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MOFCOM's Wal-Mart Decision and Its Wider Implications

Zhuowei (Joyce) Li & Ying (Tracy)
ZhouHan Kun Law Offices

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Zhuowei (Joyce) Li & Ying (Tracy) Zhou¹

I. INTRODUCTION

On August 14, 2012, the Chinese Ministry of Commerce (“MOFCOM”) released its announcement on the approval of the planned acquisition of 33.6 percent equity in Newheight Holdings by Wal-Mart subject to conditions.² This is the first published decision by MOFCOM regarding a merger review of a transaction³ involving variable interest entity (“VIE”) structures. The decision provides a good platform to discuss the feasibility, the underlying issues, and the likely results of merger control filings involving VIE structures.

As further analyzed below, we believe that the VIE structure is a special issue of concern for MOFCOM during its anti-monopoly review. In order to better understand the background of MOFCOM's *Wal-Mart/Newheight* decision, we first briefly introduce the VIE structure and its application in China.

II. VIE STRUCTURES

A. Concept Of Vie

VIE derives from an accounting concept. As mentioned, its full name is variable interest entity. It means that one party (“Controlling Company”) indirectly owns the equity interests of another company or enterprise (“VIE Company”) through a series of agreements and written arrangements (“VIE Agreements”) in order to actually control or dominate the equity interests, profits, or decisions of the VIE Company. In that way, the Controlling Company is able to consolidate the financial statements of the VIE Company according to International Accounting Standards or U.S. Generally Accepted Accounting Principles.

B. The Application Of Vie Structures In China

VIE structures have generally been adopted in China in industries where foreign investment is restricted, such as telecommunications, education, etc., and have been used especially to obtain overseas financings. Under a typical VIE structure, the VIE Company is a domestic company established according to Chinese laws, and all of its registered shareholders are Chinese citizens or domestic companies. In addition, the typical VIE Company owns specific business licenses and permits that a foreign-invested enterprise (“FIE”) would not be able to

¹ Partners, Han Kun Law Offices.

² Ministry of Commerce, Public, Announcement [2012] No. 49 of August 14, 2012 (the *Wal-Mart/Newheight Decision*).

³ As to anti-monopoly notification of concentrations between business operators, no public decision or announcement is required if the transaction is approved unconditionally. However, publication of the decision is required if MOFCOM prohibits or conditionally approves the transaction.

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obtain. Thus, the VIE Company is able to engage in businesses that are restricted or forbidden for foreign investors.

The real shareholders include the Chinese founders (who would usually be the registered shareholders of the VIE Company) and foreign investors who will own the equity interests of an offshore company (“SPV”), which directly or indirectly sets up a wholly foreign-owned enterprise (“WFOE”) in China as a Controlling Company. The WFOE, the VIE Company, and the registered shareholders of the VIE Company typically sign VIE agreements to enable the SPV to enjoy the profits of the VIE Company, to control the VIE Company, and to consolidate its financial statements.

While there have been concerns on whether the VIE structure might be deemed as a circumvention of Chinese laws and its validity thus might be dubious, the VIE structure is widely applied in specific industries in China. Particularly at present, the VIE structure has been widely used by Chinese companies in the technology, media and telecommunications, and education sectors. Many of the companies with a VIE structure have gone public in offshore securities markets. To date there has been no affirmative or negative official statement from the Chinese government authorities regarding the validity of the VIE structure.

C. Merger Review for Transactions Involving VIE Structures

Transactions involving companies with a VIE structure may trigger a merger review if the statutory notification criteria are met. Under Chinese law, turnover is used as the standard to trigger antitrust notification in China. If the specific turnover thresholds are met, the companies must file a notification to MOFCOM.

Importantly, when calculating the turnover of each company involved in the transaction, the turnover of the company's affiliates must also be included. Under a typical VIE structure, since the Controlling Company clearly controls the VIE Company through VIE Agreements and consolidates the financial statements of the VIE Company, the turnover of both the WFOE and the VIE Company needs to be included for the purpose of calculating whether the turnover threshold is triggered. This is the case irrespective of whether the party directly involved in the transaction is the SPV, the WFOE, or the VIE Company.

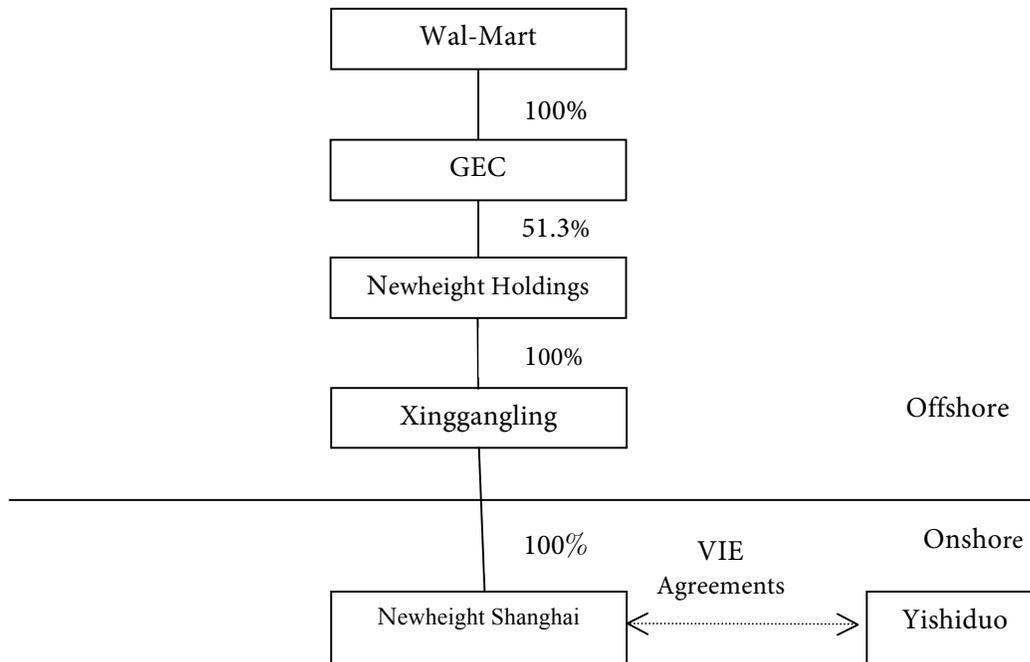
In practice, we have seen an increasing number of transactions that involve companies with VIE structures. For some companies, the notification thresholds would be easily triggered for many of their proposed transactions. However, due to the controversy on the validity of the VIE structure, and the ambiguous attitude of the authorities towards the VIE structure, many companies are hesitant to submit merger control notifications for transactions involving VIE structures, in the fear that the approval may be denied or delayed.

III. BACKGROUND OF THE WAL-MART/NEWHEIGHT TRANSACTION

A. Introduction to the Transaction

According to MOFCOM's public decision, Wal-Mart Stores Inc. (“Wal-Mart”) proposed to acquire 33.6 percent of the equity interests of Newheight Holdings Co., Ltd. (“Newheight Holdings”) through its wholly-owned subsidiary GEC2 PTE. (“GEC”). Immediately after the closing of the transaction, GEC would be the beneficial owner of 51.3 percent of the equity interests of Newheight Holdings.

Xingangling Limited (“Xingangling HK”), the wholly-owned subsidiary of Newheight Holdings, owns 100 percent of the equity interests of Newheight Information Technology (Shanghai) Co., Ltd. (“Newheight Shanghai”), a wholly-foreign invested enterprise located in Shanghai. In turn, Newheight Shanghai controls the online business of online shopping platform “Yihaodian” (“Yihaodian”) through VIE arrangements. Yihaodian is operated by Shanghai Yishiduo E-commerce Co., Ltd. (“Yishiduo”). The post-closing corporate structure of the transaction is as follows:



B. Business of Yishiduo Prior to the Transaction

According to the MOFCOM decision, Yishiduo—as a VIE Company controlled by Newheight Shanghai—had, prior to the transaction, been mainly engaged in the online direct sales business and the provision of value-added telecommunication services.

Online direct sales business means that an enterprise uses its online platform to sell its own products, rather than providing services for other parties. Previously, given that online direct sales business is done through the internet, in practice it was not clear whether a value-added telecommunication business permit (“ICP License”) was needed for conducting such business. If a business is determined to be a value-added telecommunication service (“VATS”) and thus a special license is required, then a company with foreign investors as controlling shareholders would not be allowed to engage in that business.

Historically, the Chinese Ministry of Industry and Information Technology (“MIIT”)⁴ treated online direct sales business as a value-added telecommunication service. Consequently, such businesses were deemed to be restricted for foreign investors for a long time. This situation

⁴ MIIT is the regulatory authority that is in charge of, among other industries, the telecommunication industry.

changed when MOFCOM issued the *Circular of the General Office on Issues Related to Examination, Approval, and Administration of Online Sales and Vending Machine Sales Projects of Foreign-Invested Enterprises*. This circular clearly specifies that an ICP License is not required for a FIE to engage in online direct sales business.⁵ Thus, pursuant to that circular, foreign investors can legally own a 100 percent equity interest in an online direct sales business.

To date, MIIT has not issued any official statement to endorse MOFCOM's opinion in that respect. Notwithstanding the foregoing ambiguous attitude of MIIT, MOFCOM clearly indicates in the *Wal-Mart/Newheight* decision that an FIE (including a WFOE) is allowed to engage in online direct sales business without an ICP License.

VATS means telecommunication and information services provided through public network infrastructures. According to the *Catalogue of Telecommunication Service Classification*,⁶ VATS can be classified into two categories and eight subcategories of businesses. The business of providing an online platform for other parties—which Yishiduo had engaged in—belongs to information services business under category II of VATS. This category refers to voice information services (telephone information services) or online information and data retrieval and other information services directly provided for end users through fixed networks, mobile networks, or the internet and other public communications networks by means of information gathering, development, processing, and construction of information platforms.

Pursuant to Chinese law, foreign capital cannot exceed 50 percent of the equity interest in a VATS company. In practice, it is very difficult for an FIE to obtain an ICP License, even if the foreign investors are only minority shareholders. Hence, since Yishiduo provides online platform to third parties for online sales business, it provides a VATS that is restricted for foreign or foreign-invested companies. Newheight Shanghai as a WFOE would not be allowed to directly engage in this activity.

IV. ANALYSIS OF MOFCOM'S PUBLIC DECISION

A. Issues on MOFCOM's Decision

Normally, the key factor for deciding whether to approve, conditionally approve, or block a transaction under merger control rules is whether the transaction itself has anticompetitive effects in the relevant market. Therefore, the definition of the relevant market is a crucial step during the merger review process.

According to the MOFCOM decision in *Wal-Mart/Newheight*, Wal-Mart is a primary competitor in the supermarket chain markets globally and in China, mainly engaging in the physical supermarket store business. In turn, Yishiduo is the biggest online supermarket in China. Yishiduo's scope of business includes the online direct sales and VATS businesses. The MOFCOM decision defines the relevant product market as the B2C online retail market (i.e.,

⁵ MOFCOM and its local counterparts are the regulatory authorities that are responsible for the approval of the formation of FIEs.

⁶ Value-added telecommunication services are divided into Category I and Category II. Category I includes online data processing and transaction processing services, domestic multi-party communications services, domestic internet protocol virtual private network services, and internet data center services. Category II includes store and forward services, call center services, internet access services, and information services.

online direct sales market). The relevant geographic market is defined as China. MOFCOM concluded that, after the closing of the transaction:

Wal-Mart will be able to leverage its competitive advantages in the traditional physical market into the online retail business of Yishiduo ... The comprehensive effects of the concentration will substantively enhance the ability of the post-transaction entity to compete in the online retail industry.

However, following this logic, MOFCOM did not draw the conclusion that the transaction would have anticompetitive effects in China's B2C online retail market. The analysis of the B2C online retail market was not completed. Instead, pursuant to the first remedy set forth in the decision, "the acquisition of Newheight Shanghai shall be limited to the online direct sales business carried out with its own online platform." This means that the post-transaction entity is clearly allowed to engage in the B2C online retail market.

To achieve its purpose, MOFCOM resorted to the "leveraging" argument. Under this approach, in addition to the aforementioned "relevant market" review, MOFCOM further investigated the VATS market. MOFCOM concluded that:

[t]he investigation results indicate that if the post-merger entity enters the value-added telecommunications market via Yishiduo's online store, it will be able to rapidly expand its business by relying on its comprehensive competitive advantages in both the existing physical retail market and the online retail business, gain a dominant position in the value-added telecommunications market, and substantively enhance its bargaining power against users of online platforms, and therefore may have the effects of excluding or restraining competition in China's value-added telecommunications market.

According to the *Provisional Regulation on the Assessment of the Impact of Concentration between Business Operators on Competition* and other published merger decisions by MOFCOM, the key factors for deciding whether a transaction has anticompetitive effects include:

- the market shares of the parties participating in the transaction in the relevant market, as well as their controlling power in the relevant market; and
- the degree of concentration in the relevant market.

However, MOFCOM did not analyze the VATS market or the market shares in any detail. As mentioned above, VATS are categorized into two categories and eight subcategories of lines of business. Many of these VATS are not substitutable with each other. For example, the third-party transaction platform offered by Yishiduo is not substitutable with news websites, video websites, game websites, mobile networks services, etc. Thus, MOFCOM lacks a legal basis to treat all VATS as a single relevant market.

Furthermore, although Yishiduo accounts for a significant portion of China's e-commerce market, the major part of its businesses is online direct sales business. As a result, its participation in VATS business is not significant (especially considering that there are many e-commerce companies engaging in VATS, such as Taobao, QQ Mall, 360buy, and so on). Since foreign investors are restricted from engaging in VATS, the participation of Wal-Mart in China's telecommunication market prior to the transaction had obviously been quite limited. However, in its public decision MOFCOM did not analyze the possible market position of Wal-Mart and Yishiduo in the VATS "market" when putting forward its "leveraging" theory.

Following the brief analysis conducted by MOFCOM, MOFCOM approved the transaction subject to three conditions:

- (1) this acquisition of Newheight Shanghai shall be limited to the online direct sales business carried out with its own online platform;
- (2) without obtaining the ICP License, Newheight Shanghai shall not use its own online platform to provide network services for other transaction parties subsequent to the completion of the Transaction; and
- (3) upon closing of the transaction, Wal-Mart is not allowed to engage in the value-added telecommunications business currently operated by Yishiduo through its VIE structure.

Generally speaking, it seems that the conclusion in the MOFCOM decision that the transaction may exclude or restrict competition in China's VATS market lacks sufficient market analysis. It is thus not convincing from an antitrust perspective. If we review the conclusion from another angle, however, we could re-phrase the aforementioned restricted conditions simply as: Wal-Mart can use the VIE structure to engage in Yishiduo's online direct sales business, but Wal-Mart *cannot* use the VIE structure to engage in Yishiduo's VATS business. The implication in this regard will be further analyzed below.

B. MOFCOM's Attitudes towards Transactions Involving VIE Structures

1. VIE Structures Involving Businesses Not Subject to Restrictions for Foreign Investment

By controlling Yishiduo via VIE agreements, Newheight Shanghai has been engaged in both online direct sales business and VATS. As mentioned, the first type of business is open for foreign investors, while the second type is restricted. According to the first and the third restricted conditions set out in the *Wal-Mart/Newheight* decision, MOFCOM did not prevent Wal-Mart from continuing to offer the online direct sales services currently operated by Yishiduo through its VIE structure.

Thus it can be seen that, if a transaction involving companies with VIE structures does not result in foreign investors gaining control over business activities that are restricted or prohibited for foreign investment, then MOFCOM will probably accept such a structure and will not block the transaction because of the existence of the VIE structure—absent genuine anticompetitive effects, of course.

2. VIE Structures Involving Businesses Subject to Restrictions for Foreign Investment

As indicated by the third condition set forth in the MOFCOM decision, Wal-Mart is prohibited from engaging in the VATS currently offered by Yishiduo. The rationale for imposing this condition was based on the rarely used "leveraging" theory.

Although the argument of the conclusion was not satisfactory from the antitrust perspective, the condition succeeded in its aim of prohibiting the use of VIE structures from engaging in activities that are restricted or prohibited for foreign or foreign-invested businesses. We suspect that MOFCOM's Anti-Monopoly Bureau probably did not want to directly declare that using VIE structures to engage in VATS is illegal (since such judgment does not fall within

the jurisdiction of the Anti-Monopoly Bureau). At the same time, it seems the Anti-Monopoly Bureau did not want to indirectly—through its anti-monopoly review—endorse the use of VIE structures either. Based on such an interpretation, we cannot exclude the possibility that MOFCOM's Anti-Monopoly Bureau may have felt it needs to use its market analysis to reach the conclusion that Wal-Mart cannot resort to the VIE structure to operate in a restricted sector—no matter how satisfactory or convincing its arguments are.

Our interpretation is that MOFCOM's Anti-Monopoly Bureau probably did not wish to directly make any comment or conclusion on the legitimacy of VIE structures before the government authorities in charge of foreign investment have given their official opinion on this point.

However, in *Wal-Mart/Newheight*, MOFCOM's Anti-Monopoly Bureau was clearly very concerned about the existence of VIE structures. Beyond this case, our understanding is that the Anti-Monopoly Bureau's usual practice is to prevent foreign investors from engaging in restricted and/or prohibited sectors via VIE structures. In its merger control procedure, the Anti-Monopoly Bureau would analyze the legitimacy of the underlying legal structure of a transaction and, if it has doubts, might probably refuse to approve the transaction purely from an anti-monopoly perspective.

Therefore, if an acquisition by a foreign investor of business, which operates in sectors restricted or prohibited for foreign investment through a VIE structure, requires a notification under the Anti-Monopoly Law, then—at least for now—we do not see a possibility that MOFCOM's Anti-Monopoly Bureau would approve such transaction.

3. Acquisitions by Companies with VIE Structures

Another issue is how the Anti-Monopoly Bureau would view acquisitions made by companies with VIE structures. Such transactions may not result in foreign investors entering into restricted/prohibited sectors via VIE structures. For example, an FIE or a foreign enterprise with a VIE structure intends to acquire a business where foreign investment is permitted. Given that the Anti-Monopoly Bureau's attitude towards VIE structures is not clear, most companies with a VIE structure may feel very hesitant to submit a merger control notification to MOFCOM where the statutory thresholds are triggered, even if the acquired businesses are not restricted for foreign investors. The reason is that such companies are concerned that their own legal structures may be challenged in the merger control procedure.

We are of the opinion that as long as the transaction itself does not create a new VIE structure through which foreign investors enter into restricted/prohibited sectors, the Anti-Monopoly Bureau should just focus on the antitrust issues and review the case purely from the perspective of the Anti-Monopoly Law. In short, the existing VIE structures of the companies should not be reviewed, and should not delay the review process. Instead of pushing companies away, MOFCOM, at least in practice, should give clear guidance which companies with existing VIE structures can follow in terms of anti-monopoly reviews.