>dujia qiquan xieyi</i>	exclusive option agreements
借款协议	<i>jiakuan xieyi</i>	borrowing agreements