CLIFFORD CHANCE

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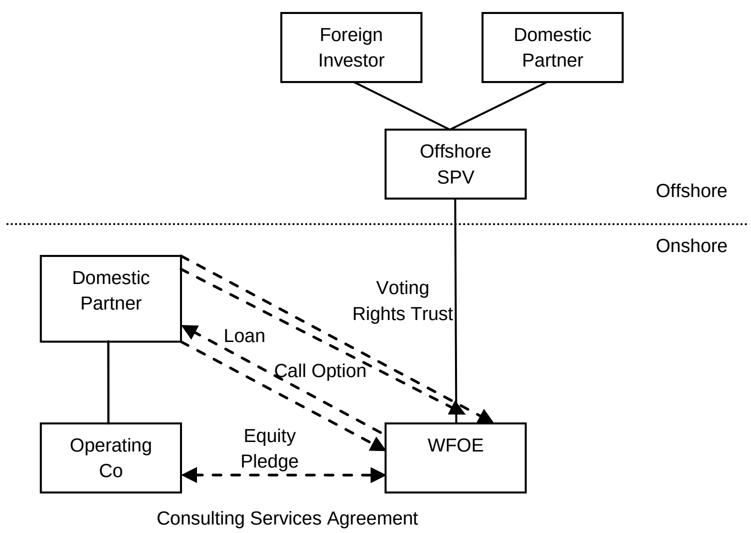
# VIE structure in China faces scrutiny

The "variable interest entity" structure (**VIE Structure**) is an investment structure used in China which relies on a series of contractual arrangements to enable a foreign investor to control (but not directly own) and obtain economic benefits from an operating company. Under the VIE Structure, the operating company is typically wholly-owned by domestic shareholders who act as nominees of the foreign investor. The VIE Structure has been used by foreign investors to indirectly invest in China's restricted sectors as well as a means for a Chinese domestic company to achieve an offshore financing or listing.

For many years, the use of the VIE Structure appears to have been tacitly accepted or at least acquiesced by China's regulatory authorities. This briefing looks at recent developments and regulatory scrutiny that may cast doubt on the long-term viability of the VIE Structure. Finally, this briefing considers potential ways for foreign investors to mitigate the risks posed by the VIE Structure.

## 1. What is a "VIE STRUCTURE"?

A typical VIE Structure is illustrated below.

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**Key Issues**


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If you would like to know more about the subjects covered in this publication or our services, please contact:

**Beijing**

Terence Foo +86 10 6535 2299

He Wei +86 10 6535 4906

Jiang Niao +86 10 6535 2298

**Shanghai**

Kelly Gregory +86 21 2320 7234

To email one of the above, please use firstname.lastname@cliffordchance.com

www.cliffordchance.com

If you would like to know more about our China publications, please contact:

Chlorophyll Yip +852 2826 3426

Clifford Chance, 28th Floor, Jardine House, One Connaught Place, Hong Kong SAR
www.cliffordchance.com

Under a typical VIE Structure, the foreign investor (**Foreign Investor**) will establish jointly with a domestic partner (**Domestic Partner**) an offshore SPV (**Offshore SPV**) to directly or indirectly own a wholly foreign-owned enterprise in China (**WFOE**). The Domestic Partner will, if not already done so, establish a subsidiary (**Operating Co**) to apply for all operating licenses and permits required for the operation of the relevant business. In addition to the shareholding structure, the relevant parties will enter into various contractual arrangements in order to ensure the WFOE's (and therefore indirectly, the Foreign Investor's) control over and economic interest in the business. Such contractual agreements (**VIE Agreements**) typically include the following:

(i) Consulting services agreement – the Operating Co enters into a service agreement with the WFOE for the provision of services, such as consultancy or management or technology support services pursuant to which the Operating Co will pay to the WFOE certain service fees;

(ii) Call option agreement – to be entered into between the WFOE and the Domestic Partner, pursuant to which the WFOE will have the right, at its sole discretion, to acquire or designate a third party to acquire all or part of the equity interests held by the Domestic Partner in the Operating Co, to the extent permitted by the then-effective Chinese laws and regulations;

(iii) Equity pledge agreement – to be entered into between the WFOE and the Domestic Partner, under which the Domestic Partner will pledge its equity interests in the Operating Co to the WFOE to secure the full performance by the Operating Co or the Domestic Partner of their respective obligations under the other VIE Agreements. Under Chinese law, the equity pledge agreement needs to be duly registered with the relevant authority in order to be perfected;

(iv) Loan agreement – to be entered into between the WFOE and the Domestic Partner, under which the WFOE lends to the Domestic Partner typically to fund the establishment of the Operating Company. The Loan Agreement usually forms the main underlying obligation for the Equity Pledge Agreement; and

(v) A voting rights trust or power of attorney – under which the Domestic Partner irrevocably grants to the WFOE the power to exercise all of the voting rights to which it is entitled as the shareholder of the Operating Co.

The above contractual arrangements are structured so as to (i) allow the WFOE (and indirectly, the Foreign Investor) to effectively exert control over the Operating Co; (ii) enable the Foreign Investor to extract the economic benefits generated by the Operating Co; and (iii) enable the Offshore SPV to consolidate the financial statements of the WFOE as well as the Operating Company on the basis that the WFOE exercises control over the Operating Co.

## 2. Use of VIE Structure

There are various reasons for adopting the VIE Structure. Two of the more common reasons are described below.

### 2.1 Enable foreign investors to indirectly invest in restricted sectors

Under China's foreign investment regime, foreign investment in sectors are classified into "encouraged", "permitted", "restricted" or "prohibited" with different foreign ownership restrictions, levels of government approvals and tax policies applicable depending on the classification.

The VIE Structure was made famous by Sina Corporation in 2000, one of the first Chinese Internet companies to list on Nasdaq. The VIE Structure was first developed to circumvent foreign investment restrictions in "restricted" sectors such as telecommunications and media. For example, foreign investment in internet content provision, online gaming, online retail, online media and other value-added telecoms services must be made through a Sino-foreign joint venture where the foreign investor may hold a maximum 50% equity interest. But the approvals required to establish such joint ventures are in practice difficult to obtain.

The VIE Structure allows foreign investors to enjoy the economic benefits of investing in a "restricted" sector without having to obtain approvals for a direct investment. The VIE Structure has since been widely adopted, particularly in the value-added telecoms sector with many of China's leading Internet companies having listed overseas using this structure, including Sohu, Netease, Shanda, Ctrip, Baidu, Youku and Dangdang (all listed on

Nasdaq or New York Stock Exchange (**NYSE**)) as well as Tencent and Alibaba.com (both listed on the Hong Kong Stock Exchange (**HKSE**)).

2.2 Enable round-trip investment without triggering M&A rules

The Provisions for the Acquisition of Domestic Enterprises by Foreign Investors (**M&A Rules**) provide that if an offshore company established or controlled by a Chinese domestic resident acquires a domestic company which is affiliated to such Chinese domestic resident (often referred to as a "round-trip investment" which is typically undertaken to prepare for an offshore financing or IPO), then approval must be obtained from the Ministry of Commerce (**MOFCOM**). However, since the enactment of the M&A Rules in 2006, it has proved to be extremely difficult to obtain MOFCOM approval for "round-trip investments".

In recent years, there has been a trend of Chinese companies owned by PRC nationals resorting to the VIE Structure in order to achieve an offshore financing or listing. As the VIE Structure does not involve any acquisition of a domestic company by a foreign investor, many observers consider that the M&A Rules are not applicable.

There are recent examples of the use of the VIE Structure in "restricted" sectors which extend beyond the traditional Internet or value-added telecoms sectors, such as China Qinfa Group Limited (coal logistics, listed on HKSE) and ZhengTong Auto Services (automobile distribution, listed on HKSE). Even companies that operate in "encouraged" or "permitted" sectors have used the VIE Structure to list overseas. Examples include Charm Communications Inc. (advertising, a "permitted" sector, listed on Nasdaq) and New Oriental Education & Technology Group (education, a "permitted" sector, listed on NYSE), AutoNavi Holdings Limited (software development, an "encouraged" sector, listed on Nasdaq) and iSoftStone Holdings Limited (IT services, an "encouraged" sector, listed on NYSE).

## 3. Risks associated with investment in VIE structure

3.1 Regulatory risks

The main risk with the VIE Structure is that, although the Foreign Investor does not directly own an equity stake in the Operating Co, the combination of VIE Agreements could be viewed by the Chinese governmental authorities as constituting de facto foreign investment in the Operating Co without obtaining the necessary foreign investment approvals. There is therefore the risk that the governmental authorities may require the VIE Structure to be unwound or rectified.

That said, the VIE Structure has been common for a number of years in the value added telecoms sector as well as other restricted sectors in China. Given the number of high profile Chinese companies that have listed overseas using the VIE Structure, it appears that the VIE Structure has been tolerated by the Chinese government authorities. There is also a general perception that a concerted campaign to ban the VIE Structure would be unlikely as it will have significant implications on many well known Chinese companies.

*Increased regulatory scrutiny of VIE structure*

However, in recent years, it appears that a number of PRC authorities are taking a more aggressive stance towards the use of VIE Structures:

(a) Notice on value added telecommunication service by foreign investors

In July 2006, the Ministry of Information and Industry enacted the *Notice Regarding Strengthening Business Management of Operating Value-added Telecommunication Service* invested by Foreign Investors, which provides that domestic telecom companies are not allowed to lease, transfer, or sell licences relating to the telecom business to foreign investors. Additionally, they may not provide resources, sites, or equipment to foreign investors illegally engaging in telecoms business in China. This suggests that the Ministry of Information and Industry would be taking a closer look at VIE Structures used by Internet and telecom companies. However, the industry did not view this as an outright prohibition of the VIE Structure, and some observers even view this as tacit acceptance of the VIE Structure by the regulator.

(b) Notice on internet games

In 2009, the State Commission Office for Public Sector Reform issued the *Notice on the Publication of 'Interpretations made by the State Commission Office for Public Sector Reform on Certain Provisions Relating to the Joint Law Enforcement by the Ministry of Culture, the State Administration of Radio, Film and Television and the General Administration of Press and Publication in the Animation, Web-based Game and Cultural Markets under the "Three Decisions" Regulations'* (**Notice**). The Notice provides that foreign investors are not allowed to have de facto control or participate in a domestic business that is engaged in online gaming business by means of setting up a joint venture company, entering into contractual arrangement or offering technical support. This Notice sends a much stronger signal that the PRC government was well aware of VIE Structures and their use, and is prepared to prohibit VIE Structure when it deems appropriate.

(c) Provisions on national security review

*The Provisions regarding the Implementation of the Security Review System of Mergers and Acquisition of Chinese Enterprises by Foreign Investors,* which was recently promulgated by MOFCOM and became effective on 1 September 2011, appears to address concerns about the use of VIE Structure to circumvent foreign ownership restrictions. It is explicitly provided that a foreign investor cannot use "contractual control" arrangements (which is widely understood to include the VIE Structure) to circumvent the national security review requirements for foreign investment in certain "key sectors" that would otherwise be subject to the national security review process.

(d) Recent CSRC report

A recent press article[1] cites a report, purportedly issued by the China Securities Regulatory Commission (**CSRC**), requesting the State Council to clamp down on the use of the VIE Structure by pushing MOFCOM to take the lead to regulate the use of such structures. Media reports suggest that such a move may potentially involve imposing government approval requirements for the future overseas listings of Chinese companies which adopt the VIE Structure but, at the same time, in order not to cause widespread disruption to the capital markets, existing Chinese companies that have listed overseas using the VIE Structure may be "grandfathered".

So far, there has been no official source verifying the genuineness of this report, which is not on CSRC's letterhead. Some investors may take comfort that it usually takes an extended period of time for such proposals to become enacted as legislation, especially taking into account that CSRC is pushing MOFCOM to take the lead and inter-departmental cooperation may slow down the momentum.

3.2 Enforceability of the VIE agreements

Under the VIE Structure, the Foreign Investor does not have direct ownership of the Operating Co and relies on the VIE Agreement to exercise effective control over the Operating Co. However, as far as we are aware, the validity and enforceability of the VIE Agreements remain untested in the PRC courts. There is a risk that the VIE Agreements may be viewed as a circumvention of foreign ownership restrictions and may not be upheld by PRC courts. Accordingly, in the event that the Operating Co or its subsidiaries are transferred out of the VIE Structure by the Domestic Partner in breach of the VIE Agreements, there is no guarantee that the VIE Agreements will be fully enforceable.

The recent case involving the severance of Alipay (China's leading online payment system) by Alibaba from a VIE Structure is an example of the enforceability risks of the VIE Structure. According to public media, the dispute with Yahoo Inc. and Softbank Corp. as foreign investors in Alibaba, arose when Jack Ma, the founder and CEO of Alibaba transferred the ownership of Alipay under a VIE Structure to a domestic company controlled by Jack Ma. This was purportedly done to avoid the risk that People's Bank of China would, under newly issued regulations, refuse to issue a permit to an online payment company that has foreign ownership, whether directly through equity interests or indirectly through the use of the VIE Structure.

[1] Please see http://www.reuters.com/article/2011/09/18/us-china-investment-idUSTRE78H0SP20110918

## 4. Mitigating the risks of VIE structure

Although the use of the VIE Structure is fairly widespread, recent developments have cast some uncertainty on the long-term viability of the VIE Structure. Foreign investors who have already invested or are considering investing in Chinese businesses using the VIE Structure should consider ways to mitigate the potential risks associated with the VIE Structure.

4.1 Migrate assets and businesses to WFOE

In some cases, it may be possible for the operating assets and businesses to be transferred from the Operating Co to the WFOE. Alternatively, for non "restricted" sectors, business expansion or future acquisitions can be done through the WFOE (which may be subject to foreign exchange controls) or the Offshore SPV in order to add more value to the entities which are under the direct ownership of the foreign investor.

4.2 Hybrid ownership structure

For "restricted" sectors with foreign ownership limits, it may be possible to adopt a "hybrid" ownership structure for the Operating Co and its subsidiaries whereby the WFOE or the Offshore SPV takes a direct equity interest in newly-acquired businesses not exceeding the relevant foreign ownership limits. Nevertheless, such hybrid ownership structure may not work for foreign investment in the value-added telecoms sector as the approvals to set up a Sino-foreign joint venture in such sector are in practice difficult to obtain.

4.3 Improve corporate governance

The risk of the Operating Co or its subsidiaries being transferred out of the VIE Structure in breach of the VIE Agreements could be mitigated to some extent by having stronger corporate governance controls over the Operating Co and the WFOE. Also, foreign investors should ensure that the necessary ancillary documents are in place in order to take control of the Operating Co under the VIE Agreements in the event it becomes necessary to do so.

4.4 Other round-trip investment structures

As mentioned above, the VIE Structure has been used in some cases to avoid the approval requirements for "round-trip investments". In some cases, it may be possible for foreign investors to apply other tried and tested alternative methods to effectively achieve a round-trip investment structure.

Although the VIE Structure has been around for a number of years, it is increasingly becoming under scrutiny. The risks are higher in the case of Chinese companies that use the VIE Structure with a view to seeking an overseas listing. Foreign investors need to carefully consider the risks of the VIE Structure and to adopt appropriate measures to try to mitigate against such risks.



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