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# Newsletter

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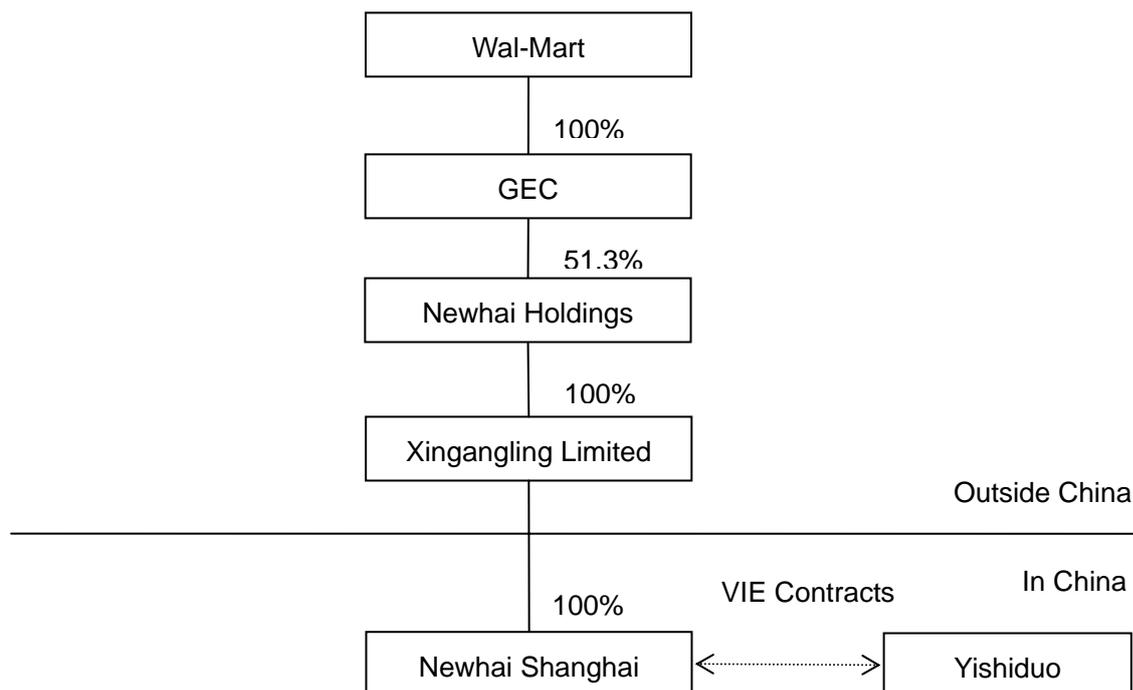
**MOFCOM’s First Mention of VIE in Anti-monopoly Review Regarding the Acquisition of Niu Hai Holdings by Wal-Mart (Authors: Joyce LI, Tracy ZHOU, Zaiguang LU, Haoze LI)**

On August 14, 2012, the Ministry of Commerce of the People’s Republic of China (“**MOFCOM**”) released on its website the Announcement on the Decision of Conditionally Approving the Acquisition of 33.6% of the Equity of Niu Hai Holdings by Wal-Mart Stores Inc. (the “**Announcement 49**”). It has been the first published anti-monopoly review announcement regarding a transaction involving variable interest entity (“**VIE**”) structures and could shed some light on future notifications involving VIE structures.

**The Transaction**

**1 Transaction Structure**

According to Announcement 49, Wal-Mart Stores Inc. (“**Wal-Mart**”) proposed to acquire 33.6% of the equity interest of Niu Hai Holdings Co., Ltd. (“**Niu Hai Holdings**”) via its holding company GEC 2 PTE (“**GEC**”) and immediately after the closing of the Transaction, Wal-Mart’s will be the beneficial owner of 51.3% of equity interest of Niu Hai Holdings. Niu Hai Holdings is the sole beneficial owners of Niu Hai Information Technology (Shanghai) Co., Ltd. (“**Niu Hai Shanghai**”, a wholly foreign invested enterprise located in Shanghai) which controls Shanghai Yishiduo E-commerce Co., Ltd. (“**Yishiduo**”, a domestic PRC company running the online shopping platform “**Yihaodian**”) through VIE contracts. The post-closing corporate structure of the Transaction is as follows:



## 2 Businesses engaged by Yishiduo Prior to the Transaction

According to Announcement 49, Yishiduo, as a VIE company controlled by Niu Hai Shanghai, are mainly engaged in online direct sales business and value-added telecommunication business.

Pursuant to the Circular of the General Office on Issues Related to Examination, Approval, and Administration of Online Sales and Vending Machine Sales Projects of Foreign-Invested Enterprises (“**Circular 272**”) promulgated by MOFCOM, MOFCOM does not require a foreign invested enterprise (“**FIE**”) to apply for a value-added business permit (“**ICP License**”) to engage in online direct sales business; instead, only a recordation with competent government authorities for the sales platform (“**ICP Recordation**”) is sufficient. However, the Ministry of Industry and Information Technology (“**MIIT**”) has yet promulgated any similar regulations nor publicly commented on the Circular 272. In practice, MIIT’s counterparts in some regions require online direct sales (whether domestic or foreign) companies to apply for the ICP License while in other regions they only require for ICP Recordation. Notwithstanding the foregoing ambiguous attitudes of MIIT and its local counterparts, MOFCOM clearly indicates in Announcement 49 that a FIE (whether a Sino-foreign equity joint venture, Sino-foreign cooperative joint venture or a wholly foreign owned enterprise) is able to engage in online direct sales business without a ICP License. Therefore, New Hai Shanghai is able to operate the online direct sales business engaged by Yishiduo prior to the Transaction.

However, unlike online direct sales business, foreign investors are restricted to engage in value-added telecommunication businesses (i.e., foreign capital shall not take more than 50% of the equity interest in a value-added telecommunication company) in accordance with relevant laws and regulations. In practice, it is very difficult for an FIE to obtain an ICP License, even if its foreign participation is lower than 50%. Therefore, New Hai Shanghai, as a WFOE, is not allowed to engage in the value-added telecommunication business engaged by Yishiduo prior to the Transaction.

### Review Decision and Analysis

Normally, the key factor for deciding whether to approve, conditionally approve or disapprove a merger transaction in an anti-monopoly review is whether the transaction itself would cause eliminative or restrictive effects on other competitors in the relevant market and the extent of these effects. Therefore, the definition of the relevant market is a crucial step in the anti-monopoly review process.

In the Transaction, the relevant market was defined as the B2C online retail market (i.e., online direct sales market) and the relevant geographic market was the PRC market. MOFCOM held that after the closing of the Transaction, “Wal-Mart will be able to transfer its competitive advantages in the traditional physical market to the online retail business of Yishiduo’s Yihaodian” and “The comprehensive effects of the Transaction will substantively enhance the ability of the post-merger entity to compete in the online retail industry.” However, MOFCOM did not draw a clear conclusion

that the Transaction will cause eliminative or restrictive effects on other competitors in the PRC B2C online retail market. Conversely, pursuant to the first restrictive condition set forth in the Announcement 49, MOFCOM permits Wal-Mart to engage in the PRC B2C online retail market after the closing of the Transaction.

However, it is noted that in the Announcement 49, MOFCOM unprecedentedly introduced the methodology of “extended investigation”, which meant in addition to the aforementioned “relevant market review methodology”, MOFCOM further analyzed and valued the effect of the Transaction in another market, i.e. the PRC value-added telecommunication market. In the “extended investigation”, MOFCOM held that “The investigation results indicate that should the post-merger entity decides to enter the value-added telecommunications market via Yishiduo’s Yihaodian, it will be able to rapidly expand its business by relying on its comprehensive competitive advantages of both the existing physical retail market and the online retail business, gain a dominant position in the value-added telecommunications market, and substantively enhance its bargaining power against users of online platforms, and therefore may ultimately exclude or restrain competition in PRC’s value-added telecommunications market.”

After the aforementioned analysis, MOFCOM conditionally approved the Transaction with three restricted conditions, i.e.: (1) this acquisition by Niu Hai Shanghai shall be limited to the online direct sales business carried out with its own online platform; (2) without obtaining the ICP License, Niu Hai Shanghai shall not use its own online platform to provide network services for other transaction parties subsequent to the completion of the Transaction; and (3) upon closing of the Transaction, Wal-Mart is not allowed to engage in the value-added telecommunications business currently operated by Yishiduo through its VIE structure.

As discussed in Section 2 above, we could paraphrase the aforementioned three restricted conditions as: i) Wal-Mart can use the VIE structures to engage in Yishiduo’s online direct sales business; ii) Wal-Mart CANNOT use the VIE structures to engage in Yishiduo’s value-added telecommunication business.

### **MOFCOM’s Attitudes towards Notifications Involving VIE Structures**

We could infer the MOFCOM’s attitudes towards notifications involving VIE structures from Announcement 49:

#### **(1) VIE Structures Involving Foreign Permitted Businesses**

According to the first restricted condition set out in Announcement 49, MOFCOM will probably approve an FIE using VIE structures to engage in businesses permitted to be conducted by foreign investors in accordance with PRC relevant laws and regulations, unless the transaction itself would cause eliminative and/or restrictive effects in the relevant market.

#### **(2) VIE Structures Involving Foreign Restricted or Prohibited Businesses**

As indicated by the third restrictive condition set forth in Announcement 49, Wal-Mart is prohibited from engaging in the value-added telecommunications business currently operated by Yishiduo via its VIE structure and the rationale of elaborating the reasons for such condition was based on an unprecedented methodology. We could infer that for a future notification involving VIE structures used by in restricted and/or prohibited businesses, MOFCOM would take much more prudent steps than VIE structures involving non-restricted businesses. With regard to these notifications, we predict that MOFCOM might probably disapprove or approve with restricted conditions the VIE structure shall not be used in the restricted and/or prohibited businesses, similar to MOFCOM's stance in the Transaction.

## 1. HKEx Updates Listing Decision on Contractual Arrangements (Authors: Huan WANG, Alan LUO)

In 2005, the Hong Kong Exchanges and Clearing Limited (the “**HKEx**”) issued a listing decision (cited as HKEx-LD43-3, the “**Listing Decision**”) regarding a listing applicant incorporated outside Hong Kong (the “**Applicant**”), which controls an entity that is incorporated inside China (the “**OPCO**”) to run business via contractual arrangements. HKEx should determine whether the Applicant has demonstrated the legality of contractual arrangements and whether it has the ability to ensure the sound and proper operation of the contractual arrangements based on the material facts and the PRC legal opinion. If the decision were positive, HKEx should adopt a disclosure-based approach to deal with the application, and so long as appropriate disclosures in terms of contractual arrangements and the risks associated therewith were included, the Applicant as well as its business should be suitable for listing.

In November 2011, HKEx adopted an amendment to the Listing Decision, pursuant to which, in principle, HKEx should accept contractual arrangements on a case-by-case basis when assessing a listing application. If the business covered by the contractual arrangements is not restricted to or prohibited from foreign investment in accordance with applicable PRC laws and regulations, the Listing Division of HKEx should normally refer the case to the Listing Committee of HKEx. Meanwhile, HKEx further requests that (1) the Applicant should disclose the rationale for adopting the contractual arrangements; (2) the Applicant should unwind the contractual arrangements as soon as the law allows the business to be operated without contractual arrangements; and (3) the Applicant should follow a series of provisions to ensure the proper implementation of contractual arrangements.

In August 2012, HKEx adopted another amendment (the “**Amendment**”) to the Listing Decision, clarifying the disclosure requirements of the contractual arrangements in prospectus. We will interpret the provisions of the Amendment with reference to certain arrangements of Flying Financial Service Holdings Limited (Stock code: 8030) (“**Flying Financial**”), a newly listed company in HKEx adopting the contractual arrangements.

| S/N in the Listing Decision | Mandatory Disclosures regarding the Contractual Arrangements in the Prospectus  | Note/Interpretation/Solution   |
|-----------------------------|---|--|
| 19a                         | Detailed discussion about the OPCO's registered shareholders and a confirmation that appropriate arrangements have been made to protect the Applicant's interests in the event of death, bankruptcy or divorce of the OPCO's registered shareholders to avoid any practical difficulties in enforcing the contractual arrangements. | <p>Given the nature of "personal cooperation" of a limited liability company, it can be provided in the OPCO's articles of association that in the event of death of a registered individual shareholder, his/her lawful heir(s) shall not have the right to inherit the shareholder's right; or otherwise, relevant inheritance issues can be demonstrated in prospectus and a confirmation from the heir(s) of the registered individual shareholder of OPCO consenting to execution of the structured contracts can be included in the structured contracts. Please refer to relevant disclosures on page 67 of Flying Financial's prospectus.</p> <p>PRC laws and regulations have yet to regulate individual bankruptcy.</p> <p>A letter from spouse of a registered shareholder of OPCO waiving his/her claim to OPCO's respective equity interest as jointly owned property can be included in the structured contracts; or otherwise, a commitment from the spouse covenanting to cooperate with OPCO to execute the structured contracts in case he/she acquires respective equity interest of OPCO due to divorce with a registered shareholder of OPCO.</p> |
| 19b                         | The extent to which the Applicant has arrangements in place to address the potential conflicts of interest between the Applicant and the OPCO's registered shareholders, particularly in cases where these shareholders are officers and directors of the Applicant.  | <p>The Applicant can designate any third party to become or serve as registered shareholder, legal representative and/or director of OPCO to avoid abusing of shareholder rights by founders of OPCO.</p> <p>The business license, official seal and other important documents and seals can be kept by a wholly foreign-owned enterprise (the "WFOE") established</p>   |

| S/N in the Listing Decision | Mandatory Disclosures regarding the Contractual Arrangements in the Prospectus   | Note/Interpretation/Solution  |
|-----------------------------|--|---|
|                             |  | <p>by the Applicant or any third party designated by the Applicant.</p> <p>Fully exercise of shareholder rights authorized by OPCO's registered shareholder to the WFOE in accordance with a power of attorney. Please refer to relevant descriptions on page 67 of Flying Financial's prospectus.</p> <p>The articles of association or other corporation governance documents of the Applicant can provide the withdrawal system for directors/senior management.</p> |
| 19c                         | Bases why the directors believe that each of the agreements conferring significant control and economic benefits from the OPCO to the Applicant is enforceable under the PRC and local law.  | PRC counsel to issue PRC legal opinion. Please refer to relevant descriptions from page 68 to 69 of Flying Financial's prospectus.  |
| 19d                         | The economic risks the Applicant bears as the primary beneficiary of the OPCO, in what way the Applicant shares the losses of the OPCO, the circumstances that could require the Applicant to provide financial support to the OPCO, or other events or circumstances that could expose the Applicant to losses. | It can be provided in the structured contracts that the Applicant promises to provide (or via WFOE) unlimited financial support to OPCO.  |
| 19e                         | A discussion on whether the Applicant has, to date, encountered any interference or encumbrance from any PRC governing bodies in operating their business through the  | Disclosure requirement  |

| <b>S/N in the Listing Decision</b> | <b>Mandatory Disclosures regarding the Contractual Arrangements in the Prospectus</b>  | <b>Note/Interpretation/Solution</b>   |
|------------------------------------|--|---|
|                                    | OPCO under the contractual arrangements.   |   |
| 19f                                | The limitations in exercising the option to acquire ownership in the OPCO, include a separate risk factor explaining these limitations, and clarifying that ownership transfer may still subject to substantial costs. | To include an independent risk factor, disclosing relevant risks and limitations in connection with exercise of exclusive call option by WFOE to acquire OPCO's equity interest from registered shareholder of OPCO. Please refer to relevant descriptions from page 65 to 66 of Flying Financial's prospectus. |
| 19g                                | The contractual arrangements as material contracts in the "Statutory and General Information" section and make them available on the Applicant's website, or to justify and disclose the basis of not doing so.        | Disclosure requirement  |
| 19h                                | Corporate structure table in the "Summary" section for the purpose of illustrating the contractual arrangements and facilitating investors' review and understanding of the arrangements.                              | Disclosure requirement  |

HKEx further regulates the disclosure requirement in the risk factor section of the prospectus regarding the contractual arrangements, requiring that all risks in relation to the contractual arrangements should be disclosed under one risk factor, and at least include the followings:

1. The PRC government may determine that the contractual arrangements do not comply with applicable regulations;
2. The contractual arrangements may not provide control as effective as direct ownership;
3. The domestic shareholders may have potential conflicts of interest with the applicant; and
4. Contractual arrangements may be subject to scrutiny of the PRC tax authorities and additional tax may be imposed.

Flying Financial's prospectus can be obtained from

<http://gem.ednews.hk/listedco/listconews/GEM/2012/0420/GLN20120420014.pdf>.

In consideration of the recent incidents with respect to the contractual arrangements and the risks involved, obviously the Amendment is aimed at regulating such risks, and the Amendment also emphasizes the disclosure requirements at the same time. We think HKEx should also believe that fundamental risk of the contractual arrangements cannot be eliminated for now and thus, a full disclosure approach would probably be the best option to protect investors at this stage. While U.S. Securities and Exchange Commission is now conducting an investigation on New Oriental's change to its contractual arrangements, the issuance of Amendment at this moment evidences attention to contractual arrangements from both U.S. and Hong Kong two major capital markets. Thus, it is advisable that PRC companies that have listed or are considering to be listed overseas, shall seek advice from their PRC counsels prior to creation of or effect of any change to the contractual arrangements in order to avoid any unnecessary trouble.

## **2. Comments on Guidelines for the Administration over Property Rights Registration of State-funded Enterprises (Authors: Lynn TENG, Yeting CAI)**

In recent years, property rights registration faces new situations and challenges as great changes occurred to the institutional environment and targets of state-owned assets supervision and administration. For the purpose of having a comprehensive understanding and knowledge on the overall property rights conditions of state-funded enterprises and their invested enterprises in the context of mixed ownership, reflecting the distribution of state-owned capital in different areas, industries, primary and secondary businesses inside the enterprise, as well as further standardizing the administration over property rights registration of state-funded enterprises, the State-owned Assets Supervision and Administration Commission of the State Council (hereinafter referred to as

the “SASAC”) issued the *Guidelines for the Administration over Property Rights Registration of the State-funded Enterprises* (hereinafter referred to as the “*Guidelines*”) on July 24, 2012, a follow-up to *Interim Administrative Measures for Property Rights Registration of State-funded Enterprises* (hereinafter referred to as the “*Interim Measures*”) issued by SASAC on April 28, 2012. Consisting of seven chapters and thirty-three articles, the *Guidelines* mainly:

### **Complement and Interpret the *Interim Measures***

First, the *Guidelines* identify management information system for property rights registration of State-funded enterprises (hereinafter referred to as the “Property Rights Registration System”) as the platform for the administration over property rights registration. Enterprises must register property rights by following the operating instructions of the Property Rights Registration System. Secondly, the *Guidelines* define certain terms used in the *Interim Measures*. For example, it provides that, for the purpose of Article 2 of the *Interim Measures*, “authorized administration” means that people’s governments at all levels authorize the state-owned assets supervision and administration authorities at the same level to perform the duties of capital contributors in accordance with law, or to fulfill basic management responsibilities concerning state-owned assets, such as registration of property rights; it also provides that, for the purpose of Article 5 of the *Interim Measures*, “other equity held for the purpose of sale in the near term (within one year)” refers to the equity that is held by enterprises for the purpose of making short-term profits and that should be credited under the item of “trading financial assets” in accordance with accounting standards. Finally, the *Guidelines* specify the abbreviations, as used in the Property Rights Registration System, of capital contributors of all types as referred to in Article 4 of the *Interim Measures*.

### **Elaborate Procedures for Administration over Property Rights Registration**

A state-controlled capital contributor must review and submit required materials to the relevant State-funded enterprise level by level via the Property Rights Registration System according to the property rights level or management level of the said enterprise. A State-funded enterprise must review the materials and then apply for registering property rights to the relevant State-owned assets supervision and administration authority. The *Guidelines* elaborate the duties of different entities during the property rights registration procedure, as follows:

#### **1) State-controlled Capital Contributor**

A state-controlled capital contributor must review and submit required materials via the Property Rights Registration System. Further to the *Interim Measures*, the *Guidelines* identify what to submit, namely, the basic enterprise information, the information on economic behavior and the catalog of compliance materials. Basic enterprise information means the profile of an enterprise and the status of its property rights at the time of registration of property rights. Information on economic behavior means the information on the operating process of the economic behavior of an

enterprise as involved in property rights registration. The catalog of compliance materials means the catalog of relevant materials and information that must be prepared by an enterprise for registration of property rights.

## **2) State-funded Enterprise**

A state-funded enterprise must submit application documents to the relevant state-owned assets supervision and administration authority when applying for registering property rights. The application documents should be affixed with the special seal for property rights registration of the State-funded enterprise, and be submitted to the state-owned assets supervision and administration authority via the Property Rights Registration System. The application documents should mainly cover the time of occurrence, decision-making, approval, execution process, etc. relating to the economic behavior involved in the registration of property rights, and the review opinions of the state-funded enterprise.

## **3) State-owned Assets Supervision and Administration Authority**

A State-owned assets supervision and administration authority reviews the items for property rights registration. It may process the registration, if the registration requirements are met, or return the said documents and materials to the applicant, if the application fails to meet the registration requirements. It may issue a notice to order the said enterprise to rectify, within the prescribed time period, items for property rights registration that are in violation of relevant laws or standards of state-owned assets supervision and administration systems or that have other defects during the execution of relevant economic behavior. Such notice shall include the matters to be rectified, the rectification requirements and deadlines, etc. A state-owned assets supervision and administration authority may process the registration if the said enterprise meets the registration requirements after rectification. If the State-funded enterprise fails to rectify as required, the state-owned assets supervision and administration authority may circulate a notice of criticism against the said enterprise, and hold relevant persons accountable.

It is noteworthy that the state-owned assets supervision and administration authority of the State Council authorizes state-funded enterprises to issue the property rights registration form to its enterprises that perform the duties of capital contributors. Provincial-level state-owned assets supervision and administration authorities may choose to authorize state-funded enterprises to issue the property rights registration form. To issue the property rights registration form, a state-funded enterprise shall apply for a uniform code from the state-owned assets supervision and administration authority of the State Council via the Property Rights Registration System, and affix thereon its special seal for property rights registration.

## **Add Administration over Property Rights Registration of Special Entities**

The *Guidelines* define the rules on filling out “registered capital”, “paid-up capital”, “enterprise level”

for public institutions belonging to state-funded enterprise, as well as the administration over property rights registration of overseas enterprises. Firstly, it defines that overseas enterprises included in the scope of property rights registration shall refer to the enterprises that are funded and established overseas as well as in the Hong Kong Special Administrative Region, the Macao Special Administrative Region and Taiwan Region by state-funded enterprises or all levels of sub-enterprises under the effective control of state-funded enterprises (excluding companies whose shares are partially held by state-owned capital) pursuant to local laws. Overseas representative offices and general offices of state-funded enterprises, and other economic organizations not qualified as legal persons do not fall under the scope of property rights registration. Secondly, the *Guidelines* specify filling rules on monetary amounts involved in the property rights registration of overseas enterprises, “enterprise level” of overseas enterprise, an established special-purpose company, and an overseas enterprise whose shares, due to special reasons, are held by an individual or a company established under the name of an individual upon entrustment. It is noteworthy that the property rights registration of enterprises invested and established within the territory of China by overseas enterprises (excluding enterprises whose shares are partially held by other investors) would be administered in accordance with the provisions on domestic enterprises.

### **Improve Supervision and Inspection of the Administration over Property Rights Registration**

The *Guidelines* also require state-owned assets supervision and administration authorities at all levels, and state-funded enterprises regularly summarize and analyze the property rights registration data, to form quarterly analysis information and generate annual analysis reports. A state-funded enterprise shall, by March 31 of each year, complete the inspection over the registration of property rights in the preceding year by its enterprises that perform the duties of capital contributors, and report the inspection results to the State-owned assets supervision and administration authority at the same level in writing. Supervision and inspection must focus on the timeliness, truthfulness and accuracy of property rights registration by enterprises, as well as the compliance of the economic behavior involved in the registration of property rights

As a follow-up to the Interim Measures issued by SASAC in April 2012, the issuance of the *Guidelines* is a vital move taken to reinforce and regulate the basic management of the state-owned assets, and will have great significance for understanding the distribution of property rights of state-funded enterprises, pushing enterprises to optimize the deployment of property rights, expediting the adjustment on distribution structure of the state-owned economy, and perfecting the advancement or retreatment of state-owned capital.

## **Important Announcement**

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