Accounting Matters — Guest Series

The Three Terrors of Investors in Chinese Stocks

25 July, 2013

Poor share performance of overseas listed Chinese companies is partly due to accounting fraud, regulatory holes, and variable interest entities (VIEs). Authorities appear to have pulled back from the most extreme possibility, to delist them all; however, the current situation means that these companies will be subject to lower levels of regulatory supervision and structured through contracts unenforceable in Chinese courts. Around 1-in-5 has been delisted owing to fraud; how many more to go?

Accounting fraud

A recent McKinsey study shows that about one in five Chinese companies listed overseas has been delisted, mostly a consequence of fraud allegations. Companies with back door listings were particularly prone to fraud as they were able to avoid IPO due diligence. Fortunately, new rules have placed these under greater scrutiny. Recent short selling attacks have failed perhaps suggesting that the low hanging fruit has been picked. However, there are still regulatory holes….

Regulatory holes

US listed Chinese companies are subject to far lower levels of regulatory oversight than other US listed securities and the potential for fraud remains. At one stage it looked like all Chinese companies listed in the US would have to de-list but this threat has receded since China ceded enough to defuse the situation. While the Chinese will send working papers on frauds upon request to SEC investigators, they will not conduct joint inspections of audit performance with the PCAOB. An uneasy status quo has been reached.

Variable interest entities

Many overseas listed Chinese companies use VIE structures in an attempt to circumvent Chinese foreign ownership restrictions. While Chinese law courts do not have to follow precedent, a number of past cases suggest that Chinese courts will not reinforce the VIE contracts. In other words, VIEs are becoming unsustainable. For Chinese regulators, the easier path is simply to allow the structures to continue to be used, but to declare them void whenever they are challenged. This presents a substantial risk to investors. However, as long as investors continue to buy shares in companies that use this structure, its use will likely continue.

About the author

Paul Gillis is Professor of Practice and co-director of the IMBA program at Peking University's Guanghua School of Management and is a member of the PCAOB's Standing Advisory Group. He was a partner at PWC until 2004. Professor Gillis has lived in China for 16 years and his research focuses on transnational accounting regulation.

Forensic Asia
1801-02, Wing On House
71 Des Voeux Road
Central, Hong Kong

Regulated by the **SECURITIES AND FUTURES COMMISSION** of Hong Kong

Paul L. Gillis, PhD, CPA
Guanghua School of Management
Peking University
Beijing, China
paulgillis@me.com

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Introduction

China has been on an amazing run for the past 20 years, as its economy surged to become the world's second largest. Investors, however, have done poorly. Bloomberg[1] reported that Chinese stocks available to foreigners have returned less than 1% per year over the past 20 years, as Figure 1 shows. U.S. listed Chinese stocks have fared even worse in recent years. According to an analysis by McKinsey[2], The aggregate market capitalization of US-listed Chinese companies fell in 2011 and 2012 by 72%—and around one in five was delisted. Unsurprisingly, investors have lost most of their appetite for Chinese stocks, and the IPO markets for Chinese companies are moribund.

Chinese economy has done well but not reflected in stock market performance

In my view, three major factors explain the poor performance of US-listed Chinese stocks – accounting fraud, regulatory holes, and variable interest entities. These issues continue to hang over the market. This research note will update the status of these issues.

This is down to accounting fraud, regulatory holes and VIE structures

Figure 1: Hong Kong China Enterprises Index: 1994-2013

Source: Gillem Tulloch

Accounting Fraud

First and foremost has been the large number of accounting frauds and governance scandals associated with these companies. Overseas listed Chinese stocks have been badly shaken by a series of accounting and governance scandals. While there had been earlier cases, I like to point to Muddy Water's successful attack on Rino International (RINO US) in November of 2010 as marking the beginning of the crisis. As the McKinsey studies shows, about one in five of these companies have been delisted, mostly a consequence of fraud allegations by short sellers who have found easy targets.

One in five overseas listed Chinese companies delisted mostly as a consequence of fraud

[1] http://tinyurl.com/ppqsqa4
[2] http://tinyurl.com/nen2855

Figure 2: Rino International: 2008-2013

Source: Gillem Tulloch

Early frauds predictable and should have been found earlier

In the early stages of the crisis few companies survived short-seller allegations. The script became predictable – a short seller would allege fraud, the auditor would recheck the bank balances and resign, and then the company would be delisted. The frauds were poorly concealed and easily found. If the auditors had been paying attention, they should have found the frauds earlier.

Frauds within reverse mergers were common as able to avoid IPO due diligence…

…new rules have made this more difficult

Many of the alleged frauds were companies that had come to market though reverse mergers. A reverse merger involves a Chinese company merging into an already public shell company, avoiding the customary due diligence conducted for an IPO. Reverse mergers were a cheap and quick way to get shares into the hands of investors hungry for Chinese stocks. The lack of due diligence and regulatory oversight created an environment that was ripe for fraud. NASDAQ and the NYSE modified their rules to require a seasoning period before they would list reverse mergers. The seasoning period gives time for regulators and auditors to examine the company's filings before the stock is traded. As a consequence of these new rules, there is no longer any significant advantage to a reverse merger over a traditional IPO and they have stopped coming to the market. Many existing reverse mergers have "gone dark," stopping required filings, and the SEC deregisters a half a dozen or more every month.

Recent short selling attacks have failed

Recent short seller attacks on Chinese companies have mostly failed. Citron Research attacked Qihoo 360 in November 2011 when the stock was trading at $20. Today it trades at over $55. Companies have learned how to fight back, and perhaps all of the low hanging fruit has already been picked. There will not be a seminal event to herald the end of accounting fraud in China. Regaining investor confidence will be a long process, and there have been sufficient numbers of new cases such as Caterpillar's Siwei disaster and Ambow Education's (AMBO US) receivership to keep investors on the sidelines.

Figure 3: Qihoo 360 Technology: 2011-2013

Source: Gillem Tulloch

Regulatory Holes

Use offshore holding companies to avoid Chinese regulation

Related to the flood of accounting scandals have been regulatory holes that allow fraudulent companies to avoid supervision by the regulators assigned to protect investors. The companies cleverly structured themselves by using offshore holding companies, typically organized in the Cayman Islands, to get themselves out from under Chinese regulation. Because these are foreign companies, the China Securities Regulatory Commission (CSRC) has no regulatory authority over them.

Companies listed in the US come under SEC regulation but difficult to regulate the audit

Companies that list in the United States fall under the regulatory jurisdiction of the Securities and Exchange Commission (SEC). All companies listed in the United States must have independent auditors, and the Public Company Accounting Oversight Board (PCAOB) regulates the auditors. But these regulators have been hamstrung in their attempts to regulate U.S. listed Chinese companies.

Chinese authorities do not permit the SEC to come into China to conduct investigations

When the accounting scandals began to break both the SEC and the PCAOB sprang into action, but both immediately ran into roadblocks. The SEC has found it difficult to investigate the rash of accounting frauds in China. The alleged perpetrators are usually in China, and Chinese authorities do not permit the SEC to come to China to conduct investigations. While China has agreed to share information with the SEC under the terms of its membership in the International Organization of Security Commissions (IOSCO), the SEC has found such sharing to be elusive. The PCAOB has also been blocked from coming to China to conduct required inspections of the audit quality of Chinese auditors that sign off on U.S. listings.

As a consequence of this stand-off, investors have not received normal protection

As a consequence of the standoff between U.S. and Chinese regulators, the normal protections of U.S. securities laws for investors in U.S. listed Chinese companies have not been available. The SEC and the PCAOB have been unable to effectively enforce U.S. securities laws. U.S. listed Chinese companies have been operating in a regulatory hole, a place where neither U.S. nor Chinese regulators can watch them. Unsurprisingly, regulatory holes attract

unscrupulous people. What better place to commit a crime than a place with no policemen?

SEC against the accounting firms

Blocked in efforts to obtain documents from China, the SEC turned its attention to the large international accounting firms and demanded that they hand over their working papers on suspected frauds. Accounting firms are required by U.S. law to cooperate with the SEC on such matters. The accounting firms refused, saying that Chinese regulators had told them that any Chinese accountant who gave working papers to a foreign regulator would be violating Chinese laws, including those related to state secrets. The penalty for doing so might be life in prison for the responsible partner and expulsion from China for the firm.

SEC demanded that auditors hand over working papers but accounting firms refused given Chinese government penalties

Deloitte received a subpoena from the SEC demanding it turn over its working papers related to Longtop Financial Technologies (Longtop, LGFTY US). Longtop had collapsed under fraud allegations. Deloitte refused, citing the grounds above, and the SEC then brought suit in federal court seeking enforcement of the subpoena.

SEC then brought a suit against Deloitte over Longtop

Figure 4: Longtop Financial: 2008-2013

Source: Gillem Tulloch

The SEC also made requests for working papers from each of the Big Four, and also from a Chinese accounting firm that was then affiliated with BDO, a second-tier international network. The firms all refused, citing Chinese restrictions. In December 2012, the SEC filed administrative charges against the firms for failure to cooperate. If the SEC wins the case, it may seek to ban the firms from auditing U.S. listed companies. That could leave the firm's clients in the lurch. All listed companies are required to have auditors that are registered with the PCAOB and which have the right to practice before the SEC. If the SEC banned the auditors, their clients might be unable to find auditors. Not having an auditor would lead to delisting of the securities.

All major auditors have refused to hand over Chinese working papers to the SEC which means they could be banned from auditing US listed companies

The U.S. Chamber of Commerce fretted over the broad reaching implications of disqualifying the Chinese auditors. Most multinational corporations (MNCs) have significant operations in China, and a ban on auditing U.S. listed companies for Chinese auditors might make it difficult for these MNCs to issue accounts.

This is a problem for US MNCs with Chinese operations

A similar case developed in Hong Kong when Ernst & Young refused to turn over audit working papers to the Securities and Futures Commission. That case has been working its way through the Hong Kong courts.

Similar cases are emerging in Hong Kong

All legal processes in the Longtop case appear to be complete and the judge could rule at any time. The SEC case against the accounting firms was the subject of a public hearing during the week of July 8, 2013. A decision is due by the end of September.

A ruling is imminent on the Longtop case

PCAOB Inspections

Over 50 Chinese accounting firms have registered with the PCAOB to do audits of U.S. listed companies, including the local member firms of the Big Four. Under PCAOB rules, these firms are to be inspected every three years to determine whether they are conducting their audits following PCAOB standards. No inspections in China have taken place.

The PCAOB has been unable to audit any Chinese accounting firms registered with it

When the PCAOB attempted to come to China to inspect Chinese accounting firms that audit U.S. listed companies, Chinese regulators blocked them. Chinese regulators said that they could not allow foreign regulators to enforce foreign laws on Chinese soil against Chinese people. They had been down that road before, during the Opium Wars and Japanese Occupation, and it had not worked out well for China. In the view of Chinese regulators, such activity would interfere with China's national sovereignty. Negotiations for access have been going on for nearly a decade.

The Chinese claim these inspections are a violation of its sovereignty

The PCAOB faced similar objections in many other countries in the world, yet nearly all have been resolved by agreement to conduct joint inspections with local regulators. The PCAOB made that offer to the CSRC and the Ministry of Finance, who jointly regulate the accounting profession in China. The Chinese regulators rejected the offer. Instead, in October, 2012, the Chinese regulators allowed the PCAOB to observe the work of Chinese regulators when they evaluated the internal processes of Ernst & Young. The PCAOB was not permitted to examine working papers, which is the primary activity in PCAOB inspections. Chinese regulators hoped to convince the PCAOB that its regulatory efforts were robust, and that the PCAOB could rely upon their work rather than conducting their own inspections. China has reached an agreement with EU regulators for regulatory equivalency, allowing EU accounting regulators to rely on the work of the CSRC and MOF. The PCAOB does not recognize regulatory equivalency and insists on joint inspections at a minimum.

The PCAOB requires joint inspections at a minimum but the Chinese are only willing to let it observe

The SEC does not recognise regulatory equivalency, similar to China's agreement with the EU

On May 7, 2013, the PCAOB, CSRC, and MOF announced they had entered into a memorandum of understanding (MOU) that would allow for the sharing of certain information in connection with enforcement activities. Enforcement activities are a small part of the PCAOB's agenda, with only 11 sanctions handed out last year. The major responsibility of the PCAOB is to conduct inspections, and the MOU does not allow for PCAOB inspections, either by the PCAOB itself or jointly with Chinese regulators.

Some ground has been made but only at the margin

Strategic and Economic Dialogue

For the past eight years, the United States and China have held a Strategic and Economic Dialogue (SED) to discuss important issues in the relationship of the two countries. The issue of accounting regulation has been on the agenda for the past several years.

Accounting issues discussed at the SED

This year's meeting was held the week of July 8th in Washington. Prior to the meeting, Chinese regulators announced they were preparing to release certain working papers to the SEC. The SEC confirmed that in the public hearing held the same week in the case against the Big Four firms, noting that the CSRC had asked the SEC to send money for postage before sending the 20 boxes of working papers related to Longtop.

Chinese released 20 boxes of working papers on Longtop to the SEC…and sent it the postage bill!

No further breakthrough on accounting regulation happened at the SED. Secretary of Treasury Jacob Lew observed that the Chinese had agreed to begin releasing auditing working papers, but said that the issue was highly technical. Most notably, no deal was announced for PCAOB inspections. PCAOB spokesperson Colleen Brennan told Reuters that while the announcement of the release of working papers to the SEC was a positive step forward, the PCAOB wanted to strike a second agreement with the Chinese to allow for inspections as well.

Deadlock remains

Prospects for further deals

In testimony at the SEC's Big Four hearing on July 11, 2013 Alberto Arevalo, an official in the SEC's international affairs office testified that Chinese officials had promised to provide documents in connection with 23 requests over previous years and had yet to follow through. Arevelo said he did not see how getting records through the CSRC was a viable option for the SEC. I don't think that the SEC is going to get any other options.

The SEC wants more than just getting access to just records

China seems to have prevailed in the negotiations with U.S. regulators. The delivery of the Longtop working papers should quickly lead to dismissal of the action against Deloitte. I expect that the CSRC will soon release the working papers in the other cases that have led to charges against the Big Four and BDO, and release the working papers in the similar case in Hong Kong. The firms will then undoubtedly ask that the case against them be dismissed. Technically, the SEC could continue the case, since it is seeking to punish the firms for not producing the working papers when it first asked for them, but I don't expect the SEC will do that. I think it will reluctantly agree to dismiss the case, reserving the right to charge the firms anew should the CSRC object to them producing any papers in the future. The CSRC has placed themselves as gatekeepers to China for the SEC, and while the SEC finds that unacceptable, it may not be able to do much about it. China has likely conceded just enough to take the nuclear option off the table. The nuclear option would be removing the practice rights of the accounting firms before the SEC, effectively delisting Chinese stocks from U.S. exchanges.

The provision of working papers means that the case against Deloitte is likely to be dismissed but the CSRC is now the gatekeeper to China for the SEC

China has likely ceded enough to force the delisting of Chinese stocks from US Exchanges

China has also outmanoeuvred the PCAOB. The announcement of the MOU on sharing documents in conjunction with inspections has convinced investors that the nuclear option of the PCAOB deregistering accounting firms is off the table. I also believe that it is now politically impossible for the PCAOB to exercise its nuclear option of deregistering the firms it cannot inspect. Without the leverage of the nuclear option, I think it is unlikely that Chinese regulators are going to move much further on joint inspections. They may allow for further observation of Chinese inspections, but it is clear that Chinese regulators have drawn a line in the sand – they will decide when and if U.S. regulators see any documents from China.

Chinese will not concede on joint inspections

How did this happen?

The PCAOB has run out of political capital, and I believe it could not take an action that might lead to the delisting of Chinese companies from U.S. stock exchanges. Law firms, investment banks, and accounting firms have more influence than the PCAOB, and they all have an interest in keeping U.S. markets open to Chinese companies. Recent legislative actions illustrate the diminishing political capital of the PCAOB.

The PCAOB has been outmanoeuvred by law firms and investment banks that all have an interest in keeping US markets open to the Chinese

The House of Representatives passed a bill on July 8 to forbid the PCAOB from adopting a rule to require auditor rotation. The bill passed with a vote of 321-62 but faces an uncertain future in the Senate. The House vote was unsurprising given that accounting industry political action committees have contributed $19 million to members of Congress since 2007. This is the second time that U.S. lawmakers have attempted to hamstring the PCAOB. The Jobs Act allows an exemption for certain companies from new rules that might be proposed by the PCAOB.

Lobbying appears to have scuppered the auditor rotation bill in the US

Auditor rotation is strongly opposed by the Big Four accounting firms and by many of their clients. Auditors are rarely rotated in practice, and some companies have used the same auditors for a century. According to a 2011 PCAOB study, the average audit tenure in the U.S. is 28 years. Critics say that impairs the auditor objectivity. The firms argue that partners are regularly rotated, and that ensures that the engagements get a fresh pair of eyes on a periodic basis. They argue that auditor rotation would be expensive, and would impair, rather than improve audit quality.

Auditor rotation is opposed by the Big $ and many of their clients

The PCAOB had not even proposed that auditors be rotated. They had simply put the issue on the table for discussion. But the accounting firms turned on their lobbying machines to make certain that a proposal never surfaced. It is shameful behavior for Congress to create a regulator but then bar that regulator from finding ways to do the job it is tasked to do.

Congress turned on its own regulator

The debacle over auditor rotation (and the earlier Jobs Act), when coupled with the standoff in China, call into question the relevance of the PCAOB. Congress is unwilling to allow the PCAOB to consider unpopular positions that might improve audit quality. Is Congress really interested in protecting investors, or is it more focused on protecting powerful lobbies that make large campaign contributions?

Relevance of the PCAOB brought into question

What does it mean for investors?

Effective enforcement of U.S. securities laws is one of the promises made to investors in securities listed on U.S. stock exchanges. In China these promises have been broken. While recent agreements may improve the ability of the SEC to enforce U.S. securities laws, and for the PCAOB to help head off accounting scandals by improving audit performance, the situation will remain inferior to the protection provided on other U.S. listed securities. I do not see that situation changing, and investors must consider Chinese securities to be of higher risk than other securities traded on U.S. exchanges.

Chinese securities listed in the US will have inferior supervision….

I expect that the CSRC will soon reach a deal with Hong Kong's SFC to settle the case against E&Y. The MOU with the PCAOB sets precedent for that deal.

The good news for investors is that the risk of a mass delisting of U.S. listed Chinese companies now seems remote. It does not appear to me that either the SEC or the PCAOB has the stomach for this fight.

…but the good news is that a mass delisting appears unlikely

Variable Interest Entities

China restricts foreign investment in certain sectors of its economy, including two sectors of particular interest to foreign investors: internet and education. Chinese entrepreneurs found a clever way, the variable interest entity (VIE), to evade these restrictions and allow companies in restricted sectors to list overseas and sell shares to foreigners.

China restricts foreign investment from key sectors such as education and internet

The term "VIE" comes from an American accounting standard that was introduced in response to the Enron crisis. Enron, like many companies at the time, made extensive use of off balance sheet financing. To do this they formed a company (a VIE) that was not owned by Enron, but rather by its treasurer, Andy Fastow. While Enron remained on the hook for the debt, it was not required to consolidate Andy Fastow's company because accounting rules at the time required ownership of more than 50% of the shares before consolidation was allowed. Accounting standard setters reacted to Enron's collapse by introducing VIE accounting rules that forced companies to consolidate the VIEs, putting the debt back on the balance sheet.

VIEs formed to overcome these restrictions

Chinese entrepreneurs used the new VIE accounting rules in reverse. While the VIE rules were intended to put debt back on balance sheets, Chinese companies used the same rules to put assets of companies they did not own on their balance sheets.

Used in China to put assets not owned on the balance sheet

A Chinese VIE is a company that is owned by Chinese individuals, but is controlled through a series of contracts by a publicly listed company. Because Chinese laws prohibit foreign investment in restricted sectors, the VIE contracts arguably avoid the restrictions on foreign investment because there is no actual foreign ownership. Investors would have been wise to stop right there – no actual ownership – means what it says. Because the contracts assign most of the benefits of ownership to the public company, the VIE accounting rules allow the company to be consolidated in the financial statements. VIEs are widely used; half of U.S. listed Chinese companies use the structure, as do many multinational corporations.

Most of the benefits accrue to the public company

VIEs are widely used

Control through contract is usually inferior to control through ownership, and many investors in Chinese VIEs have painfully learned this lesson. Over the past few years, several VIE arrangements have cost investors dearly. The most significant was when Alipay was restructured into a VIE and then taken out of the Alibaba Group, shocking Yahoo!, who owned 40% of Alibaba. In the Alipay case, Chinese regulators are said to have refused to grant a third party payment processor license unless the VIE arrangements were terminated.

Control through contract is inferior to control through ownership as investors have found out at their expense

The Alipay case, and several other problems with VIEs made investors aware of the risk associated with the structure. Several recent cases heighten that concern.

Nina Wang was a legendary Hong Kong tycooness who became Asia's richest woman after her husband disappeared and she took over the ChinaChem empire. She wanted to invest in China Minsheng Bank, but direct ownership of a Chinese bank by a Hong Kong person was not permitted. So ChinaChem loaned funds to a Chinese company that purchased the ChinaChem shares. The loan agreements provided that the interest on the loan would be equal to the dividends on the shares. Soon thereafter the Chinese company began to ignore the loan agreements and failed to turn over the dividends. ChinaChem sued,

The Nina Wang case with Minsheng Bank (2012) shows that the Chinese are not tolerant of structures aimed to circumvent foreign investment rules

and the case worked its way through China's courts for the last dozen years. In late 2012, China's Supreme People's Court ruled the agreements invalid because they were designed to circumvent China's foreign investment rules and accordingly "concealed illegal intentions with a lawful form".

Chinese courts are not required to follow precedent but this is an insightful case

China has a civil law system, as opposed to the common law system used in many Western countries. Court decisions, even Supreme Court decisions, have no precedential value in a civil law system, and lawyers promoting the VIE structure are quick to point out that the court is not bound by this decision in future cases that may come before it. Most VIEs in use today are structured differently than Nina Wang's investment in Minsheng Bank. However, it is apparent that all VIE structures are designed to circumvent China's foreign investment rules and could be argued to be "concealing illegal intentions with a lawful form".

Two other cases involving gaming companies also ruled against VIE structures

Two other cases were addressed in arbitration. In 2010 and 2011 the China International Economic and Trade Commission (CIETC) Shanghai ruled in two related cases that VIE agreements for an online game operating company were void because they violated regulations that prohibit the use of VIE structures in that industry. All online game operators that I am aware of use the VIE structure. The prohibition of VIE investment in online games comes from Circular 13 that was promulgated by several Chinese regulators. I have seen a legal analysis by a law firm that seems to argue that the Circular can be ignored because it did not include all regulators and did not come from the State Council. Good luck with that.

Becoming clear that the VIE structure is unsustainable

So where are we with VIEs? It is becoming clear that the VIE structure is unsustainable. It will work unless its validity is called into question, and then it will fail. Lawyers will continue to bless the VIE structure, but the caveats in their opinions will become longer and stronger. The VIE is simply too important to the ecosystem of Chinese lawyers and accountants for anyone to declare the game over. Use of the VIE requires application of the greater fool theory. VIE investments will work fine, as long as you exit the investment before the contracts need to be enforced. Hold the investment too long, and you may be wiped out.

Chinese regulators unlikely to shut down the structure but instead react when someone tries to enforce a contact

I believe it is becoming clearer how Chinese regulators plan to deal with the VIE. I do not expect them to aggressively shut down use of the structure. Instead, Chinese regulators will react when they are forced to, which will usually be when someone tries to enforce a VIE contract. Then, the courts and regulators will retreat to the rule of law, and find the contracts void. Investors will be wiped out, but they have been warned, and they should have seen this coming. Most VIEs, however, will be able to continue to operate so long as they can avoid a controversy over the enforceability of the contracts.

Companies can mitigate the risk

If Chinese regulators do not intervene, I expect VIEs will continue to be used until investors stop buying shares in companies that use them. Companies can help manage the risk by minimizing the amount of business that is conducted in the VIE. Some companies do this already, while others operate the entire business in the VIE. A few have restructured operations to move businesses formerly operated in VIEs to wholly owned subsidiaries, which is the best alternative, albeit not one available to companies operating in restricted sectors.

The solution to the VIE problem requires changes in China's foreign investment regime. The present rules that restrict foreign ownership were intended to prevent foreign control of sensitive industries. However, these sensitive industries needed foreign capital in order to develop. In the case of internet companies, China's own stock market is unlikely to be able to provide capital for these companies, since they typically list before they have established the necessary track record to list in China. The better alternative for China would be to change the focus of the foreign investment rules to control instead of ownership. Doing so would concentrate on making certain that Chinese remain in control of sensitive decisions. That can be accomplished with two classes of shares – Class A with voting rights that can only be owned by Chinese, and Class B with equal rights other than voting that can be owned by foreigners. Many U.S. listed Chinese companies (and many tech companies in general) already use this structure. Multiclass structures are not ideal from a corporate governance perspective, but this solution would allow the public company to actually own the VIE, which in my view is more important.

The solution to the VIE problem requires changes in China's foreign investment regime to change the focus of the foreign investment rules to control instead of ownership…

…maybe through different share classes

Moving to a control based foreign investment regime would require changes beyond the foreign investment rules. Chinese corporate law currently does not allow multiple share class structures. While offshore parent companies could still be used for this purpose, Chinese regulators would be wise to reform corporate law so that Chinese companies can directly list abroad instead of using foreign holding companies. That would bring overseas listed Chinese companies firmly under the control of Chinese regulators. I suggest that the CSRC be appointed the gatekeeper for all Chinese companies that choose to list abroad. The CSRC could block unscrupulous companies and those that are too sensitive to national security from listing, while working with foreign regulators to make certain those that do follow the rules. Investors and Chinese regulators both win in that scenario.

Chinese corporate law does not allow multiple share classes so would need to change the law

Would also need to allow companies to list overseas which would bring companies firmly under Chinese regulatory authority

I expect that reform to the VIE will be slow in coming. Any attempt to reform the foreign investment rules will undoubtedly stir up opposition from those opposed to foreign investment in these sectors in the first place. Here the debate becomes similar to the current U.S. debate over immigration. Why provide amnesty to the lawbreakers, why not just enforce the laws and deport them? For Chinese regulators, the easier path is simply to allow the structures to continue to be used, but to declare them void whenever they are challenged. As long as investors continue to buy shares in companies that use this structure, I expect its use will continue.

Change is likely to be very slow and instead

Allow current structures to be used and declare them void whenever challenged