CPI's Asia Column Presents:

A Discussion of VIE-structured Companies from a Merger Review Perspective

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Recently, the U.S. Federal Trade Commission ("FTC") issued special orders to big tech companies to request them to provide information regarding historical transactions that were not reported under the HSR Act.[2] A few days later, European Commissioner Margrethe Vestager made a speech indicating that the European Commission ("EC") would look into smaller acquisitions made by big tech companies over the last decade.[3]

The two major competition jurisdictions are not the only ones concentrating on transactions by big tech companies. China has focused on the anti-monopoly issues related to internet giants for several years. Mergers involving internet companies adopting a "VIE structure" have attracted growing concern, especially as increasingly powerful internet giants stretch into more business domains by continuously investing in and acquiring smaller enterprises.

Variable interest entities (or "VIE-structured companies"), have existed in China for more than 20 years, and there have been continuous discussions of VIE-related issues. It is commonly believed that Chinese regulators, and the judiciary, were generally reluctant to provide feedback on matters involving such structures. Even the new Foreign Investment Law, issued by the National People's Congress on March 15, 2019, chose to set aside the VIE issue, taking a big step back from the 2015 Exposure Draft.[4] The recently issued Implementation Regulations for the Foreign Investment Law adopted the same approach as the Foreign Investment Law with regards to the VIE issue, taking a similar step back from the 2019 Draft for Comment version.[5]

In the merger review domain, clients often ask whether the Chinese anti-monopoly authority (the "SAMR") has started to review merger filings involving VIE-structured companies, and if not, whether it is possible for the SAMR to do so. This article shares some thoughts on these issues and gives some advice for VIE-structured companies that are active in the M&A market from an anti-monopoly review perspective.

Has the SAMR started to review merger filings involving VIE-structured companies?

On April 4, 2019, the SAMR published the list of unconditionally approved merger filings in the first quarter of 2019. Of this list, some organizations and scholars suggest that the filing for a proposed joint venture by Yonghui Superstores, PARKnSHOP and Tencent Mobility (the "Yonghui transaction") is the first publicly known transaction involving an internet giant (Tencent) that adopted a VIE structure. In the past, it appeared that VIE-structured companies had chosen to ignore the merger filing requirement or had encountered difficulties in completing the filling.

However, after a closer look at the "Yonghui transaction," the governance structure of the proposed joint venture seems to show that Tencent Mobility would possibly not be one of the controllers of the joint venture.[6] The list also demonstrates that only Yonghui Superstores[7] and PARKnSHOP are "undertakings participating in the concentration." According to the relevant Chinese merger filing, it can be inferred that the SAMR did not even need to focus on Tencent Mobility, not to mention its VIE structure. Therefore, even though a VIE-structured company was involved in the transaction, the filing and the review of the "Yonghui transaction" likely did not touch on the regulation of Internet giants or relevant VIE issues.

More recently, the SAMR published a simple case which involve a proposed joint venture by Mingcha Zhegang and Huansheng (a wholly-owned subsidiary of Yum China) (the "Mingcha Zhegang transaction").[8] In the publicity form for notification of simple case, it clearly states that Mingcha Zhegang's ultimate parent is Leading Smart Holdings Limited, a company incorporated in the Cayman Islands, and Leading Smart Holdings Limited "controls Mingcha Zhegang through a series of contractual arrangement." Different from Yonghui transaction, in this transaction, Mingcha Zhegang is one of the"undertakings participating in the concentration," and therefore presumably Mingcha Zhegang's VIE structure as well as its business would be focused during the merger review.

However, as the information disclosed by the publicity form is relatively limited, it is unclear whether Mingcha Zhegang's business involves restricted or prohibited domains for foreign investment (i.e. whether Mingcha Zhegang's VIE structure was created to circumvent relevant regulations), would Mingcha Zhegang transaction set up a good example for VIE-structured companies that operate business in restricted or prohibited domains for foreign investment in regards to merger filing? Moreover, as Mingcha Zhegang is a Chinese entity, would a case be accepted and reviewed like this transaction if the "undertaking participating in the concentration" is the offshore entity or the structure of the transaction is established outside mainland China are also currently unknown. Besides, we can hardly know whether the Mingcha Zhegang transaction touch upon the historical filing issue and how the filing party as well as the SAMR deal with it.

Aside from the "Mingcha Zhegang transaction," based on the lists of unconditionally approved merger filings, it seems that until now no further breakthrough has been made for merger reviews involving VIE-structured companies even though there are constantly other notable transactions involving such companies. It is said that attempts have been made by certain VIE-structured companies to make merger filings. For the majority, however, this is not an easy route to take, as their unreported historical transactions have piled up high, and it is unclear how the SAMR would look back at these historical transactions once companies begin to file, thus raising new questions.

When we are talking about VIEs, what are the relevant issues?

The VIE structure was created mainly to circumvent relevant Chinese regulatory requirements regarding foreign investment. Specifically, as the VIE structure is set up through a series of agreements ("control through agreement"), which is different from control through stocks or assets, it is not directly covered or regulated by the Provisions on Merger and Acquisition of Domestic Enterprises by Foreign Investors (the "Regulation No. 10").[9] Therefore, no prior approval by the Ministry of Commerce ("MOFCOM") or the China Securities Regulatory Commission ("CSRC") would be necessary for transactions using this approach.

Yet, there are two main issues as to the legality of the VIE structure: whether the structure itself is valid (the "validity issue"), and whether the investment itself is in compliance with relevant industrial policies (the "compliance issue"). This article will then analyze how a merger review may touch upon the above two issues.

The SAMR is not in the position to opine on the "Validity Issue," and therefore an anti-monopoly approval does not equate to an acknowledgement of the legality of the VIE structure.

The SAMR was established in March 2018, and it has an integral market regulation function. From the perspective of anti-monopoly enforcement, the anti-monopoly law enforcement responsibilities of the three agencies – the National Development and Reform Commission (the "NDRC"), MOFCOM, and the State Administration for Industry and Commerce (the "SAIC") are now gathered under the same roof.

As the predecessor agency responsible for merger review, MOFCOM is also the authority that promulgated Regulation No. 10. It is known that, so far, no "M&A with related party" (usually the preparatory process in the offshore listing) as stipulated in the Regulation No. 10 has been approved by MOFCOM, and therefore the VIE structure was adopted as an alternative. Consequently, if a merger filing involving VIE-structured companies were to be presented before MOFCOM, there would be concerns about whether approval would constitute an acknowledgement of the validity of the VIE structure from MOFCOM's standpoint.

This is also apparent from MOFCOM's decision on the August 2012 Walmart/Niuhai Holding transaction, where MOFCOM carefully expressed that "Walmart is not allowed to use its VIE structure to engage in the value-added telecom services currently operated by Yishiduo E-Commerce (Niuhai Holding's subsidiary controlled through a VIE agreement)." It is clear that MOFCOM merely reiterated relevant requirements in the 2011 Industrial Guide for Foreign Investment (effective at that time) for value-added telecom services,[10] while in the other parts of the decision, it evaluated the competition concerns arising out of the transaction and adopted remedy measures to prevent possible anti-competitive effects, as in other high-profile cases.

However, this article is of the opinion that the new SAMR could, from a relatively pure market regulation perspective, review merger filings involving either companies in a general sense or VIE-structured companies, and evaluate competition concerns without much regard for the external form of the filing parties. More importantly, unlike MOFCOM, the SAMR is not the competent authority to opine on the "validity issue" of VIE structures. Anti-monopoly approval only means that the SAMR recognizes that the concentration would likely not harm competition in the relevant market, but it does not acknowledge the legality of the VIE structure.

The SAMR is also not in a position to opine on the "Compliance Issue," and therefore anti-monopoly approval does not equate to an acknowledgement of the compliance of the foreign investment.

Aside from the validity issue, another difficulty is that the filing party must commit in the merger filing form that it will comply with Chinese laws and regulations. The VIE structure remains in a legal grey area even under the new Foreign Investment Law and its Implementation Regulations. Some argue that approval by the SAMR could be viewed as an acknowledgement of the compliance of the structure.

The 2015 Exposure Draft of the Foreign Investment Law sought to address the compliance issue of VIE-structured companies. For example, the Draft includes relevant legal liabilities for making investments, through VIE structures or other methods, in prohibited industries or in restrictive industries without approval. It also provides for methods to deal with preexisting VIE structures.[11] However, given that there are a great many domestically-operated companies (notably in the Internet, education and media industries) that use VIE structures and are active in foreign capital markets, making enormous contributions to the development of the Chinese economy, it is relatively difficult to figure out a satisfactory way to handle the compliance issue from a general foreign investment regulation perspective.[12]

Moreover, the SAMR or other administrative regulators – the governmental agencies in charge of the regulation of a company's general matters such as its establishment or change of company form – are not the competent authorities to solve this issue. Rather, industrial regulators – the governmental agencies in charge of the regulation of a company's operation in a specific industry – would be in a better position to do so. This is also reflected in the Supreme People's Court's ruling in *Changsha Yaxing v. Beijing Normal University Anbo*, a contractual dispute case,[13] in which the court opined that "for foreign equity's participation in or *de facto* control over private schools that engage in compulsory education… it is the education administrative department's duties to regulate such behavior."[14]

Given that the SAMR is not an industrial regulator, it is not the designated authority to examine the compliance issue for such investments, and thus, a decision issued by the SAMR does not mean that the structure adopted by the filing party is necessarily compliant (or not).

Other administrative regulators have already touched upon VIE-structured companies. It is estimated that the SAMR might also take a more explicit position.

After discussing the "validity issue" and the "compliance issue," it seems that there is no material barrier to the SAMR reviewing transactions involving VIE-structured companies. Moreover, if the SAMR were to review such filings, it would not be the first to touch upon VIE-structured companies. Other administrative regulators such as the State Administration of Foreign Exchange ("SAFE") and the CSRC have already expressed their attitude towards VIE-structured companies under the relevant rules and regulations.

<u>SAFE's practice in the foreign exchange regulation domain</u>

As early as 2005, SAFE issued Rule No. 75 (now nullified),[15] which stipulated that "a round-trip investment means direct investment activities in China by a domestic resident through a special purpose company by means of, including but not limited to … establishment of a foreign investment enterprise within China so as to purchase stocks in or 'control through agreement'[16] … domestic assets."

Then in the subsequent Rule No. 35,[17] SAFE stipulated that "control" under this means "business management rights, right to earnings, or decision making rights of a special purpose vehicle obtained by a Chinese resident through acquisition, trust, holding on behalf of others, voting rights, buyback, convertible bonds, etc." As such, from the perspective of foreign exchange regulation, stock holding, VIE structures, or others are just different means of exercising control. In fact, the regulator does not focus on how the control is exercised, but on how these relevant activities would need to follow the foreign exchange regulation rules.

The CSRC's practice in the security regulation domain

Similarly, VIE structures or, more generally, "control through agreement" also appears in recent Chinese security regulation rules. In March and June 2018, the General Office of the State Council and then the CSRC issued rules regarding the domestic issuance of shares or depositary receipts by innovative enterprises.[18] These rules state that "if an overseas underlying securities issuer has different voting rights of shareholders, VIE-structure or similar special arrangements, it shall fully and elaborately disclose relevant information, especially risks and corporate governance at notable places in its prospectus and other public offering documents ..."

Then in January 2019, the CSRC's rules regarding China's new Science and Technology Innovation Board further indicated that Red Chip companies in accordance with relevant rules can apply to be listed on the Science and Technology Innovation Board.[19] In April 2020, the CSRC made it more explicit that for pilot innovative Red Chip companies that hope to list in Chinese capital market, after the CSRC accepts relevant application, it will solicit opinions from industrial regulators according to the domain that the domestic entities of the Red Chip company operate business, the National Development and Reform Commission and the MOFCOM, and would handle the matter in accordance with the laws and regulations.[20] These security regulation rules show that as long as the legitimate rights and interests of investors are properly protected, the CSRC welcomes all kinds of existing forms of companies including VIEs or other special arrangements to Chinese capital market.

Takeaways

To sum up, though the "validity issue" remains untouched in the Foreign Investment Law as well as its Implementation Regulations, and different industrial regulators may have evolving opinions on the "compliance issue" for foreign investment in specific sectors along with China's opening-up process, administrative regulators such as SAFE and the CSRC possess a relatively open attitude towards VIE-structured companies as long as regulatory rules for relevant necessary purposes are satisfied.

If the SAMR were to review filings involving VIE-structured companies, it can merely adopt a similar approach or just ignore this external structure. After all, the SAMR could simply focus on the competition law issues for a transaction in its anti-monopoly review.

Looking Forward: Some Initial Advice for VIE-Structured Companies

As previously demonstrated, we believe that there is no material barrier for the SAMR to review filings involving VIE-structured companies. Moreover, as the SAMR is not the competent authority to examine the "validity issue" or "compliance issue" of VIE-structured companies, a merger review decision by the SAMR is not in any way equivalent to an acknowledgement of the legality of the structure or its compliance with foreign investment rules. As other administrative regulators such as SAFE and the CSRC have already gone a step further, and the recent filing and acceptance by the SAMR of “Mingcha Zhegang transaction” appears to some extent to be a signal for similar-structured transaction, it is believed that the SAMR would, quite possibly, become more proactive in reviewing merger filings involving VIE-structured companies in the very near future.

On the other hand, with the degree of market concentration continuously increasing in some industries, certain have objected either to specific transactions that might threaten to already dampen competition (or already have), or to the established “no response” practice, especially when the law enforcement agency has the obligation, according to law, to investigate the transaction if the transaction has or may have anti-competitive effects.[21] Presumably the SAMR must take positive actions to respond to such questions.

More importantly, in the recently issued exposure draft for the revision of Anti-Monopoly Law of China, the SAMR is seeking to make it clear in law that for a concentration which does not reach the filing thresholds but has or may have the effect of eliminating or restricting competition, the authority not only can impose restrictive conditions or even prohibit the concentration based on their analysis of the competition concerns raised by the concentration, it can also make an order to restore the pre-concentration status if the concentration has already been implemented.[22]

Moreover, the SAMR also hopes to make it clear in law that the SAMR may formulate and revise the filing threshold according to factors such as the economic development level and scale of industry,[23] implying that there is a possibility to formulate filing thresholds for specific industries, just like the separate rules for the financial sector. Though whether these articles in the exposure draft will remain in the final version of the new Anti-Monopoly Law of China remains to be seen, it is suggested that VIE-structured companies stay focused and carefully evaluate the possible anti-monopoly risks for their acquisitions or establishment of joint ventures.

Lastly, considering the recent focus on the historical transactions of big tech companies by the FTC and the EC, there is a possibility that the SAMR would be inspired to make similar proactive moves. Therefore, it is highly recommended for the internet giants to closely follow the SAMR’s merger review activities and to keep an eye on recent trends. With regards to unreported historical transactions, it is also necessary to undertake a thorough internal review, and to be crystal clear about these transactions. If they do so, companies may be in a position to devise prompt solutions to minimize risk in a reasonable and efficient manner, once the time comes.

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[2] See FTC website, "FTC to Examine Past Acquisitions by Large Technology Companies" at https://www.ftc.gov/news-events/press-releases/2020/02/ftc-examine-past-acquisitions-large-technology-companies.

[3] See CNBC website, "EU says it will look closer at smaller acquisitions made by big tech firms after 'shopping spree'" at https://www.cnbc.com/2020/02/18/eu-margrethe-vestager-will-look-closer-at-smaller-acquisitions-made-by-big-tech-firms.html.

[4] The 2015 Exposure Draft of Foreign Investment Law made it clear that it would like to address the legal ambiguity for VIEs by requiring the identification of the *de facto* owner of the domestic entity, therefore bringing contractual or trust arrangements as well as VIE structures into the scope of regulation.

[5] Article 35 of the 2019 Draft for Comment version for the Implementation Regulations for the Foreign Investment Law stipulates that "where a wholly-owned enterprise established outside Mainland China by a Chinese natural person, legal person or organization of any other type makes investment in the Mainland, the wholly-owned enterprise may, subject to review by relevant competent departments of the State Council and approval by the State Council, be exempted from the restrictions on market access special management measures prescribed by the negative list of foreign investment access." This article appears to be a signal for the intention to bring VIE structures into the scope of the regulation (though under very limited circumstances), but the *Implementation Regulations* did not keep this Article.

[6] According to the announcement of Yonghui Superstores which could be found at http://www.cninfo.com.cn/new/disclosure/detail?plate=sse&stockCode=601933&announcementId=1205530367&announcementTime=2018-10-25, Tencent Mobility would hold 10 percent stocks in the joint venture, and could only appoint one director (not the chairman) in the BOD with 6 members.

[7] According to public information, Linzhi Tencent, also a subsidiary of Tencent, is one of the shareholders of Yonghui Superstores. It is unlikely that the SAMR would look at Linzhi Tencent when evaluating Yonghui Superstores' turnover or market shares since Linzhi Tencent is only a minority shareholder. Moreover, though Tencent also holds stocks in JD, another minority shareholder of Yonghui Superstores, it is likely that the SAMR mainly focused on Yonghui Superstores' actual controllers, two natural persons, just as Yonghui Superstores' disclosures in its annual report.

[8] More information about this simple case could be found at http://www.samr.gov.cn/fldj/ajgs/jzjyajgs/202004/t20200420_314431.html.

[9] In *No.10 Regulation*, Article 11 stipulates that "in the event of M&A by a company, enterprise, or natural person in China, in the name of a company that it has legitimately established or controls outside China, of a Domestic Company affiliated thereto, the M&A shall be submitted to the MOFCOM for examination and approval."

[10] In the 2011 Industrial Guide for Foreign Investment, foreign entities shall not hold more than 50 percent stocks in Chinese entities engaging in value-added telecom services.

[11] For example, the exposure draft listed several recommended solutions for pre-existing investments through VIE structures while the investment still belongs to the prohibited or restricted domain for foreign investment after the law enter into force, and sought to solicit opinions so as to make further research and provide suggestions for solutions.

[12] For example, when the Ministry of Justice released the 2018 exposure draft for the implementing regulation for the Law on the Promotion of Privately-run Schools, it clearly stipulated that "companies that are *de facto* controlled by foreign entities shall be prohibited from exercising *de facto* control over [a] private school that engages in compulsory education in China." Though this is in line with the regulations in the 2018 foreign investment negative list, immediately after the exposure draft was released, the price of shares of U.S. listed companies, TAL and New Oriental Company, dropped correspondingly.

[13] 长沙亚兴置业发展有限公司与北京师大安博教育科技有限责任公司合作合同纠纷上诉案[*Changsha Yaxing v. Beijing Normal University Anbo on Contract Disputes*] (2015)民二终字第117号, (The Civil Division II of the Supreme People's Court, Jul. 2nd, 2016) CLI.C.9036337.

[14] Similarly, the Minutes of the Meeting on the Work of Civil and Commercial Trials of the National Courts (the exposure draft issued by the second chamber of the Supreme People's Court of China) which was issued in August 2019, seem to indicate that there is a low likelihood that the VIE arrangement would be found to violate the mandatory provisions of laws and administrative regulations. In any event, this remains an interpretation by the Supreme People's Court from a contractual, not a compliance perspective.

[15] The Notice on Issues relating to Foreign Exchange Administration for Financing and Round-trip Investments by Domestic Residents through Overseas Special-purpose Companies.

[16] Though VIE is an accounting term, and "control through agreement" is a legal term, there is no significant difference between these two terms for the purpose of this article.

[17] The Notice of the State Administration of Foreign Exchange on Issues Relating to Foreign Exchange Control for Overseas Investment and Financing and Round-tripping by Chinese Residents through Special Purpose Vehicles.

[18] The Notice of the General Office of the State Council on Forwarding the Opinions of the China Securities Regulatory Commission on Launching Pilot Projects for the Domestic Issuance of Shares or Depositary Receipts by Innovative Enterprises, March 2018; The Administrative Measures for the Issuance and Trading of Depositary Receipts (for Trial Implementation), June 2018.

[19] The Opinions on setting up the Science and Technology Innovation Board and experiment of registration-based IPO system in Shanghai Stock Exchange, January 2019.

[20] The announcement of the arrangement for the listing of pilot innovative red chip enterprises in China, April 2020.

[21] Article 4 of the Rules of the State Council on Declaration Threshold for Concentration of Undertakings.

[22] Article 34 of the exposure draft for the revision of Anti-Monopoly Law of China.

[23] Article 24 of the exposure draft for the revision of Anti-Monopoly Law of China.