

*CPI's Asia Column Presents:*

# China Signals VIE No Longer an Obstacle in Merger Filing

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## I. Introduction

This July, the Chinese antitrust authority (State Administration for Market Regulation, “SAMR”) unconditionally cleared a joint venture between Yum China and Mininglamp involving a VIE structure (“M/H”),<sup>2</sup> the first of its kind since the conditional clearance of Walmart’s acquisition of Yihaodian in 2012<sup>3</sup> and marks a milestone for future VIE filings.

For years, uncertainties have clouded the prospect of docketing and clearing a VIE structured transaction under the Chinese Anti-Monopoly Law (“AML”). Although there exist no legal grounds for exempting such a transaction, in practice, parties often adopt various tactics to keep an otherwise notifiable transaction involving a VIE structure off the China merger review radar. This has become increasingly risky in light of recent regulatory developments.

Based on our first-hand experience (incl. recent practices with SAMR) and observations, we will discuss certain key issues arising in a merger filing involving a VIE structure and practical merger filing guidance for transactions involving VIE entities or their controllers. Below are some highlights:

- (1) given the heightened exposure to failure-to-notify cases (fine up to 10 percent group revenues in the preceding year if the proposed amendment to AML becomes law), companies need to reassess their past and pending transactions involving VIE structure that crossed the filing thresholds, and to formulate proper response strategy;
- (2) the regulatory restrictions on foreign investment associated with VIE structure will not likely become an insurmountable obstacle to docket and clear a notifiable transaction;
- (3) innovative formats and dynamic landscape (e.g. digital platform competition) in a sector involving a VIE structure may impact the market definition, competitive analysis, and eventual deal structuring or notification strategy; a below threshold transaction which will otherwise be exempt from filing may still trigger scrutiny from SAMR (especially if a third party complaint is filed).
- (4) a VIE arrangement falls within the scope of “control” under the AML, and the turnover and competitive analysis will trace through the VIE structure up to the ultimate controlling party.

## II. VIE Related Issues in a China Merger Filing

A VIE (variable interest entity) structure, which is a type of “contractual control,” refers to a corporate structure where the actual controlling party does not own shares of the operating entity (i.e. VIE), but achieves *de facto* control on business operations and financial consolidation of such entity through a series of agreements (i.e. VIE agreements). In a typical VIE structure, the controlling entity is usually incorporated overseas for financing and tax planning purposes, while the controlled operating entity is a domestic company and can carry out business in the sector not yet (fully) open to foreign investors. Such a structure is believed to be first introduced in the overseas IPO of Sina.com (also known as the “Sina Model”) and later widely adopted in many emerging sectors, particularly in internet-related businesses.

In practice, there are many uncertainties surrounding the merger filing of transactions involving a VIE structure. Article 20 of the AML provides that “the acquisition of control over

other undertakings or the ability to impose decisive influence on other undertakings through *agreements* or other methods” constitutes a concentration of undertakings. This often captures transactions involving a VIE structure. Accordingly, if the filing threshold is met, there appears to be no legal grounds to exempt such transactions from a mandatory merger filing in China. Indeed, the Chinese antitrust authority has never expressly affirmed that merger filing obligations do not apply nor indicated that they will not accept a merger filing involving a VIE structure. Nevertheless, since the *Walmart/Yihaodian* Case in 2012, we are not aware of any merger filing involving a VIE structure docketed or cleared in China until the recent *M/H* case. It was reported that the failure of Sina’s proposed acquisition of Focus Media in 2009 was partially due to the unsuccessful attempt in docketing China merger filing.<sup>4</sup>

Even in the *Walmart/Yihaodian* case, it should be noted that MOFCOM (the merger control authority at the time) docketed and cleared the case subject to conditions, among others, that Walmart shall not engage in, through a VIE arrangement, the value-added telecommunications business operated by Yihaodian, which was not fully open to foreign investors at the time. According to its Announcement on the Removal of Restrictive Conditions on the Concentration of Undertakings of Wal-Mart Stores, Inc.’s Acquisition of 33.6 percent of the equity in Niu Hai Holding Ltd., MOFCOM removed the restricted conditions imposed on *Walmart/Yihaodian* Case on May 30, 2016.<sup>5</sup> Indeed, since June 19, 2015, the Ministry of Industry and Information Technology (“MIIT”) has lifted the shareholding percentage restriction on foreign investment in the area of electronic data interchange (e-commerce) at the national level and foreign investors are permitted to hold up to 100 percent equity of the operating company of such value-added telecommunications services. Therefore, the restrictive condition related to Yihaodian’s VIE structure has been of no practical meaning since then.

In short, the *Walmart/Yihaodian* case has provided limited guidance on certain key questions, such as whether the VIE structure will impact the Chinese authority’s acceptance and review of the merger filing, and if the filing is docketed, how the VIE will impact its review approach and outcome, or how the “negative list” for foreign investment interplays with the merger review.

### III. Implications of the *M/H* Case and Recent Practices

The acceptance and unconditional clearance of the *M/H* case, consistent with our recent practices with SAMR, sheds some valuable light on merger filings in China involving a VIE structure.

#### A. *It has been reaffirmed that contractual control through VIE agreements falls within the scope of “control” under the AML.*

According to the public announcement form of the *M/H* case, the Chinese party’s ultimate controlling person controls the Chinese party “through its affiliates based on a series of contractual arrangement,” which suggests that a VIE structure within one party’s group is deemed to be a kind of “control” under the AML,<sup>6</sup> and the turnover and competitive analysis must be traced through the VIE structure up to the ultimate controlling person.

Following this approach, a typical VIE arrangement in transactions in the internet sector such as concluding proxy agreements, acquiring WFOEs that control domestic operating entities will likely be deemed as “acquiring control over other undertakings,”<sup>7</sup> and will trigger the mandatory *ex ante* merger filing obligations if the filing thresholds are met.

***B. A VIE structured transaction shall assess group-level turnover and may even trigger filing obligation despite a below-filing threshold.***

Under China merger control rules and practice, a notification obligation is triggered when an acquisition of control occurs, and the turnover threshold is met. The turnover of an undertaking should be calculated based on all revenues at the group level, i.e. including the turnover of all its affiliates,<sup>8</sup> net of applicable taxes and surcharges and excluding intra-group sales. As mentioned above, for merger filing purpose, a VIE structured transaction shall assess group-level turnover (i.e. revenues from both VIE structure and non-VIE structure) under the same ultimate controlling person.

The above line for turnover calculation could be blurred for a digital platform provider, who typically operates in two or more “markets”, free-of-charge services for individual consumers on the one side, and paid or value-added services for another group (e.g. advertisers, vendors) on the other side. Indeed, it is not uncommon for an influential start-up capturing a bulk of “market” share but is still having “limited” revenues or not making profits, and accordingly shield itself from making notification on this basis in addition to the VIE structure. For example, in its acquisition of Uber China in 2016, Didi was reported to opt not to make a merger filing on the grounds that (i) neither Didi nor Uber China has made profits in China, and (ii) the turnover of Uber China in the previous fiscal year did not cross the filing threshold.<sup>9</sup> MOFCOM (and later SAMR) was reported to be probing into this transaction.<sup>10</sup>

Even if a company’s turnover has not crossed the filing threshold but has significant share and post-transaction impact on the “market” at issue (e.g. a digital platform with internet-driven business models or data-intensive applications), it is still not completely risk-free to proceed with the transaction absent thorough antitrust assessment. Indeed, the current merger filing rules authorize SAMR to carry out investigation into an anti-competitive below-threshold deal,<sup>11</sup> and the draft amendment to the AML further proposes that antitrust authorities could take appropriate remedies against such a deal (incl. orders to impose restrictive conditions, orders to cease the concentration or restore the pre-deal status, etc.).<sup>12</sup>

***C. Regulatory restrictions on foreign investment associated with VIE structure not likely an insurmountable obstacle to docket and clear a notifiable transaction.***

Some are of the view that the former Chinese antitrust authority, MOFCOM, had adopted a “passive” stance on transactions involving a VIE structure that met the filing thresholds — while not taking the position that those transactions were not subject to merger review, it had not appeared to have docketed their merger filings. Some suspect that the primary reason for MOFCOM (which is also the authority supervising foreign investment) for taking such cautious approach is to avoid creating an impression or precedent that a merger clearance could be interpreted as a blessing over the legality of VIE structure under the Chinese law, because, strictly speaking, VIE structure might be deemed to circumvent the relevant regulatory restrictions on foreign investors to engage in certain businesses in China.

The above saw a turning point following the institutional reform of China's State Council governmental agencies (incl. inception of SAMR) in 2018. The successful docketing and clearance of the *M/H* case shows that SAMR is becoming more proactive on such kind of merger filings. In this case, while the parties disclosed the VIE part involved in the transaction structure, SAMR decided to focus on impact on the market competition, and unconditionally cleared the case based on its thorough review of market data and competition analysis. This clearance demonstrates SAMR's expertise and independent exercise of its function as competition authority, and provides significant guidance on future merger filings involving VIE structure. Indeed, our recent practices suggest that the "negative list" for foreign investment will not likely become an obstacle for SAMR to review a notifiable transaction even if both parties are VIE structured.

***D. Market definition and competitive analysis becoming more challenging after factoring in innovative formats and dynamic landscape in a sector involving VIE structure.***

For merger filing purpose, market definition is the starting point for competitive analysis, and both form an essential part of the notification preparation. Internet and other digital activities are common sectors involving VIE structures, and their innovative formats and dynamic landscape are increasingly challenging the traditional approach of market definition and competitive analysis.

In digital economies, competition oftentimes happens through platform rather than standalone business. From demand perspective, almost all daily needs of consumers (e.g. social networking, shopping, dining, healthcare, transporting, entertaining, studying, officing) can be or have been digitalized through an app or another platform; from supply perspective, each player usually offers a variety of digital services (through a platform) and/or can quickly switch/expand to a new format of business depending on the market demand and competitiveness. Accordingly, it could be challenging to draw a bright line to define a product market, in particular for niche or emerging activities.

Similarly, the geographic dimension for digital activities could be complicated. On the one hand, there appears to be no barriers for consumers to receive digital services worldwide; on the other hand, the regulatory requirements, cultural and language differences may contain the relevant digital services and competition at national level. For traditional services (e.g. retail, restaurant, healthcare), a digital platform could significantly expand the radius of targeted customers to regional or national territory from local area.

How to delineate the relevant market will impact the competitive analysis, which is primarily measured by market share(s) of the company at issue and its rivals in merger filing. For novel and complex cases, SAMR officials tend to err on the side of caution and may be more receptive to looking into narrowly defined market, which could artificially elevate market share(s) and create larger number of relevant market(s). However, this may not reflect the competition dynamics in reality, as the company at issue may engage in broader activities covering services at issue, while its rivals may include various service providers and platform operators that provide "in-house" "free-of-charge" services. Even if the company at issue has limited or no presence in the relevant market (e.g. joint venture or target business), its strength in another remote area (say over 25 percent in a narrowly defined sector, which may not be an issue in a traditional case but could be "relevant" in the context of digital platform)

may potentially disqualify any future transaction from applying a simple case, in particular if there are conflicting market datasets.

***E. The prevailing practice of keeping a notifiable deal involving VIE structure off China's merger review radar will face heightened antitrust risk exposures.***

For abovementioned uncertainties on the prospect of merger filing and moderate legal liability, it has been an often-adopted tactic to keep a notifiable transaction involving a VIE structure off China's merger review radar. However, with the clearance of the *M/H* case and based on our recent practices, such tactics will more likely run into heightened antitrust risk. Considering that the draft Amendment to the AML released earlier this year proposes to significantly increase the upper limit of the penalty against a failure to notify (from RMB500,000 up to 10 percent of an undertaking's group-level turnover in the preceding year), the legal consequences and non-compliance exposure has become much more severe.<sup>13</sup> Especially for big internet players involved in a VIE structure, even a fine based on a low single digit percentage of the group revenues could see billions of dollars at stake.

On the other hand, considering the timetable for a deal in digital sector is often aggressive and unclear prospect of the merger review process, some parties in VIE-structured transactions may still decide to close first and turn themselves in later before the effectiveness of the Amendment to the AML.

#### **IV. Practical Takeaways for VIE-Structured Companies/Transactions**

A deal involving VIE structures may involve a variety of potential compliance issues, including foreign investment and operational qualification, and one should not expect that all can be clarified/resolved from the antitrust filing and/or clearance alone. Indeed, SAMR is responsible for reviewing a notifiable deal from AML perspective, but a clearance by SAMR does not give blessing to all deal aspects.

Depending on the specific circumstances, SAMR's review of merger filing involving a VIE structure will be on a case-by-case basis, and the *M/H* case is one example – it has demonstrated that a VIE structure is not an impenetrable area in China's merger control or in other antitrust enforcement activities. VIE structured firms or those who plan to introduce a VIE element in its group structure should be vigilant about antitrust compliance in their M&A transactions.

For a transaction involving a VIE structure (including establishing a VIE structure), the parties should conduct an antitrust assessment during early stages and, where a merger filing is required, formulate and implement a proper strategy to mitigate uncertainty during merger review process. Specifically,

- (1) working with an antitrust counsel to run substantive assessment, discuss and formulate filing strategies and plans, and, if necessary, proactively approach SAMR for guidance, instead of circumventing the filing obligations simply based on the misconception that SAMR will not accept the merger filing involving a VIE structure or the belief that SAMR will leave them alone;

- (2) if, upon assessment, a filing obligation will likely be triggered, planning a more flexible timetable for the merger filing to cope with unexpected circumstances during the review process;
- (3) proactively communicating with SAMR and the parties, and properly responding to the information request (and third-party objection, if any) to ensure a smooth process;
- (4) for any historical non-compliance issues, establishing a task force or engage antitrust counsel to conduct a self-review and develop a proper response strategy (based on communication with SAMR, if required).

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<sup>2</sup> The *M/H* Case concerns the establishment of a joint venture between Shanghai Mingchazhegang Management Consulting Co., Ltd. (an affiliate of Mininglamp) and Huansheng Information Technology (Shanghai) Co., Ltd. (an affiliate of Yum China). See Zhong Lun's role in the *M/H* Case at <http://www.zhonglun.com/Content/2020/07-22/1337089492.html>.

<sup>3</sup> For more detail on the Walmart/Yihaodian Case, see the Announcement of the Ministry of Commerce (MOFCOM) on the Decision to Impose Restrictive Conditions on the Concentration of Undertakings of Wal-Mart Stores, Inc.'s Acquisition of 33.6% Equity in Niu Hai Holding Ltd., at <http://www.mofcom.gov.cn/article/b/g/201209/20120908362132.shtml>.

<sup>4</sup> See MOFCOM's press release on this case at <http://www.mofcom.gov.cn/article/ae/slfw/200910/20091006561474.shtml>.

<sup>5</sup> See MOFCOM's announcement at <http://fldj.mofcom.gov.cn/article/ztxx/201606/20160601335200.shtml>.

<sup>6</sup> See Article 6 of the *Guiding Opinions on Notification of Concentrations of Undertakings* (关于经营者集中申报的指导 意见).

<sup>7</sup> See Article 20 of the AML.

<sup>8</sup> The "affiliate" refers to the entities directly or indirectly controlled (or joint controlled) by such undertaking, the ultimate controlling person of such undertaking, and all entities directly or indirectly controlled (or joint controlled) by such ultimate controlling person, etc. The concept of "control" also covers various instances of having the power to exert a "decisive influence" (incl. veto right) over strategic commercial matters of an entity, such as decisions relating to budget, business plan, major investments and appointment of senior management, etc.

<sup>9</sup> See, e.g. *DiDi Responds to MOFCOM's "Merger Filing" Comment: Not Crossed Filing Threshold*, available at: [http://money.163.com/16/0802/12/BTFAUIKP00254R2Q.html#sns\\_weibo](http://money.163.com/16/0802/12/BTFAUIKP00254R2Q.html#sns_weibo).

<sup>10</sup> See, e.g. [http://www.xinhuanet.com/fortune/2018-11/16/c\\_129995829.htm](http://www.xinhuanet.com/fortune/2018-11/16/c_129995829.htm).

<sup>11</sup> See Article 4 of the *Provisions of the State Council on Filing Thresholds for Concentrations of Undertakings* (国务院 关于经营者集中申报标准的规定).

<sup>12</sup> See Articles 24 and 34 of the draft AML amendment. For more detail, see our highlights on the draft Amendment to the AML at <http://www.zhonglun.com/Content/2020/02-09/1955422055.html> (in English) and at <http://www.zhonglun.com/Content/2020/01-08/1626562985.html> (in Chinese).

<sup>13</sup> See our highlights on the draft Amendment to the AML at <http://www.zhonglun.com/Content/2020/02-09/1955422055.html> (in English) and at <http://www.zhonglun.com/Content/2020/01-08/1626562985.html> (in Chinese).