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CLIENT BRIEFING

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CHANGING WINDS

VIE DEALS SUBJECT TO CHINESE MERGER CONTROL AFTER ALL

For more than a decade, companies structured as variable interest entities (**VIEs**) were commonly treated as "unacceptable" for Chinese merger control purposes due to their dubious legal status. This notion was recently "rectified" by the Chinese market regulator with a series of fines on three groups for failing to report past deals involving VIEs. The potential impact of this on VIEs generally should not be easily dismissed. We look at the implications of this development in the briefing below.

First fines for not notifying reportable transactions involving VIEs

On 14 December 2020, the State Administration for Market Regulation (**SAMR**) imposed fines on Alibaba Investment, China Literature and Shenzhen Hive Box Network Technology, for failing to report past transactions involving VIEs that exceeded Chinese merger control thresholds. Each was fined RMB 500,000 (approximately US$76,000), being also the first gun-jumping fines to reach the statutory maximum.

Before the decision, it was not clear whether transactions involving VIEs are notifiable under China's merger control regime. VIEs have been commonly used in China over the past 20 years in sectors subject to restrictions on foreign investment, notably in technology, media and telecommunications sectors. The unique structure of VIEs enables Chinese businesses to obtain offshore financing (e.g. through foreign listings) and non-PRC investors to sidestep foreign investment restrictions in China.

Chinese merger filings involving VIEs were understood to be "unacceptable" in the past possibly due to concern over official recognition of such a regulatory grey area.

This is no longer the case, as made clear by SAMR's decision to penalise these three companies for failing to notify deals involving VIEs for the first time. In its press interview (in Chinese), SAMR emphasised that transactions involving VIEs "are also subject to [Chinese] merger control review and shall be notified in advance and shall not be implemented before obtaining the clearance". This applies regardless of the VIE structure being present in the acquirer, the target or the controller of the relevant company.

In setting the administrative penalties, SAMR noted the absence of competition concerns arising from the deals that were not notified, meaning that structural remedies were not appropriate. As such, SAMR opted for imposing fines. Interestingly, whilst SAMR had always, in past gun-jumping decisions, provided a reduction for the parties' cooperation in SAMR's investigation when calculating the fines, it did not do so in these three cases. SAMR imposed the maximum fine permissible under the current Anti-Monopoly Law (**AML**), in consideration, amongst other factors, the prominence of the companies in the industry, their transactional experience and access to professional legal advisors.

A striking reversal in policy

The decisions mark a dramatic departure from previous practice and have sent shockwaves amongst tech companies in China.

Aside from mandating merger control filings on VIE deals going forward, SAMR's press interview noted that "Internet platform enterprises [i.e. firms commonly using VIE structures] should systematically review their previous concentrations", implying that its latest position on requiring filings on VIE deals has full retroactive effect. Indeed, one of the VIE deals that was fined by SAMR dated as far back to 2014. SAMR could therefore possibly scrutinise all VIE deals since the AML took effect in 2008.

However, SAMR's changing attitude towards VIEs does not come as too big of a surprise, as there were signs appearing in the months before that it was looking to take greater enforcement action in the Internet and technology sectors. In April 2020, SAMR accepted, for the first time, a merger filing for a joint venture between the units of Leading Smart and Yum China that involved a VIE structure. In November 2020, SAMR published a ***draft Anti-monopoly Guideline for the Platform Economy Industry*** for consultation, which specified that parties with VIE structures must notify SAMR of their transactions that meet the filing thresholds for merger review.

What lies ahead

SAMR's warning on the need to notify VIE deals is clear. Going forward, companies looking to conclude transactions involving a VIE structure can be confident that SAMR will accept their merger control filing, but they will also have to conduct a full competitive assessment of the transaction and factor in the timing implications on their transaction timetables.

With the risk of SAMR's scrutiny looming over past non-notified deals, businesses with a history of non-notified transactions involving VIEs will have to consider their options for approaching the Chinese regulator about those deals. When noting that maximum fines of RMB 500,000 may not be a significant deterrent generally, SAMR indicated that this is an area to be reviewed in the coming revisions to the AML. The current proposal is to replace the current monetary cap in the AML with a maximum fine based on 10% of annual sales (see our January 2020 Briefing **here**). It may therefore be prudent for businesses with VIE structures to report non-compliant deals to SAMR before new limits on fines are announced and take effect.

At a broader level, Chinese tech giants and businesses operating in China's digital economy should note the increasing regulatory scrutiny on the sector. When announcing its penalties on the three companies, SAMR also announced its intention to ramp up enforcement in the Internet sector. Given the direction the wind is blowing regarding VIE deals and the online sector in China, now is an opportune time for those businesses to ensure compliance with competition laws, both in the PRC and globally, in all aspects of their businesses.

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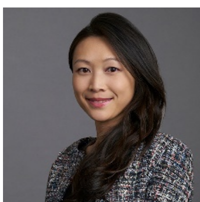

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