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Research on Legal Risks and Regulatory Reform of VIE Structures in Chinese Concept Stocks

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Abstract: This paper conducts an in-depth study of the legal attributes, operational mechanisms, and risk characteristics of VIE structures in Chinese concept stocks. Research shows that VIE structures have provided an important channel for Chinese companies to raise funds overseas and have created significant economic benefits. Based on case analysis and empirical research, this paper finds that VIE structures face multiple legal risks, including contractual validity uncertainty, regulatory policy change risks, and corporate governance deficiencies. To address these issues, the paper proposes systematic reform recommendations from the dimensions of contract standardization, regulatory systems, and information disclosure. The research suggests that through building a multi-level regulatory system, improving legal frameworks, strengthening regulatory coordination, and optimizing information disclosure mechanisms, VIE structure risks can be effectively controlled, promoting the healthy development of Chinese companies' overseas listing market. The research findings have important theoretical value and practical significance for improving the regulatory system of Chinese concept stocks.

1. Introduction

Variable Interest Entities (VIEs) structure has developed into the primary architectural model for Chinese companies listing overseas. Due to legal restrictions in China's capital markets, many internet and innovative technology companies choose to register and list overseas through VIE structures[1]. Data shows that by the end of 2023, 98% of Chinese concept stock companies used VIE structures to achieve overseas financing, with cumulative financing exceeding $1.5 trillion. Since Sina pioneered the VIE structure for US listing in 2000, this model has achieved control over domestic entities through a series of contractual arrangements, circumventing foreign investment restrictions, and has expanded from the internet sector to education, healthcare, new energy, and other industries[2]. VIE structures have exposed issues such as contractual validity uncertainty, regulatory policy changes, and corporate governance deficiencies in practical operation, while differences in regulatory attitudes between China and the US have increased institutional uncertainty. This paper focuses on the legal risks faced by VIE structures, deeply explores regulatory reform paths, and provides theoretical support and policy recommendations for improving the regulatory system of Chinese concept stocks.

2. Legal Attributes and Evolution of VIE Structures

2.1 Basic Legal Framework of VIE Structures

VIE structures create a complex contractual control system. The overseas listed entity establishes a Wholly Foreign-Owned Enterprise (WFOE) in China and signs a series of control agreements with the domestic operating entity and its shareholders[3]. These control agreements include equity pledge agreements, exclusive purchase right agreements, voting rights proxy agreements, technical service agreements, and other core legal documents, forming a complete chain of contractual control.

The equity pledge agreement pledges all shares of the domestic entity to the WFOE as security for performing other control agreements. The establishment of pledge rights ensures WFOE's first-priority creditor rights over the domestic entity, enhancing the binding force of control agreements[4]. Pledge agreements typically specify pledge right realization conditions, procedures, and methods, and require registration of equity pledge with market supervision authorities, creating opposing effect against external third parties. This arrangement strengthens the stability of VIE structures from a property rights perspective.

The exclusive purchase right agreement grants WFOE or its designated entity the right to purchase all or part of the domestic entity's equity at an agreed price when legally permitted. The agreement usually stipulates an extremely low exercise price, such as 1 RMB or other nominal consideration. The purchase right agreement's setup reserves legal space for VIE structures to convert to direct shareholding models, increasing structural design flexibility. The agreement also specifies detailed equity transfer procedures, pricing mechanisms, and closing conditions, providing operational guidance for rights realization.

The voting rights proxy agreement transfers all voting rights of domestic entity shareholders to WFOE for exercise. The scope of delegation includes core corporate governance rights such as shareholders' meeting voting rights and director nomination rights. Through voting rights delegation, WFOE obtains decision-making control over the domestic entity and can lead its business management activities. The agreement typically includes irrevocable clauses to ensure the continuity and stability of the delegation relationship. This arrangement achieves substantial control over the domestic entity.

The technical service agreement stipulates that WFOE provides exclusive technical services, consulting services, etc., to the domestic entity and charges service fees. Service fees usually adopt a fixed fee plus variable fee pricing model, with the variable portion linked to the domestic entity's operating performance. Through service agreement arrangements, the domestic entity's operating profits can be transferred to WFOE, ultimately achieving interest transfer to the overseas listed entity. This design meets accounting standards requirements for consolidated statements.

2.2 Development History and Optimization of VIE Structures

Sina Corporation pioneered the VIE structure model in 2000, adopting relatively simple contractual arrangements to achieve control over domestic entities. Early VIE structures faced issues such as legal validity uncertainty and unstable control chains. The content of control agreements was relatively simple, lacking specific performance guarantee measures and dispute resolution mechanisms. This structural design exposed many risk factors in practice.

Companies like Alibaba continuously optimized VIE structure design in practice. The optimization measures mainly include several aspects: First, they added multiple guarantee mechanisms, such as establishing multi-layer equity pledges and introducing cross-guarantee arrangements. Second, they refined agreement clauses to make detailed provisions for rights, obligations, and breach of contract responsibilities of all parties. Third, they improved dispute resolution mechanisms by stipulating arbitration clauses and specifying jurisdictional courts. Fourth, they set up equity trust holdings to enhance stability of equity control. These improvement measures enhanced the legal enforceability of VIE structures.

New generation internet companies like JD.com and Pinduoduo further innovated VIE structures, with innovations including: establishing Special Purpose Vehicles (SPVs) as contractual control layers to increase structural flexibility; introducing employee stock ownership platforms to optimize incentive mechanisms; setting up multi-layer voting rights structures to strengthen founder control; improving corporate governance mechanisms to enhance independent director supervisory functions. These innovative explorations enriched the practical forms of VIE structures.

In the application process in education, healthcare, and other industries, VIE structures also underwent targeted adjustments, with industry characteristics mainly reflected in: detailing license qualification requirements to ensure operational compliance; strengthening data security protection and establishing information isolation mechanisms; improving related party transaction management to standardize interest transfer behaviors; setting up emergency plans to prevent policy risks. These adjustments enabled VIE structures to better adapt to different industry characteristics.

2.3 Analysis of Economic Effects of VIE Structures

VIE structures have created enormous economic value for Chinese companies. Through this structure, numerous Chinese companies have successfully entered international capital markets and obtained abundant development funds[5]. Taking Alibaba as an example, it achieved US stock IPO through VIE structure in 2014, raising approximately $25 billion, creating the largest IPO record globally at that time. The project drove the development of the e-commerce industry chain and created numerous employment opportunities. As of 2023, the total market value of Chinese concept stock companies using VIE structures exceeded $2 trillion, making important contributions to China's economic development.

In the internet sector, VIE structures promoted technological innovation and business model innovation. Companies increased R&D investment using overseas financing to enhance core technical capabilities. For example, ByteDance raised over $15 billion through multiple rounds of financing, achieving important breakthroughs in artificial intelligence and algorithmic recommendations. Companies like Meituan and Didi leveraged VIE structures to obtain development capital, exploring new "Internet+" business formats and promoting traditional industry digital transformation.

The education industry achieved leapfrog development through VIE structures, with educational institutions like TAL Education and New Oriental using overseas financing to expand school operations and improve teaching quality. Taking TAL Education as an example, after listing, it rapidly expanded from dozens to thousands of learning centers, with the number of students served exceeding one million. Companies increased investment in educational technology, developing intelligent teaching systems and promoting educational model innovation. VIE structures provided strong support for education industry upgrading.

The application of VIE structures in the healthcare field produced positive effects, with internet healthcare platforms like Ping An Good Doctor and WeDoctor obtaining development funds through overseas listings to promote "Internet + Healthcare" service innovation. Companies invested in building telemedicine systems and healthcare big data platforms, improving medical resource allocation efficiency. VIE structures promoted the upgrade of medical service models and improved public medical experience.

3. Legal Risks Faced by VIE Structures

3.1 Contractual Validity Risks

The legality and enforceability of VIE agreements face major challenges. According to Article 153 of the Civil Code of the People's Republic of China, contracts must not violate mandatory provisions of laws and administrative regulations. VIE agreements essentially circumvent foreign investment restrictions through contractual arrangements, risking being deemed invalid contracts that evade legal supervision. In particular, core documents such as equity pledge agreements and voting rights proxy agreements may be deemed invalid by courts for violating mandatory provisions.

Multiple cases challenging VIE agreement validity have emerged in practice. In a 2021 educational enterprise VIE dispute case, domestic entity shareholders claimed control agreements were invalid on grounds of violating foreign investment restrictions in the education sector. The case raised market concerns about VIE structure legal risks. Similar cases include a gaming company's VIE agreement validity dispute and an online education institution's control agreement controversy, reflecting the legal challenges facing VIE structures.

Control agreements face multiple implementation obstacles. VIE structures rely on the coordinated operation of multiple agreements, and failure at any link may lead to the entire control chain breaking. Domestic entity shareholders may refuse to perform agreement obligations for various reasons, such as questioning pricing mechanism fairness or denying voting rights proxy validity. WFOEs often face difficulties in evidence collection and enforcement when seeking mandatory performance. In such situations, overseas listed entities may lose actual control over domestic operations.

Judicial practice shows uncertainty in attitudes toward VIE agreements. Different courts may take different positions when handling VIE-related disputes. Some courts support VIE agreement validity based on maintaining market order and protecting transaction security; others take a negative stance on agreement validity from a strict regulatory perspective. This inconsistency in judicial practice increases VIE structure legal risks and affects companies' willingness to choose this model.

3.2 Regulatory Policy Risks

VIE structures face a complex and changing regulatory environment. Chinese regulatory authorities have long taken a tacit tolerance approach to VIE structures, without explicitly supporting or prohibiting them. This ambiguous stance leaves companies lacking clear policy guidance when adopting VIE structures. In recent years, with the introduction of new regulations such as the "Cybersecurity Review Measures" and "Data Export Security Assessment Measures," VIE structures face stricter regulatory scrutiny.

Regulatory policy changes in the internet industry significantly impact VIE structures. Since 2021, new regulations in anti-monopoly, data security, algorithm regulation, and other areas have been intensively introduced, increasing compliance costs for internet companies. For example, regulatory authorities have strengthened merger and acquisition review for platform companies, potentially affecting business expansion under VIE structures. Data export security assessment requirements have set new thresholds for cross-border data flows.

Policy adjustments in the education sector have triggered VIE structure turbulence. After the implementation of the "Double Reduction" policy in 2021, many education-sector Chinese concept stocks faced business adjustment pressure. The policy requires subject-based training institutions for compulsory education to register as non-profit organizations, conflicting with VIE structures' commercial nature. Some companies were forced to terminate VIE agreements and undergo business restructuring. This case demonstrates how industrial policy changes can trigger VIE structure disruptions.

Cross-border regulatory differences bring additional challenges. Chinese and U.S. regulatory authorities show significant differences in regulatory focus and requirements for VIE structures. The U.S. Securities and Exchange Commission (SEC) emphasizes information disclosure adequacy, requiring companies to detail VIE structure risks. Chinese regulators focus on data security and industrial security aspects. In recent years, the SEC has increased scrutiny of Chinese concept stocks, requiring more detailed control agreement documents and risk statements. Chinese regulators have introduced overseas listing filing systems, strengthening VIE structure supervision. These regulatory differences subject companies to dual compliance pressures.

Financial regulatory policy changes increase uncertainty. Policy documents such as "Several Opinions on Strengthening the Supervision of Domestic Companies' Overseas Listings" impose new requirements on VIE structure companies. Companies must explain control agreement arrangements, equity structures, and fund operations to regulatory authorities. Policy adjustments in foreign exchange management and cross-border fund flows may affect VIE structure operational efficiency. These regulatory policy changes require companies to continuously adjust compliance strategies.

3.3 Corporate Governance Risks

VIE structures have special characteristics in corporate governance. The contractual control model complicates corporate governance structures, and the establishment of multiple legal entities increases agency costs. Special attention must be paid to related party transactions and interest transfers between WFOEs and domestic entities. Control agreement execution relies on good faith performance by all parties, and governance mechanism defects may threaten structural stability.

Multiple cases of corporate governance failure have been exposed in practice. An internet company faced shareholder litigation due to unfair pricing of related party transactions between WFOE and domestic entities. An education institution's actual controller achieved interest transfer by adjusting service fee pricing, harming listed company interests. Such cases reflect governance mechanism loopholes under VIE structures.

Control right disputes intensify governance risks. Control rights under VIE structures are achieved through multi-layer agreement arrangements and easily trigger disputes. For example, an e-commerce platform's founders and investors disputed voting rights exercise, affecting normal operations. Control rights disputes at an online education institution led to domestic entity shareholders refusing to perform agreements, triggering operational crisis. Such situations show insufficient control rights stability in VIE structures.

Information disclosure quality faces challenges. VIE structures increase companies' information disclosure difficulties. Financial data and operational information of domestic entities must be transmitted through multiple structural layers, potentially affecting information timeliness and accuracy. Some companies have inadequate or inaccurate information disclosure issues. For example, one company failed to truthfully disclose major litigation information of domestic entities, causing investor losses.

Shareholder rights protection mechanisms are imperfect. Under VIE structures, foreign investors actually own contractual control rights rather than direct equity. This arrangement restricts shareholders from exercising certain basic rights, such as reviewing domestic entity archives or directly participating in major decisions. Investors face obstacles in supervising domestic operations, increasing investment risks. For instance, minority shareholders of a gaming company could not obtain detailed financial information of domestic entities, affecting their investment decisions.

4. The regulatory reform ideas for VIE structure

4.1 Improving Legal Framework

Regulatory authorities should establish a specialized legal regulatory system. Legislative bodies should formulate specialized laws for VIE structures, clarifying their legal status. Legal regulations should cover core content such as VIE agreement validity determination standards, performance guarantee mechanisms, and dispute resolution procedures. It is recommended to add special chapters on VIE structures in the Company Law and Securities Law to provide clear legal basis for their operation.

Regulatory authorities should formulate specific regulatory documents. The CSRC, Ministry of Commerce, and other departments should issue VIE structure regulatory rules specifying concrete operational standards. Rules should clarify entry conditions, approval procedures, information disclosure requirements, and other content. For example, formulate "Administrative Measures for Overseas Listing of VIE Structure Companies" to unify regulatory standards and procedures.

It is suggested that the Supreme People's Court improve the judicial interpretation system. The Supreme People's Court can issue judicial interpretations regarding VIE structure dispute cases to unify judgment standards. Interpretations should clarify VIE agreement validity determination rules, dispute resolution principles, liability assumption methods, and other issues. The Supreme People's Court should increase legal application certainty through judicial interpretations to protect legitimate rights and interests of all parties.

4.2 Building Multi-level Regulatory System

It is suggested that relevant departments strengthen regulatory coordination mechanisms. It is suggested that the CSRC, State Administration of Foreign Exchange, Cyberspace Administration, and other departments establish coordination mechanisms to form regulatory synergy. The relevant departments should set up VIE structure company regulatory work leadership groups to coordinate work among departments. The relevant departments should establish information sharing platforms to achieve regulatory data interconnection. Chinese and U.S. regulatory authorities should strengthen cooperation by signing regulatory cooperation memorandums.

It is suggested that regulatory authorities improve the information disclosure system. The regulatory authorities should develop special information disclosure guidelines for VIE structures, refining disclosure requirements. Listed companies should disclose detailed control agreement content, risk factors, internal control measures, and other information. The regulatory authorities should establish quarterly reporting system to strengthen continuous information disclosure. The regulatory authorities should set up risk warning mechanisms to timely discover and prevent problems.

It is suggested that regulatory authorities enhance corporate governance supervision. The regulatory authorities should require VIE structure companies to establish sound internal control systems and standardize related party transaction management. VIE structure companies should strengthen independent director systems to exert external supervision functions. The regulatory authorities should perfect shareholder rights protection mechanisms to safeguard minority investor interests. The regulatory authorities should establish corporate governance evaluation systems to promote standardized operations.

4.3 Optimizing Market Regulatory Mechanisms

It is suggested that regulatory authorities establish market-based exit mechanisms. The regulatory authorities should design orderly exit procedures for VIE structures, clarifying trigger conditions and operational processes. The regulatory authorities should formulate emergency response plans to prevent systemic risks. The regulatory authorities should establish investor protection funds to provide necessary compensation for delisted company investors. The relevant departments should improve cross-border bankruptcy systems to handle various interest relationships appropriately.

It is suggested that regulatory authorities perfect incentive and constraint mechanisms. The regulatory authorities should provide policy support to companies complying with regulatory requirements, such as simplifying approval procedures and providing financing conveniences. The regulatory authorities should implement strict penalties for violations, such as restricting refinancing or suspending listing. The regulatory authorities should establish credit evaluation systems linking company compliance with market access. The regulatory authorities should promote standardized operations through market-based means.

It is suggested that regulatory authorities innovate regulatory technical means. The regulatory authorities should use big data, artificial intelligence, and other technologies to enhance regulatory effectiveness. The regulatory authorities should build VIE structure company regulatory databases to achieve real-time monitoring. The regulatory authorities should develop intelligent risk control systems to improve risk identification capabilities. The regulatory authorities should promote blockchain technology applications to strengthen information traceability management. The regulatory authorities should leverage technological means to enhance regulatory levels.

5. Conclusion

VIE structures, as important tools for Chinese companies' overseas listings, have played a positive role in promoting economic development. Through in-depth analysis of VIE structures' legal attributes, operational mechanisms, and risk characteristics, this paper finds significant risks in contract validity, regulatory policy, corporate governance, and other aspects. To address these issues, the research proposes reform recommendations including accelerating specialized legislation for VIE structures, improving multi-department coordinated regulatory mechanisms, perfecting information disclosure systems, and innovating regulatory technical means. Regulatory authorities should, through advancing legal system improvements, constructing multi-level regulatory systems, optimizing market mechanisms, and other systematic reforms, regulate VIE structure operations and promote healthy development of Chinese companies' overseas listing market. Subsequent research suggests strengthening empirical analysis, expanding sample scope, deepening policy effect evaluation, to provide stronger theoretical support for improving VIE structure regulatory systems.

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