

**CHINA VIE STRUCTURE FOR FOREIGN INVESTMENT
UNDER ATTACK FROM MULTIPLE DIRECTIONS: WILL IT
EMERGE (RELATIVELY) UNSCATHED OR IS ITS VERY
SURVIVAL THREATENED?**

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Further information

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1. INTRODUCTION-WHAT IS A VIE STRUCTURE?

Historically the VIE structure and its predecessors essentially came about as a "workaround" to allow indirect non-equity based "investment" in industries in China in which foreign investment was restricted or prohibited, e.g., telecommunications services and media. For those with long memories, the Chinese-Chinese-Foreign (中-中-外) ("**C-C-F**") structure was initially thought up by China Unicom to get round the then prohibition on foreign investment to establish various mobile telecommunication ventures involving foreign investment in the 1990s. The structure was declared "irregular" in 1998, but has since re-emerged in various forms and guises. It was notably adopted by various Chinese Internet-based companies including Sina in its 2000 listing on NASDAQ to allow them to list overseas, despite industry restrictions on foreign investment. This transaction was particularly notable as it was reported that the then industry regulator, the Ministry of Information Industry ("**MII**") issued an opinion to the Administration of Industry and Commerce recognising the spin-off of Sina's Internet Content Provider business to a domestic company and granting permission for the newly-incorporated domestic entity to be issued an Internet-related operating permit as part of the pre-IPO restructuring, perhaps the closest MII has ever got to approving the structure. A slightly modified form of the structure was subsequently renamed the Variable Interest Entity ("**VIE**") structure.¹

The VIE structure uses various contractual arrangements to avoid direct foreign ownership that would trigger restrictions (e.g. a cap on foreign investment of 50% in Value Added Telecommunications Services ("**VATS**") and 49% in Basic Telecommunications Services ("**BTS**")) or a prohibition (e.g. on ownership of broadcast radio or TV networks, news websites, networked audio-visual programming services or Internet cafes), not to mention government approvals.

Under the typical VIE structure, founders who have retained Chinese nationality remain registered as shareholders of the domestic capital company holding the required licenses and permits ("**Permits**") needed for the business in question to operate ("**OpCo**"). These Permits can typically only be obtained by a domestic capital company, or, at the very least, would be very difficult and/or time consuming for a company with foreign investment to obtain. The contractual arrangements effectively transfer the actual control and economic benefits of the business of the OpCo from the registered shareholders to a wholly foreign-owned enterprise ("**WFOE**") separately established by the offshore holding company ("**HoldCo**") set up by the founders for offshore financing purposes.

A typical structure chart is attached in Appendix A. The contractual arrangements often include the following elements (although there are many variants):

- A cooperation agreement or technical services agreement between the WFOE and OpCo, whereby the OpCo's revenue and profits are transferred to the WFOE, typically as service fees, and then repatriated to the HoldCo as profits;
- A voting proxy from the registered shareholders of the OpCo granting the HoldCo or its affiliates the right to exercise shareholders' rights and management control over the operations of the OpCo;

¹ The structure is also sometimes referred to as the "Sina structure" or a "contractual (control) arrangement".

- An equity pledge agreement between the OpCo's registered shareholders and the WFOE as security for the proper performance of the contractual arrangement; and
- An option agreement granting the HoldCo or its affiliates the right to acquire, if and when permitted by PRC law, the equity interests in and/or assets of the OpCo for the lowest possible permitted price.

Whilst the initial role of the VIE structure was to circumvent foreign investment restrictions, that role expanded exponentially with the promulgation of the *People's Republic of China Provisions on the Merger or Acquisition of Enterprises in China by Foreign Investors*² (the "**M&A Rules**"), which imposed a new set of restrictions on cross-border acquisitions of domestic capital companies, often carried out in relation to an (overseas-listing-related) pre-IPO restructuring.

Article 11 of the M&A Rules provides that where a company, enterprise, or natural person in China acquires an affiliated company in China in the name of its lawfully established or controlled overseas company, examination and approval procedures must be gone through with MOFCOM. The parties must not circumvent the aforementioned requirements, whether by means of making investments in China through a foreign-invested enterprise or otherwise.

As a practical matter, MOFCOM usually does not approve such affiliated acquisitions.

Approvals for cross-border affiliated acquisitions under the M&A Rules proved in practice to be extremely difficult to obtain (and in some cases were simply not forthcoming, depending on whether Chinese policy was favourable or hostile to Chinese companies listing overseas at the time), as the authorities imposed numerous gating requirements as a pre-condition to approval. This created pressure on Chinese businesses to develop an offshore financing structure after the M&A Rules. The VIE structure adopts contractual arrangements rather than direct equity transfer, thereby circumventing the official scrutiny of MOFCOM and its local counterparts (not to mention others, such as the National Development and Reform Commission). As a result, the VIE structure started to be deployed to avoid having to obtain approvals under the M&A Rules for cross-border acquisitions as well, not just in the restricted or prohibited sectors to foreign investment.

2. THE LESSONS OF HISTORY

The VIE structure has attracted significant official and media scrutiny recently. This is attributable to a number of factors including the following: (i) the high profile dispute between Yahoo and Alibaba over Alipay; (ii) the number and range of transactions and industries in which the structure has been deployed; (iii) ill-advised public statements by some industry participants and their advisors who appear to have become somewhat blasé about the use of the structure and who seem to have forgotten the inconvenient fact that it is an attempt to circumvent foreign investment restrictions and has no express legal basis.

² Promulgated by the Ministry of Commerce ("**MOFCOM**"), the State-owned Assets Supervision Administrative Commission, the State Administration of Taxation ("**SAT**"), the State Administration of Industry and Commerce ("**SAIC**"), the China Securities Regulatory Commission ("**CSRC**") and the State Administration of Foreign Exchange ("**SAFE**") with effect from 8 September 2006. The M&A Rules are actually a restatement of the interim provisions of the same name which were effective 12 April 2003 and which were repealed by the M&A Rules.

Whilst a detailed examination of the legal risks relating to the VIE structure is beyond the scope of this note, just because VIE structures have been widely adopted in the market does not mean they are legally sound or risk-free propositions, a fact that seems to have been lost by some people in their enthusiasm for "getting the deal done". Some investors appear to have been lulled into believing the superficially attractive "everyone is doing it so it must be ok" or "VIE is now too big to fail" arguments, and to have forgotten the lessons learnt from the C-C-F structure, namely that "workarounds" without a clear legal basis such as VIE or C-C-F give regulators the freedom to allow them to continue whilst policy is flexible, but also allow them the flexibility to shut them down when policy changes.

In straightforward terms, no-one with any sense of history should be under any illusions that the continued existence of the VIE structure depends on the direction the Chinese policy winds are blowing. In this connection, it may be helpful to compare the situation now with the last time there was a crackdown in this area. What is different between now and 1998 when the C-C-F structure was declared "irregular" and foreign investors were forced to exit the C-C-F structures in the mobile telephony sector (where China Unicom held the licences)?

Firstly, the telecoms services industry in the days of C-C-F was prohibited to foreign investment (not restricted as in the post-World Trade Organisation ("**WTO**") period commencing from China's accession date, 11 December 2001); second, the number of transactions in which C-C-F was deployed was fairly limited, whereas no-one seems to have a clear idea of the number of extant transactions in which a VIE structure has been deployed, but we are probably talking thousands (as opposed to under a hundred for C-C-F) and hence the sums involved in unwinding the VIE structures would be extremely significant; third, whilst the closing out of C-C-F was partially driven by a need to "clean shop" before China Unicom's listing, including closing out the structures to clear the way for a listing of majority State-owned Unicom without extensive disclosures of the C-C-F structures, now the situation is very different: a large number of famous-name privately-owned Chinese companies listed overseas would be placed in a very difficult position if the VIE structures were to be unwound.

3. **THE CIRCULAR ON STRENGTHENING THE ADMINISTRATION OF THE PROVISION OF VATS INVOLVING FOREIGN INVESTMENT IMPACTS ON VIES**

On 13 July 2006, MII, the predecessor of the now Ministry of Industry and Information Technology ("**MIIT**"), issued the *Circular on Strengthening the Administration of the Provision of Value-Added Telecommunications Services Involving Foreign Investment* (the "**VATS Circular**"). The VATS Circular was widely seen as a thinly-veiled attack on VIEs.

The VATS Circular once again raised questions as to the validity of the C-C-F model in VATS projects. It repeats prior restrictions in stating that foreign investors must go through a foreign invested telecoms enterprise ("**FITE**") approval procedure and obtain an operating permit from MIIT before engaging in telecoms services in China. Any foreign investor that fails to go through the proper procedures "must not invest in the provision of telecoms services in China." In addition, the VATS Circular reiterates a long-standing principle that VATS companies in China may not "lease, lend, transfer or resell operating permits to foreign investors in any disguised form." Further VATS operators in China may not provide "in any form whatsoever the

conditions for foreign investors to unlawfully provide telecoms services in China, including resources, premises, facilities and so forth," thus stirring dormant worries about the validity of the C-C-F model.

Notably, the VATS Circular stipulates that VATS operators must use internet domain names and registered trademarks that are specifically owned by themselves or their shareholders in accordance with law ("依法持有"). The exact meaning of the term "specifically owned in accordance with law" is not clear, but suggests that use through a license arrangement with an intellectual property rights owner other than its shareholders fails this leg of the test for holding a VATS Permit. Hence, two of the important "links" between a foreign investor's alter-ego, i.e. its WFOE, and the (typically domestic capital) VATS operator are removed in the classic VIE structure. There seems little doubt that this further restriction was directed at VIE structures which, until then, typically had used trademark licences as one of the suite of contracts used to transfer cash out of OpCo into the hands of the WFOE.

4. HONG KONG STOCK EXCHANGE'S LATEST GUIDANCE OPINION ON VIE STRUCTURES

More recently, another attack on the VIE structure has come from a somewhat unexpected source (given its interest in attracting listings from the mainland), namely the Hong Kong Stock Exchange ("**HKEx**"), which, in November 2011, published a revised listing decision with tougher requirements for VIE structures.³ This will have a significant impact as many Chinese companies listed on the US stock market are struggling at present due to accounting disputes and issues, which have reportedly reduced the appeal of Chinese companies to US investors and resulted in lower valuations on the US markets. This trend has coincided with a recent spike in the number of Chinese companies applying for listing on the HKEx.

While the HKEx's listing committee confirmed the practice of allowing VIE structures on a case-by-case basis after full consideration of the reasons for adopting such arrangements, the HKEx's listing division will normally refer the case to the listing committee if non-restricted businesses (with respect to foreign investment) are involved.

The HKEx also requires any listing applicant using the contractual arrangements to:

- provide reasons for the use of the contractual arrangement in its business operations;
- unwind the contractual arrangement as soon as the law allows the business to be operated without them;
- ensure that the contractual arrangements include specified clauses on a power of attorney to exercise the OpCo's shareholder rights as well as specified dispute resolution clauses; and
- address the OpCo's assets, and not only the right to manage its business and the right to revenues. This is to ensure that the liquidator, acting on the contractual arrangement, can seize the OpCo's assets in a winding up situation for the benefit of the applicant's shareholders or creditors.

³ This would appear to be a reaction to abuse of the structure by potential listing candidates and is consistent with the HKEx's insistence on a rigorous listing process for China-based and other companies.

These latest developments should give companies using the VIE structure and looking to the Hong Kong market for a potential IPO exit pause for thought. If these new requirements are not already satisfied, the VIE structure should be reviewed and restructured accordingly to meet the criteria before the submission of an IPO application to HKEx.

5. OTHER LEGISLATIVE ATTACKS ON VIES

Pursuant to the *Circular on Establishing the Security Review System for Mergers and Acquisitions of Enterprises within China involving Foreign Investors* ("**Security Review Circular**") dated 3 February 2011, the State Council lays out a formal national security review process ("**National Security Review**") for various categories of inbound M&A transactions involving foreign investors. The Security Review Circular came into effect as of 5 March 2011.

MOFCOM, the ministry designated by the Security Review Circular to be the body tasked with receiving national security filings, promulgated the final version of the *Ministry of Commerce Implementing the National Security Review System for Mergers and Acquisitions of Enterprises within China involving Foreign Investors Security Review Provisions* ("**Security Review Provisions**") on 25 August 2011. The Security Review Provisions clarify certain procedural issues arising from the national security review system and introduce an anti-avoidance provision that many see as specifically bringing VIE structures within the frame of national security review. Article 9 of the Security Review Provisions prescribes that "*with respect to mergers and acquisitions of enterprises in China by foreign investors, whether the merger and acquisition transaction falls within the scope of mergers and acquisitions security review shall be judged from the substantive contents and actual impact of the transaction; foreign investors may not substantially evade merger and acquisitions security review by any means, including but not limited to nominee structures, trusts, multi-tier reinvestments, leasing, loans, control by agreement, overseas transactions, etc*". This explicit statement that foreign investors may not substantively circumvent review by means of "other structures" was widely seen as a direct reference to VIEs and the clearest demonstration to date that the Chinese authorities' were aware of VIEs and their prevalence within the market.

For most private equity and venture capital investors, timing is critical, as is confidentiality and hence the likelihood of a national security review procedure with all the uncertainty that brings (which may involve consideration of political factors, as in most jurisdictions) might be fatal to the investment project.

6. THE "MYSTERIOUS" CSRC REPORT

In September 2011, various media disclosed that the China Securities Regulatory Commission ("**CSRC**") had prepared an internal report recommending, among others, a crackdown on the future VIE structure and which seemed to be aimed at "persuading" major Internet companies to return to domestic stock markets for financing purposes ("**CSRC Report**"). This was not entirely accurate, as a cursory reading of the actual Report suggests it was written by a low-level official and addressed to his superior within CSRC as a research result, and in no way represents an "official" CSRC view. Hence, whether the Report represents anything more than one view from one (low-ranking) official is open to question.

CSRC also has a "horse in the race" in the sense that it has long since wanted to "bring home" top Chinese companies listing overseas (although it seems to have changed position on the issue at various times), so it is

not a disinterested observer watching as the future of the VIE structures plays out before it. CSRC is, however, also not the only stakeholder, with the Ministry of Industry and Information Technology (as the Internet and telecoms industry regulator) as well as MOFCOM (general foreign investment approval authority and regulator) clearly having big stakes in this particular "race".

6.1 Brief Summary of the CSRC Report

Entitled "Report concerning the Listing of Tudou.com and Other Internet Business Overseas", the CSRC Report includes five sections: (i) an introduction, (ii) the causes of Internet companies listing overseas, (iii) the pros and cons of Internet-related businesses being listed overseas, (iv) the VIE issue pertaining to Internet companies listed overseas, (v) policy recommendations. Also attached to the CSRC Report are certain Statistics on Chinese Internet Businesses Listed Overseas listing out major Chinese Internet Companies which have listed overseas to back up the writer's contention that most of China's "star-quality" Internet companies have gone overseas, leading to China becoming deprived of much of its best talent in this area. This author also raises the spectre of loss of control over China's Internet, presumably to get the attention of the politicians. Whether there is a real threat is highly arguable, as in our view, it is ownership and operation of the underlying communications network (which is a BTS and in which there is virtually no foreign investment) which is crucial to national security, and less so what is sent "down the pipe" (VATS).

(a) Introduction

Focusing on Internet businesses, the CSRC Report noted that 40 major Chinese Internet companies with Tudou as the latest as of 17 August 2011 were listed overseas (primarily on NASDAQ and NYSE), with a total market capitalisation of approximately USD 160 billion. The Report listings in the US as posing a serious national security threat to the Internet industry in China, clearly with the intention of bringing this to the attention of China's highest policy-making institutions and inciting them to address it.

(b) Causes of Internet Companies Listing Overseas

On the list of causes for Chinese Internet companies listing overseas are:

- (i) they materially breach Chinese policies on foreign investment industry access and hence fail to meet the criteria for being listed in China;
- (ii) they cannot completely satisfy the requirements to be listed on the Chinese A-share market, in terms of independence, compliant operations, sustained profitability capacity, use of IPO proceeds and so forth;
- (iii) impact of the overseas market "cluster effect", mostly on NASDAQ and NYSE, giving rise to high recognition and valuation and prompting more peers to follow suit; and
- (iv) other factors such as the transfer of assets to abroad, local governments' encouragement for overseas listings and the support certain of intermediary institutions for overseas listings.

(c) Pros and Cons of Internet-related Businesses Being Listed Overseas

After recognizing the initial benefits brought by overseas capital using the VIE structure, the CSRC Report cautions against a distorted scenario whereby the high-tech industries, with the Chinese Internet industry as their representative, have become completely transplanted to overseas capital markets. The disadvantages cited range from a direct threat to the security of China's network information to the facilitation of unlawful transfer of assets overseas (presumably also touching on the long-standing concern about state-owned assets being sold at an undervalue to foreign investors).

(d) Contractual Arrangement Issue Pertaining to Internet Companies Listed Overseas

- (i) *Contractual Arrangement's Emergence and Characteristics.* Starting from asset-light companies in the technology and media industries, the VIE structure has gradually found its place in traditional asset-heavy industries like coal trading and shipbuilding and engineering. The CSRC Report points the finger at the VIE structure being used to evade the approval process under the M&A Regulations, allowing transfer of Chinese assets overseas at nominal or well below market value.
- (ii) *Essence of Contractual Arrangement.* Citing the view that the VIE structure is essentially a type of merger or acquisition, the CSRC Report believes the VIE structure should be administered under policies relating to mergers and acquisitions involving foreign capital and subjected to market access policies for foreign investment (i.e. restrictions).
- (iii) *Areas in which VIEs Break the Law.* The CSRC Report believes that the VIE structure improperly evades government scrutiny of mergers and acquisitions involving foreign capital by circumventing Article 11 of the M&A Rules on acquisitions involving affiliated Chinese companies. Once again, the VIE structure is accused of evading foreign exchange administration by giving rise to unregulated transfers of Chinese assets overseas and contravening market access policies pertaining to foreign investment.

(e) Policy Recommendations

Highlighting recent developments in China's A-share stock markets and its nascent private equity industry, the CSRC Report does recommend a crackdown on the abuse of the VIE structure as well as a policy of "encouraging" leading Chinese Internet companies to consider a return to, or to return to the Chinese capital markets.

- (i) *Strengthening Regulation.* The CSRC Report recommends that overseas listings using the VIE structure should be subject to the examination and approval of MOFCOM and the consent of the CSRC (thereby undermining its attractiveness to the relevant companies and their investors). Additionally, authorities in charge of taxation, foreign exchange controls or industry and commerce (i.e. SAT, SAFE and SAIC) should not accept record filings or recognise such type of agreements absent the approval of MOFCOM and the consent of the CSRC.
- (ii) *Policy Guidance.* The CSRC Report contemplates formulating appropriate policies to support leading Internet companies with respect to their listing on the A-share markets so as to form a

"showcase" effect and cluster effect as well as other systemic support like equity incentive schemes.

- (iii) *Strengthening the Building of Multi-layer Capital Markets, Encouraging Internet Businesses to Go Public in China.* The CSRC Report suggests the development of a multi-layered capital market structure such that a greater number of early-stage companies would be able to access capital markets. Market selection is expected to identify outstanding enterprises and support Internet-related businesses in China.
- (iv) *Appropriately Relaxing the Conditions Pertaining to Overseas Direct Investment.* In order to stem overseas listings through roundabout methods, the CSRC Report suggests measures allowing the overseas listing of the relatively small number Internet-related businesses which are justified in seeking an overseas listing and which are currently unable to go public in China.

6.2 Brief Analysis/Potential Impact

The CSRC Report reflects the writer's desire to bring the VIE structure within the purview of government scrutiny, i.e., recommending MOFCOM approval of the VIE structure by reference to mergers and acquisitions involving foreign capital and requiring CSRC's consent to the offshore listing of Chinese companies using the VIE structure (as may be required in certain circumstances under the M&A Rules). If the VIE structure needs to be approved under the M&A Rules, MOFCOM may find itself taking on most of the heavy lifting with respect to the regulation of VIE structures (as well as criticism where it takes a too heavy-handed approach). In this regard, MOFCOM will also face a conundrum where on one hand the VIE structure is deemed to constitute a cross-border acquisition between affiliated Chinese companies under Article 11 of the M&A Rules, and on the other, MOFCOM historically has, in practice, declined to approve such acquisitions between affiliated entities. MOFCOM has not, to date, taken up any formal position on the issue, and has yet to promulgate any formal opinion or rules on the VIE structure.

In order to avoid market disruption on overseas capital markets, the CSRC Report recommends putting in place "policies which distinguish the old from the new", whereby "old rules apply to old cases and new rules apply to new cases". As such, the implication is that China-based companies with existing overseas listings using VIE structures would, "for the time being", be grandfathered. The CSRC Report also considers allowing overseas listed companies using the VIE structure to be dual-listed on the Chinese A-share market upon receiving special approval from the State Council. It is not clear, however, whether the CSRC Report is advocating a broader clean-up of unlisted VIE structures as well.

It should be noted that adopting the recommendations of the CSRC Report would require a collective and coordinated effort from multiple government agencies, particularly including MOFCOM, the CSRC, the SAIC, the SAFE, and the SAT, etc. Unless blessed by the State Council, any unilateral CSRC efforts to rein in the VIE structures would probably fail due to the lack of support from other government authorities on the ground. Getting Chinese bodies with different perspectives and interests to work together is not something that can happen overnight.

7. CONCLUSION

The first point to note is that in response to some of the "scare stories" floating around (mainly by people who, it seems, have not read the CSRC Report) about the imminent demise of the VIE structure, the quote from Mark Twain in the 1897 New York Journal appears to most aptly sum it up:

"The report of my death was an exaggeration."

We see the presumably deliberate leaking of the CSRC Report as being the first salvo being fired by CSRC in what may grow to be a concerted attack on the VIE structure, but is surely not at that level at present. There will need to be discussions amongst the State Council and the many stakeholders in this area, notably but not exclusively CSRC, MOFCOM, MIIT and SAFE before a concrete plan is formulated. MII's thinly-veiled attack on the VIE structure in 2006 created quite a stir at the time, but then fizzled out without really making an impact on the adoption of the structure in the market. Much depends on where the State Council comes out on the issue. We see the most likely outcome as being greater and tighter regulation of the VIE structure going forward rather than an outright ban because of the significant market disruption any retrospective ban would likely create.

What is clear is that there is much more at stake here than at the time the C-C-F structures were closed out in the late 1990s. US\$160bn of market capitalisation is not a small number, so careful consideration will need to be given to adopting a solution that does not cause both domestic and overseas investors to lose out and simply leads to more controversy and a greater flight of capital using newly-found ways around the rules.

Those making the decisions in China on this difficult and sensitive topic would be advised to reflect on why C-C-F and VIE came into being in the first place when trying to solve the conundrum of finding a solution that treads the fine line between creating huge market disruption by taking heavy-handed and ill-considered enforcement measures and the desire of bringing VIE within some sort of regulatory framework where the Chinese authorities have at least some degree of regulatory oversight and visibility. Part of the issue was unreasonable (and in some cases unwritten) policy restrictions on foreign investment in the Internet and telecoms spaces. Perhaps now is a good time for China and MIIT and MOFCOM in particular to decide whether greater regulation of VIEs needs to be counter-balanced by policy changes attacking the root cause of VIEs and addressing the fact that they exist because there is a market demand and a desire for Chinese investors to list overseas and for foreign investors to invest in these sectors without encountering restrictions and/or a difficult and time-consuming approval process. If foreign investment restrictions in the areas in question could be relaxed to the point where a direct investment becomes feasible and workable, and the approval process simplified, the attractiveness of VIEs would fall away.

Perhaps the most convincing argument for maintaining VIE structures is the fact that China still has an immature and limited early-stage financing mechanism and it would stunt and curtail the growth prospects of many SMEs that China wants to nurture if VIEs and the funding support they provide were to be cut off. China's capital markets may have come on a long way in recent years, but they are still not seen to be as well-regulated or as prestigious as some of the overseas markets, despite higher valuations. They are also not yet fully open to foreign investors: for example the A share market is only open to foreign investors through government-approved schemes and channels such as the Qualified Foreign Institutional Investor scheme.

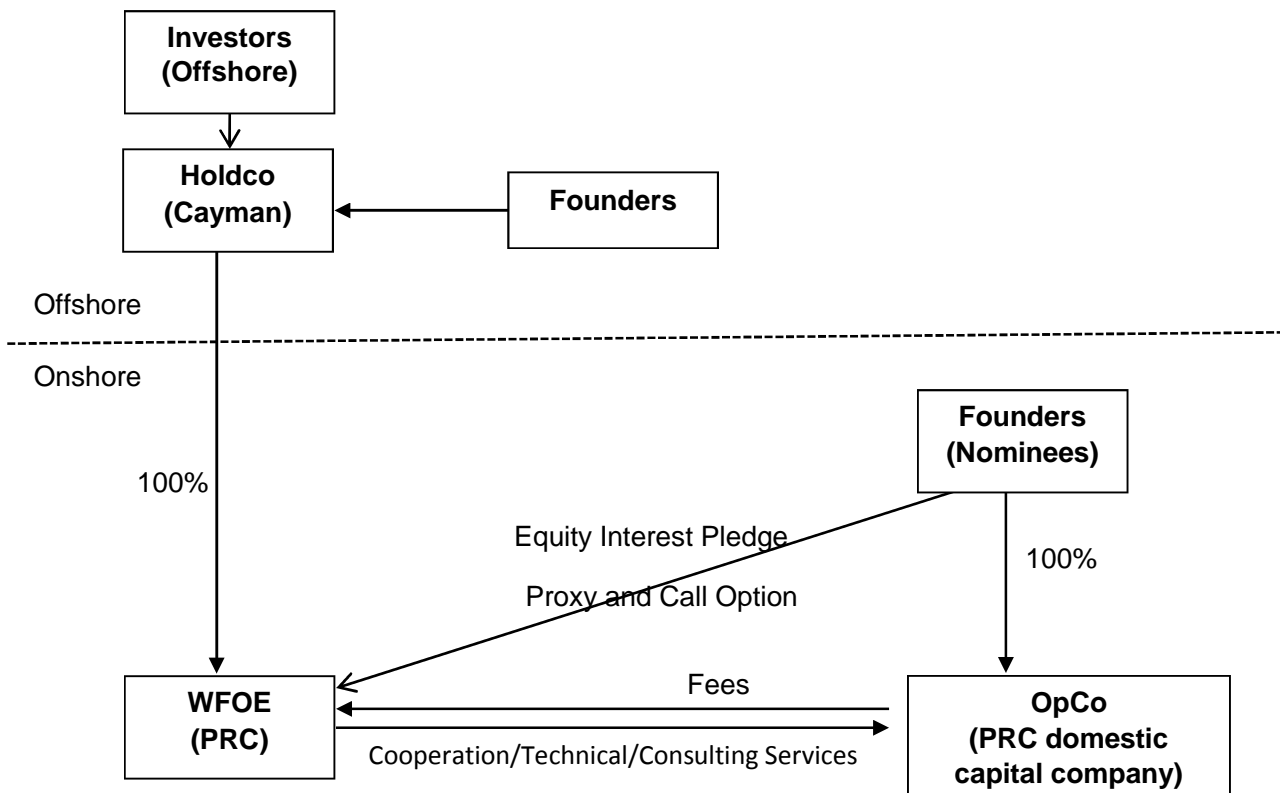
Finally, China also should give consideration as to whether it has put in place the right legal mechanisms and machinery to encourage bringing venture capital funding back "onshore" e.g. the *People's Republic of China Company Law* does not expressly allow for the creation of different classes of shares with different rights, and puts strict limits on redemption rights, when redeemable convertible preference shares are the industry-standard instrument and so forth.

In short, there is no "quick fix" for the industry that has grown up around VIE structures. It will take a complete package of measures and actions and a complete rethink of how China regulates foreign investment in some of its most sensitive industries to persuade the "star-quality" Chinese companies of the future to "come home" when it comes to a stock market listing.

Hogan Lovells
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Appendix A

VIE Typical Structure Chart



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