

China Based VIEs – Is Disclosure Enough?

Companies based in China have long sought to list their shares for trading on U.S. markets. The reason is clear – the U.S. markets are deep, liquid and the envy of the world. Nevertheless, there has been a long-standing tension regarding those listings. A key element of that tension emanates from the Sarbanes-Oxley Act of 2002 or SOX requirement that all audit work on issuers whose shares are traded on U.S. exchange is subject to inspection by the PCAOB. China has refused to permit the inspections despite repeated negotiations with the Board, enforcement actions by the Commission and the recent passage of the Holding Foreign Companies Accountable Act or HFCA Act which largely reiterates the SOX mandate.

PRC officials have recently taken steps to effectively preclude or at least discourage their firms from listing on U.S. and other foreign exchanges. Nevertheless, issuers based in the PRC continue to seek and obtain listings for their shares in the U.S. Key to that trend is the use of a VIE, a Variable Interest Entity. Those vehicles – a form of SPE – have been around for some time.

In the model being used by China based issuers, a company is created in an off-shore jurisdiction such as the Cayman Islands. Foreign investors are the shareholders. The new Cayman shell company then enters into a series of contractual arrangements with its PRC creator that give it effective control. To complete the transaction the Cayman shell company issues shares that are listed for trading on a U.S. exchange. Yet the China based company is still owned by its PRC based shareholders and subject to local law which voids any arrangement to circumvent its law. The financial statements of the PRC based entity and the Cayman shell can be consolidated.

SEC Chair Gary Gensler recently expressed concern regarding these entities stating that “I worry that average investors may not realize that they hold stock in a shell company rather than a China-based operating company.” Accordingly, he directed the staff “to ensure that these issuers prominently and clearly disclose . . .” a series of facts. Those disclosures will tell investors that they are “not buying shares of a China-based operating

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company but instead are buying shares of a shell company . . .” that has contracts with a China based issuer. Additional disclosures the Chair directed the staff to implement will inform investors that each of the issuers involved – China and the off-shore entity – and all investors will be subject to actions by the government of China and will include detailed metrics to facilitate an understanding of the consolidated financial statements.

Mr. Gensler also directed the staff to ensure that two additional disclosures are made by all China-based operating companies. Those will require disclosure: 1) if the China-based operating company received or was denied permission from the Chinese authorities granted to seek a U.S. listing or if those authorities could retract permission; and 2) that the HFCA Act which requires that the PCAOB be permitted to inspect the issuer’s public accounting firm files. The staff was also directed to do periodic, targeted reviews of these firms.

Whether the additional disclosures ordered by Chair Gensler will significantly impact the registration in the U.S. of China based shell companies is difficult to discern. More importantly, regardless of what disclosures are made about these firms, the investment is high risk. The equity ownership of the firms involved is held by China based shareholders. The assets of the company are subject to the direction of PRC authorities.

To be sure, the shareholders of the VIE Shell will have contractual rights. But the enforceability of those contracts is at best questionable. Similarly, making the entities subject to the HFCA Act in theory affords protections for investors since PCAOB inspectors should be able to examine the audit work papers. At the same time there is no reason to believe that PRC officials will permit those inspectors to review any work papers except those relating to the off-shore shell which has no assets. The repeated refusal of PRC officials to permit inspections under SOX for the last two decades all but ensures this result.

In the end, any investor purchasing shares of a VIE Shell tied to a China based issuer may well be securing rights that are little more than a piece of paper, not an interest in a China based issuer but only in a shell. Under these circumstances the real question is whether disclosure is enough? Stated differently, does it offer any real protection at all?