



The Role of Variable Interest Entities (VIEs) in China's Economic Development and Regulatory Landscape

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Abstract. This article will delve into the special structure of Variable Interest Entity (VIE), which is widely used in the business field in China. The VIE model provides an effective way for domestic companies to obtain foreign investment when facing strict local regulatory restrictions. Over the years, the VIE structure has played a key role in driving the flourishing development of major technology companies in China, helping numerous enterprises achieve rapid expansion and innovation. However, with its widespread application, VIEs have also raised a series of significant legal and financial issues, such as contract dispute risks and regulatory challenges caused by opaque information disclosure. This article will use Alibaba as a typical case study to conduct a detailed examination of the structural characteristics, potential advantages, risks faced, and potential impacts on the future business and regulatory environment of VIEs. A deep understanding of the VIE structure is of crucial importance for policy makers, investors, and companies themselves in responding to the constantly changing regulatory environment.

Keywords: Variable Interest Entities, China's Economic Development, Regulatory Landscape

1 Introduction

Through the recent decade, China's rapid economic development, fueled by market liberalization and integration into global trade systems, has attracted a significant amount of foreign investment [1]. However, since it acceded to the World Trade Organization (WTO) in 2001, China has maintained a dual approach—opening sectors like manufacturing while safeguarding "strategic" industries deemed vital to national interests [2]. Regulatory restrictions that are rooted in policies such as the Foreign Investment Catalog and the Cybersecurity Law have limited foreign ownership in sectors like technology, telecommunications, and media, where data security and ideological control remain paramount [3]. To circumvent these restrictions, Chinese firms, particularly in the early 2000s tech boom, adopted Variable Interest Entity (VIE) structures. These contractual arrangements, pioneered by companies like Alibaba and Sina, enable offshore investors to gain economic exposure without direct equity ownership, operating in a legal gray area tacitly tolerated by authorities. This

paper explores the role of VIEs, analyzing their structure, advantages, associated risks, and implications for the future of foreign investment in China.

2 The Role of VIE Architecture in China's Economic Development

2.1 The Historical Evolution of VIE Framework

A Variable Interest Entity (VIE) is a legal business structure used by Chinese companies to gain access to foreign investment without violating domestic regulations [4]. Under the VIE model, the Chinese company establishes an offshore entity that lists shares on international stock exchanges [5]. This offshore entity enters into contractual agreements with the Chinese operating company, which has granted it control and economic benefits without direct ownership. In a VIE structure, the operating Chinese company (the VIE) enters into an exclusive service agreement with a wholly foreign-owned enterprise (WFOE). Under this arrangement, the VIE agrees to use the services provided by the WFOE exclusively. These services typically include technology consulting, management support, IT infrastructure maintenance, and other operational assistance that are vital to the VIE's day-to-day business and long-term growth. The rationale behind such an arrangement is to establish a contractual basis through which the WFOE can capture the economic benefits of VIE without holding direct equity. However, as the exclusive service agreement is a cornerstone of the VIE structure, its enforceability it remains subject to Chinese regulatory interpretation [6]. Many Chinese authorities have traditionally tolerated such arrangements to facilitate foreign capital inflows, but recent regulatory scrutiny means that the terms and application of these agreements would be reexamined. With the authorities deciding that such contracts effectively mask foreign control, it posits a risk that these arrangements might be deemed unenforceable in the future. In accountable to all this, this affects the financial and operational integration of the VIE with the WFOE. To this degree, the equity pledge agreement is used to secure the obligations of the domestic shareholders of the VIE. In a typical VIE structure, although the VIE's legal ownership remains in the hands of local Chinese shareholders (often the founders), these are always shareholders entering into an equity pledge agreement whereby they pledge all or a significant portion of their equity interest to the WFOE. This pledge would act as a collateral for the performance of their contractual obligations under other VIE-related agreements such as the exclusive service or call option agreements. Often, the agreement requires that any dividends or distributions on the pledged equity be paid directly into an escrow account controlled by the WFOE. This enhanced provision can ensure that profits from the VIE are not distributed to the domestic shareholders but instead flow to the WFOE. These arrangements are critical in terms of maintaining the consolidated economic results of the VIE within the financial statements of the foreign-listed entity [7].

In the VIE structure, both exclusive service agreements and equity pledge agreements are vital in creating an economic channel that allows foreign investors to indi-

rectly control and benefit from Chinese companies despite local regulatory restrictions. This complex structure creates an indirect link between foreign investors and the Chinese operating company that eventually bypasses regulatory restrictions on foreign ownership.

2.2 The Financing Convenience Brought by the VIE Framework

VIEs offer several strategic advantages for both Chinese companies and foreign investors seeking exposure to sectors that are otherwise closed or heavily restricted for direct foreign ownership in China. Their advantages are that Chinese government regulations restrict or outright prohibit foreign investment in several key sectors—such as technology, telecommunications, media, and education—to protect national security and maintain state control over strategic industries. By using a VIE structure, Chinese companies can raise capital from foreign markets without violating these restrictions. In a VIE setup, the operating company remains legally owned by Chinese nationals while the offshore entity enters contractual arrangements with the domestic company to obtain economic rights and effective control. This arrangement enables the company to tap into international capital markets and enjoy the benefits of foreign investment while technically complying with domestic regulations [8].

2.3 Risk and Challenge

Despite their benefits, VIE structures pose significant risks and challenges. One of the most significant challenges is the legal ambiguity surrounding the contractual agreements that underpin the VIE structure. In a VIE, control is achieved not through equity ownership but through a series of contracts. However, Chinese law remains ambiguous regarding the enforceability of these agreements. Chinese courts have rarely directly ruled on these contracts, which leaves investors exposed to potential disputes that could render key provisions unenforceable. If a court determines that the contracts were designed to circumvent foreign ownership rules, it could invalidate the agreements that will eventually strip the offshore entity of its economic benefits and control over the domestic operating company.

While Chinese regulators have historically tolerated VIE arrangements as a practical workaround, there would be no statutory or regulatory framework that explicitly endorses the VIE model. The lack of formal recognition means that the regulatory environment is subject to change. For instance, if Chinese authorities decide to tighten foreign investment rules or reinterpret existing regulations, they might introduce new measures that directly impact the legality of the contracts underpinning VIEs [9]. Recent regulatory actions in sensitive sectors—such as the prohibitions on foreign involvement in online gaming or educational services—highlight the potential for abrupt policy shifts. Such changes could force companies to restructure or even dissolve their VIE arrangements, potentially causing severe disruption and financial losses for foreign investors.

3 Regulatory Framework of VIE Framework

Since the contractual framework of VIEs is governed by Chinese law and disputes are generally resolved within Chinese jurisdiction (or through arbitration panels that follow Chinese legal principles), foreign investors have limited recourse when conflicts arise. Unlike in jurisdictions such as the United States or Europe, where investors may have robust legal remedies and protections, the recourse available in China can be unpredictable and heavily influenced by local interpretations and enforcement practices. This means that if a contractual dispute arises, whether due to breach, non-performance, or a change in regulatory interpretation, foreign investors may find it difficult or even impossible to enforce their rights in a manner that fully protects their interests.

Furthermore, the VIE model relies on contractual control rather than direct equity ownership to bind offshore entities to domestic operating companies. Under this structure, founders establish offshore entities (e.g., in the Cayman Islands) to list overseas they have signed exclusive service agreements, equity pledges, and profit transfer contracts with the onshore VIE. This circumvents China's Negative List, which prohibits foreign ownership in sectors like telecommunications and online education, and ultimately avoids direct equity ties. However, on the contrary, its downside would be its lack of explicit legal recognition in China. Key laws, including Company Law and Contract Law, do not address the validity of this contractual control. The 2019 Foreign Investment Law, while introducing the concept of "actual control," stops short of regulating VIEs. This legislative gap has led to a paradoxical stance: Regulators tacitly tolerate VIEs to facilitate foreign investment but reserve the right to intervene, as seen in the 2020 suspension of Ant Group's IPO. Such ambiguity creates a "regulatory gray zone" where VIEs operate on fragile legal foundations.

4 Case Analysis

A notable example of a VIE is Alibaba Group, one of China's largest e-commerce platforms. In 2014, Alibaba conducted a record-breaking \$25 billion initial public offering (IPO) on the NYSE using a VIE structure. The offshore entity that is originally registered in the Cayman Islands has held contractual agreements with Alibaba's Chinese operating companies. The IPO allowed Alibaba to access international capital markets that have significantly boosted its market value. However, the VIE structure posed ongoing risks. In 2021, China's regulatory bodies intensified scrutiny over data security, and foreign listings have caused Alibaba's share price to plummet. The inherent vulnerability of VIE structures under changing regulatory environments has been a significant change [10].

While Alibaba's 2014 IPO exemplified the potential of VIE structures to bypass foreign ownership restrictions, the 2020 suspension of Ant Group's IPO—a financial affiliate of Alibaba—serves as a stark counterexample, which highlights the legal and regulatory vulnerabilities inherent in VIEs. Ant Group, which operates Alipay and other fintech services, initially planned a dual IPO in Shanghai and Hong Kong in

2020, aiming for a record-breaking \$37 billion valuation. Like Alibaba, Ant relied on a VIE structure to consolidate control over its Chinese operating entities through offshore holding companies. However, days before the IPO, Chinese regulators halted the listing, citing concerns over systemic financial risks, monopolistic practices, and inadequate disclosure of ownership ties under the VIE model. The suspension revealed critical flaws in VIEs, including Ant's VIE structure allowed it to operate in sensitive financial sectors, like microlending, while technically complying with foreign ownership bans. Regulators argued this created "regulatory blind spots," enabling Ant to expand without sufficient oversight. Furthermore, Ant's control over vast financial data through Alipay raised alarms under China's 2021 Data Security Law and Personal Information Protection Law, which mandate stricter governance of cross-border data flows.

The Ant case exposed the fragility of contractual controls in VIEs. Unlike Alibaba's 2014 success, Ant's IPO failure demonstrated that regulators questioned whether Ant's VIE agreements violated China's Foreign Investment Law by granting foreign investors indirect control over restricted sectors [11]. This echoed the 2011 Alipay controversy, where Alibaba unilaterally transferred Alipay's ownership out of its VIE structure, citing regulatory compliance. Moreover, Ant's abrupt suspension triggered a 50% plunge in Alibaba's stock price, eroding global investors confidence in VIEs. Shareholders faced losses with limited legal recourse, as disputes fall under Chinese jurisdiction, where enforcement remains unpredictable. The well-known of the ant case reflects a broader regulatory trend. In 2021, Chinese regulators forced Didi to delist from the NYSE just months after its IPO, citing data security risks under its VIE framework [12]. Also, New Oriental and other edtech firms saw their VIE-linked valuations collapse after China banned for-profit tutoring in 2021, rendering their offshore structures nonviable. These cases illustrate how VIEs, once hailed as a regulatory workaround, now face existential risks. Unlike Alibaba's early-mover advantage, later adopters operate in a climate of heightened scrutiny, where regulators prioritize national security and data sovereignty over capital market access.

The Ant Group case serves as a cautionary counterpoint to Alibaba's VIE success. While VIEs enabled Alibaba's global rise, their legal ambiguity and dependence on regulatory tolerance make them vulnerable to abrupt policy shifts. For investors, Ant's collapse underscores the need for rigorous due diligence, diversification, and preparedness for "policy black swans".

5 Conclusion

Variable Interest Entities (VIEs), as institutional innovations in China's specific regulatory environment, have played a key role in promoting foreign investment in restricted industries such as technology and education. This article finds through case studies such as Alibaba that the VIE model circumvents equity restrictions through agreement control, helping Chinese companies obtain international capital, but also accumulating legal and regulatory risks. The core contradiction lies in the lack of property rights protection in contract control, which puts investors at risk of policy

changes; Cross border regulatory conflicts, such as the audit dispute between China and the United States, further exacerbate structural instability.

The current VIE structure is facing transformation pressure. Policy makers need to balance regulation and market openness: in the short term, they should improve information disclosure and clarify the legal effectiveness of control agreements; In the mid-term, can explore the management of the "negative list" and restrict the application of VIE in sensitive areas such as data security; Long term need to design more compliant mechanisms for realizing rights and interests. Enterprises need to cope with uncertainty through risk reserves, structural optimization, and other means.

The future of VIE depends on three factors: the progress of China's capital account opening, the degree of international regulatory cooperation, and the evolution of digital sovereignty rules. Regardless of the outcome, the core insight is that emerging markets need to seek a dynamic balance between economic security and investment facilitation. This exploration not only affects the globalization path of Chinese enterprises, but also provides important reference for regulatory innovation for other developing countries.

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