MOFCOM's Conditional Approval of Wal-Mart's Acquisition--What does it Mean for Wal-Mart and Yihaodian and for the Future of the VIE Structure?

A recent MOFCOM ruling effectively allowing Wal-Mart to take a majority interest in the business of Yihaodian, but explicitly forbidding Wal-Mart from taking control of Yihaodian's value-added telecom business, including through a VIE arrangement, raises questions as to how Wal-Mart may reap synergistic value from the transaction and leaves in limbo the future of the VIE structure as a means to avoid PRC restrictions on foreign ownership in certain industries.

On August 13, 2012, the PRC Ministry of Commerce ("MOFCOM") issued a conditional approval of Wal-Mart's acquisition of equity interests that would give it majority ownership of Niuhai Holdings Ltd. "(Niuhai Holdings"). Niuhai Holdings is the indirect parent entity of Niuhai Information Technology (Shanghai) Co., Ltd. ("Niuhai Shanghai"), which, in turn, effectively controls Yihaodian (meaning "Store Number 1" in Chinese), one of the largest and fastest-growing online retailers in China and the ultimate target in the contemplated transaction.

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Although it presents a single user-friendly shopping experience for customers, Yihaodian engages in two distinct, but related, lines of business, (i) direct sales of its own merchandise, and (ii) B2C services to third parties as an e-commerce platform. This latter business line is commonly considered to constitute value-added telecom business ("VATB") under relevant PRC Internet regulations.

MOFCOM's approval of the proposed transaction was explicitly conditioned upon Wal-Mart only acquiring Yihaodian's direct sales business (and not Yihaodian's VATB) and not attempting to engage in VATB either directly through Niuhai Shanghai (without proper VATB licensing, which could not be obtained by a foreign-owned entity like Niuhai Shanghai) or through a VIE arrangement. For Wal-Mart, MOFCOM's ruling means that the proposed transaction will have to be fundamentally restructured if it will proceed, and the prohibition on

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the use of the VIE structure means that Wal-Mart may ultimately be unable to take control of Yihaodian's VATB. This is the first time that MOFCOM has specifically mentioned the use of the "VIE structure" in a formal ruling and its explicit disapproval of the structure in this case raises concerns that MOFCOM and other PRC authorities may challenge the use of the VIE structure in future cases as well.

Background regarding Proposed Wal-Mart/Yihaodian Transaction

According to publicly available information, Yihaodian, the target business, had sales revenues of approximately RMB2.7 billion in 2011 and had approximately 20 million registered users. Yihaodian is a platform currently owned and operated by a domestic company, Shanghai Yishiduo E-commerce Co., Ltd. ("Yishiduo"), and until very recently, Yishiduo is the actual owner of the domain name of Yihaodian (Yihaodian.com) and the Internet Content Provider registration of Yihaodian's website (the domain name of Yihaodian was very recently transferred to Niuhai Shanghai). Because Yihaodian engages in VATB, PRC regulations would not permit foreign (i.e., non-PRC) entities or individuals to collectively, directly or indirectly, hold a majority equity interest in Yishiduo.

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In the decision issued by MOFCOM, Niuhai Shanghai is identified as the actual controller of Yihaodian. Exactly how Niuhai Shanghai exerts control over Yihaodian without being a direct holder of equity in Yihaodian or its parent entities is not information that is publicly available, but it is reasonable to assume that Niuhai Shanghai partners with Yishiduo through a VIE (variable interest entity) type structure, which typically utilizes a series of contractual arrangements as a proxy for equity ownership, and Niuhai Shanghai maintains ownership of the trademark "Yihaodian" in the PRC. Niuhai Shanghai, which is a wholly foreign owned enterprise (or WFOE), is ultimately controlled by Niuhai Holdings, the offshore entity Wal-Mart intends to increase its stake in. If the transaction proceeds to closing, Wal-Mart would increase its equity ownership in Niuhai Holdings from its current ownership of 17.7% to 51.3%, and would thereby obtain control of Niuhai Shanghai, allowing Wal-Mart to also indirectly control Yishiduo and the Yihaodian businesses.

What is the Rationale for MOFCOM's Ruling? What might MOFCOM's True Motivation be?

In supporting its conditional approval of the Wal-Mart transaction, MOFCOM defined the online retail business as the "relevant product market" for purposes of its review. MOFCOM went on to apply a "leverage theory" in arguing that, if the transaction was completed as planned, Wal-Mart's strengths in physical retail stores would reinforce the competiveness of Yihaodian in its online retail business, and that Wal-Mart could then further leverage the competitiveness of both its retail stores and newly acquired online direct sales into the VATB sector, which could have the effect of eliminating or limiting competition in the VATB market place. As compared to several of the recent conditional approvals issued by MOFCOM, the ruling in this case does not contain much in the way of detailed analysis of the rationale for application of the leverage theory. This raises questions as to what MOFCOM's true motivation for rendering the conditional approval might have been, and, in particular, whether MOFCOM's principal goal may have been to limit the use by foreign investors of the VIE structure to sidestep restrictions on their investment in and operation of companies in sensitive industries such as VATB.

Generally, any intended foreign investment in a Chinese company will trigger review by MOFCOM or its local counterpart, and investment in any industry that is "restricted" with respect to foreign investment is generally disfavored. Since 2002, foreign investment in the online retail business has been considered to be "restricted", though in recent years WFOEs have been allowed to engage in online sales of their own products in China (as opposed to VATB). When VATB is involved, in addition to the customary registration of the domain name with the PRC Ministry of Industry and Information Technology or its local counterparts (collectively, "MIIT"), a special VATB license must also be obtained from MIIT. In the past, MIIT has required that VATB applicants be either wholly domestically owned or jointly owned, but domestically controlled (i.e., with foreign entities holding less than a 50% equity interest). However, in practice, many local offices of MIIT will only accept applications for VATB licenses from wholly domestic companies, meaning that, in some cases, even minority foreign investment into entities conducting VATB may not be permitted.

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Because of regulations restricting foreign investment in VATB and certain Internet and other sensitive businesses, foreign investors have frequently employed VIE structures for investments in these fields. Typically, in a VIE structure, an offshore holding company (owned by the foreign investor) has a WFOE which, instead of directly operating a restricted business such as VATB or owning equity interests in a company that operates such business, enters into contractual arrangements with a Chinese operating company with no foreign ownership (this is the "VIE") that are intended to make the WFOE the primary beneficiary of the VIE's business. These contractual arrangements, however, would not give the foreign investors any legal ownership of such restricted business, and hence have been used as a means to get around PRC foreign ownership restrictions. Nearly all offshore-listed Chinese Internet and e-commerce companies have utilized this structure, allowing them to raise much needed capital to fund the growth and operations of these ventures, generally with no specific intervention or objection from the Chinese government.

MOFCOM's ruling on the Wal-Mart/Yihaodian transaction seems to have broken its long official silence with respect to the use of VIE structuring. While MOFCOM's decision contains little in the way of data and analysis supporting the application of leverage theory, its unfavorable view of the VIE structure, at least as it is used in the VATB context, seems clear. It seems plausible that MOFCOM primarily wanted to extend the leverage theory to reach VATB in order to justify the restrictions it wished to impose on Wal-Mart with respect to the use of the VIE structure to operate a VATB.

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What does MOFCOM's Decision Mean for Wal-Mart and Yihaodian?

The direct effect of the restrictions imposed in MOFCOM's conditional approval is to eliminate the possibility of Wal-Mart controlling a VATB in China through the proposed transaction. This probably undermines an important reason for the proposed acquisition. Currently, Yihaodian has over 2000 contracted "tenants" conducting sales via its website. Though specific revenue figures related to such sales are not publicly available, VATB seems to constitute a sizable portion of Yihaodian's business. Yihaodian's direct sales business could also suffer if the Yihaodian platform is no longer thought to offer sufficient variety and loses favor with customers. Wal-Mart and the other parties involved will have to determine whether the transaction still makes sense without Yihaodian's VATB, and, if so, how the transaction can be restructured accordingly. If Wal-Mart and other parties scrap the transaction, presumably Wal-Mart could continue to hold its 17.7% equity interest in Niuhai Holdings, and Niuhai Holdings and Yishiduo could, at least for now, continue to employ their current VIE structure.

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Assuming Wal-Mart and other parties are willing to proceed with the transaction, they would have to separate the VATB and the direct sales business, divest the VATB from the current VIE structure and cause the VATB to be owned and operated by a qualified domestically-owned entity with the necessary licensing. This means that two separate domain names and two separate websites would have to be maintained. This, in turn, raises some very fundamental business and legal questions for Wal-Mart and other parties. Which business gets to keep Yihaodian.com, the direct sales business or the VATB, given that Yihaodian.com is certainly a very valuable domain name and Niuhai Shanghai is now the registrant of the Yihaodian trademark? How could the operations and the user interface of the two resulting websites still interrelate with each other so as to maintain, as much as possible, the current Yihaodian user base and realize the synergistic value of the transaction, yet remain in compliance with the MOFCOM decision?

Even assuming that direct sales now constitute the key business of Yihaodian and that the Wal-Mart controlled entity could retain this business and the Yihaodian name and website, Wal-Mart's future cross-marketing initiatives may be limited by the prohibition on VATB going forward. For instance, if the Wal-Mart controlled entity wishes to provide links to Wal-Mart's affiliates would such services be deemed to constitute VATB and create compliance concerns? Ultimately, even though certain benefits such as sharing of global sourcing and local logistic service resources could be realized through the transaction, the fundamental synergy created by having a single e-commerce platform, with VATB capability, under one well-known domain name would be lost as a result of the conditions imposed by MOFCOM's ruling.

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What does MOFCOM's Decision Mean for the Future of the VIE Structure?

The MOFCOM ruling clearly shows MOFCOM's concern that the VIE structure could potentially be used to get around PRC restrictions on foreign investment in VATB. However, it should be noted that MOFCOM seems to have intentionally avoided engaging in a broader discussion of the legitimacy of the use of the VIE structure generally.

It has long been suspected by many observers that PRC government agencies disfavor the VIE structure, since it is used almost exclusively to avoid PRC government restrictions on foreign investment. Some authorities have recently shown that they are willing to challenge the use of VIE structures in certain instances and, in two important cases from 2011, Alibaba/Alipay and Buddha Steel, the authorities effectively caused the unwinding of VIE structures by denying (or threatening to deny) required permitting or approvals. At the same time, however, the VIE structure could not have survived without various government agencies' tacit acceptance, in particular when the VIE structure is used to attract foreign capital to less sensitive, higher risk businesses.

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The Wal-Mart/Yihaodian ruling shows that antitrust review may be a new angle for PRC authorities to extend their regulatory power regarding foreign investment restrictions, especially when a particularly sensitive business is involved. The antitrust review process allows government intervention even if the transaction is structured in an offshore jurisdiction which would otherwise allow it to avoid regulatory scrutiny from other PRC authorities, including MIIT. Through this process, MOFCOM and other authorities, such as MIIT, have seemingly a justifiable venue to scrutinize matters of their concern. While one may debate whether in the Wal-Mart/Yihaodian transaction, MOFCOM had a very solid rationale for concluding that the proposed transaction specifically threatened to have an anti-competitive effect on China's VATB market, it may indeed be true that MOFCOM has decided that it cannot allow major industry players to avoid especially sensitive foreign investment restrictions through use of the VIE structure.

The ruling also reminds us that there may be other venues through which MOFCOM or other PRC authorities or interested parties may challenge the VIE structure, potentially further lessening the viability of this kind of structuring. For example, in its recently promulgated national security regulations, MOFCOM explicitly indicates that M&A deals structured through contractual arrangements and deals occurring in offshore jurisdictions may be subject to PRC national security review if such transactions result in a foreign party gaining control of a domestic company, which change of control, because of the industry of the target company, may raise national security concerns (which could include, e.g., control of natural resources and key technologies, in addition to national defense). Notably, national security review can be initiated by third parties, including PRC regulatory authorities, such as MIIT, MOFCOM and the China Securities Regulatory Commission. It is at least plausible that interested parties may, through PRC national security review, challenge VIE arrangements.