US warns of investment risks in Chinese Internet firms

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People walk past the entrance of the Alibaba headquarters in Hangzhou, east China's Zhejiang province on May 7, 2014

Buying stock in online giant Alibaba or other Chinese Internet companies that bypass Beijing's restrictions on foreign ownership could be a big risk for investors, a US government panel warns.

An agency that advises Congress on national security implications of the

US-China trade and economic relationship raised the red flag this week, as Alibaba, the world's largest online retailer, prepares for its US stock listing.

Alibaba, social networking giant Weibo and several other Chinese Internet firms use a complex legal mechanism in which "ownership is deliberately obscured by a series of shell companies," the US-China Economic and Security Review Commission (USCC) said in a report Wednesday.

In the case of Weibo, for example, the report noted that a Cayman Islands corporation owns 100 percent of a Hong Kong company that in turn controls the group through three layers of Chinese entities.

"This intricate ruse is a way of making the business appear to be Chinese-owned to Chinese regulators while claiming to be a foreign-owned business to foreign investors. Neither claim is technically true, and the arrangement is highly risky and potentially illegal in China," the report said.

Because of this structure, any legal contracts may be on shaky ground, noting that "the contracts are only binding and enforceable if Chinese courts are willing to uphold them."

Workers at a handbag factory completing orders to be sold through the Chinese internet e-commerce site Taobao in Baigou, Hebei Province on April 24, 2014

As a result, "for US investors, a major risk is that the Chinese shareholder... will steal the entity, ignoring the legal arrangements on which the system is based."

The companies must rely on foreign investors to keep their businesses growing because they cannot access sufficient capital from China's state-owned banking system or from its undersized bond market, and they also need permission to list overseas, the USCC said.

To circumvent these restrictions, the leading Chinese Internet companies use a Variable Interest Entity (VIE), essentially a holding company that links foreign investors and Chinese firms through a set of complex legal contracts. VIEs are usually based in tax havens such as the Cayman

Islands.

"US shareholders face major risks from the complexity" of the VIE structure, the report said.

Wall Street has seen a flood of initial public offerings recently by Chinese Internet companies, including Baidu, Renren, Weibo, and JD.com, the number-two online retailer after Alibaba.

Alibaba in May filed for a US-based IPO that is expected to be one of the largest in US history, with some analysts estimating it will raise $15 billion.

Alibaba founder Jack Ma speaks at an event to mark the 10th anniversary of China's most popular online shopping destination Taobao Marketplace, in the eastern Chinese city of Hangzhou on May 10, 2013

Alibaba in focus

The USCC report highlights that Alibaba's filings with the Securities and Exchange Commission show it will use a VIE and a preferential stock structure that will consolidate all decision-making authority with the company's founders in China.

"Alibaba's controversial history, with its first major foreign investor Yahoo, sheds light on the risks US investors face in buying into Chinese Internet companies under the VIE structure," it said.

Yahoo lost any direct benefit from Alibaba's spinoff of an online payment tool called Alipay, a similar service to PayPal, in a secret move by Alibaba founder and chairman Jack Ma.

"Under the VIE structure, there is no obligation of the parent company to notify foreign investors of these kinds of decisions, which can prove very costly for them."

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