Foreign internet presence in China to face scrutiny

Changes to China's mergers and acquisitions rules that took effect on Thursday mean internet companies in the country are set to face greater scrutiny of the vehicles they have been using for more than a decade to circumvent foreign ownership restrictions in the sector.

The regulations, meant to clarify national security reviews of foreign investments in Chinese companies, stipulate that foreign investors will not avoid a review through techniques such as contracts that give them control over a domestic firm, or multi-level investments.

Under the practice, a domestic company, a so-called variable interest entity (VIE), holds the license necessary for operating a business such as running an internet search engine or an e-commerce platform in China, and the foreign-invested company secures control of that domestic business through a set of contracts instead of share ownership.

The scheme is being used by foreign internet companies such as Google, but also Chinese internet groups that introduced foreign shareholders through overseas listings. These include as Baidu, the country's largest online search engine by revenues, Sina, the operator of China's leading microblog, Youku, the biggest online video company by revenues and Renren, the biggest Facebook clone by revenues.

"As of April 2011, 42 per cent of Chinese companies listed in the US have used the VIE structure and thousands of unlisted companies continue to operate through the use of the VIE structure," said Cadwallader, the law firm, in a note to clients.

Lawyers said that while an immediate all-out crackdown on VIEs appeared unlikely, the new rules no longer allowed the past assumption of Beijing's 'tacit approval' of such vehicles.

"Such corporate structures may be more closely scrutinised in future transactions, and it is unclear what impact the security review system will have on such corporate structures that are already in existence," said Tim Stratford at Covington & Burling in Beijing.

Industry insiders are particularly concerned because the VIE clause – a surprise addition to the M&A rules – follows earlier problems with such vehicles.

Jack Ma, founder and chairman of Alibaba Group, the e-commerce company in which Yahoo and Softbank are major shareholders, spun off Alipay, Alibaba's equivalent to PayPal and seen as one of its prime assets, from the group and transferred it to purely domestic ownership, triggering a fierce dispute with Yahoo. Mr Ma defended his move claiming that China's central bank had required the use of VIEs and would deny an operating license to companies with foreign ownership.

Chen Dafei of Hankun, a law firm that specialises in cross-border transactions, said given the huge market value and employment headcounts of China's listed internet companies, it was "unimaginable" that Beijing would force Baidu or Sina to unravel their VIEs.

Lester Ross, managing partner at Wilmer Hale in Beijing, said it was unlikely that the government would block access to foreign capital markets for Chinese internet companies by banning all future VIEs, but cautioned that the vague wording of the rules could give regulators greater discretionary powers.

Source: Financial Times, Kathrin Hille, Sept. 1 2011

Für weitere Fragen stehe ich Ihnen gerne zur Verfügung. Bitte kontaktieren Sie mich unter info@europeasiaservices.com.