PRE-MERGER CONTROL FILING IN CHINA CONCERNING VARIABLE INTEREST ENTITY STRUCTURES

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On 20 April 2020, the Anti-Monopoly Bureau of the State Administration for Market Regulation of China (SAMR) made a simplified pre-merger filing announcement on its website of its acceptance of a pre-merger control filing for the proposed business concentration by way of a joint venture between Shanghai Mingcha Zhegang Management Consulting Co., Ltd. (Mingcha) and Huansheng Information Technology (Shanghai) Co., Ltd. Most notably, as disclosed by SAMR in that same announcement, the ultimate controller of Mingcha has control over it through a series of contractual arrangements involving affiliates rather than through any equity interests or shares, commonly known as a variable interest entity (VIE) structure.

This is a milestone, as SAMR has not reviewed a pre-merger control filing for a business concentration that involved a VIE structure until now. Strictly speaking, the joint venture transaction does not have any VIE structure, but it is Mingcha, as a party to the transaction, that has an underlying VIE structure. It is worth noting that, in a Chinese pre-merger control filing, parties are required to certify that they do not have underlying VIE structures in conflict with the PRC law.

LEGACY ISSUES AROUND A VIE STRUCTURE

For decades, Chinese lawmakers, regulators, and courts have been reluctant in addressing the legality of a VIE structure, thereby leaving VIE structures in the “grey area.” In China, traditionally, a VIE structure has been used in:

facilitating oversea listing and financing of Chinese companies, e.g., VIE structures have been used extensively by a significant number of Chinese Internet, education, and media giants in their oversea listing structure, including Alibaba, Tencent, and Sina.com; and

circumventing Chinese regulations, where foreign direct investments are prohibited or restricted.

The 2015 draft of China's *Foreign Investment Law* sought to address this issue by making liable those who would circumvent the foreign investment restrictions by investing in prohibited or restricted industries through a VIE structure. However, these provisions were omitted in the 2019 draft of the bill that became law on 1 January 2020.

It is worth noting that the Supreme People's Court of the PRC released a judicial interpretation, effective on 1 January 2020, stating that it may uphold a claim to challenge the validity of the underlying contractual arrangement of a VIE structure if it has circumvented Chinese foreign investment restrictions.

PRE-MERGER CONTROL FILING INVOLVING A VIE STRUCTURE

A merger and acquisition transaction is “notifiable” under the Anti-Monopoly Law of the PRC (AML) where a change of control occurs and the relevant turnover thresholds are met. While the AML does not expressly define the term “control,” it is generally interpreted as the ability to exercise economic decision-making power and would include control through equity ownership, contractual arrangement, or other means.

We are not aware of any pre-merger control filings involving a transaction with a VIE structure having been accepted, or approved, without any mitigation measures, since the AML taking effect in 2008.

The first attempt of a pre-merger control filing in China involving a VIE structure could be traced back to the proposed acquisition of Focus Media by Sina.com in 2009. That filing was made but finally not accepted by the relevant regulator at the time, i.e., the Anti-Monopoly Bureau, a subordinate of the Ministry of Commerce of the PRC (MOFCOM), due to allegedly “inadequate application materials”; that deal eventually aborted.

In the conditional approval of the pre-merger filing of a multinational company's 33.6 percent acquisition by share of Yihaodian in 2012, MOFCOM required a carve-out of the online marketplace business operated by Yihaodian under a VIE structure from the acquisition as a mitigation measure. That online business was considered to be value-added telecommunication services, into which foreign investment was restricted.

It has been widely-speculated that MOFCOM's primary concern was that, in its dual capacity as the foreign investment regulator and the antitrust regulator, any approval of a pre-merger control filing of a transaction that involved a VIE structure could be seen as an endorsement of the legality of VIE structures and circumventing the application of China's foreign investment regulations that MOFCOM was also tasked to enforce.

MOFCOM has never explicitly stated that a pre-merger filing involving transactions with a VIE structure would not be accepted, and there was no basis under Chinese law that a business concentration involving a VIE structure was exempted from a pre-merger control review. However, given that the relevant notifying party(ies) would not be able to secure a clean Chinese law legal opinion supporting the validity of a VIE structure in the preparation of the pre-merger control filing application documents and, accordingly, MOFCOM in fact did not accept a pre-merger filing involving transactions with a VIE structure, the market practice had been not to make a pre-merger control filing for a transaction that involved a VIE structure.

This passive approach taken by MOFCOM could have left the door open to a distortion of competition in the relevant market and undermined the AML. It also created potentially open-ended risks to the parties involved, given the ability of the regulators to “look-back” on a transaction.

PRACTICAL CHANGES

With the SAMR established in 2018, the Anti-Monopoly Bureau moved from MOFCOM to SAMR, and SAMR was given the responsibility of enforcing the AML from a market regulation perspective. This reshuffling may have had “hands untied” and thereby enabled the SAMR to focus on any transaction purely from a competition law perspective and pursuant to the AML, without regard to foreign investment law implications.

The Mingcha case may have signified that the Anti-Monopoly Bureau under SAMR is now open to accept and review pre-merger control filings of transactions involving a VIE structure that meet the relevant turnover thresholds. It also indicates that the prior “no filing” strategy for proposed business concentrations involving VIE structures may have become risky.

However, as noted above, the joint venture in the Mingcha case did not itself use or involve any VIE structures. Accordingly, certain questions remain unanswered, such as:

whether a pre-merger filing will be accepted by the SAMR if a VIE structure was used by a notifying party to circumvent a foreign investment law restriction under the transaction that triggered the pre-merger filing; and

whether the historical issue of a VIE structure will be investigated by the SAMR after they have accepted a pre-merger filing, even if the transaction that triggered the pre-merger filing did not use a VIE structure.

In any event, the SAMR's assessment of the Mingcha case will be highly watched. Meanwhile, for a transaction involving a VIE-structured party that meets the relevant turnover thresholds, the parties are encouraged to consult with their antitrust counsel to evaluate and assess whether it remains advisable not to make a pre-merger control filing.

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