Recent Developments in the Use of Variable Interest Entities

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06/28/16

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The variable interest entity (VIE) structure has been around since the listing of Sina.com on the Nasdaq Stock Market in 2000. It enables companies to exercise control over operating entities and derive economic benefits from those entities through a series of contracts rather than direct legal ownership. The VIE structure has been used by technology and other companies, most recently in the education sector, seeking to list on the Stock Exchange of Hong Kong Limited (the HKEx) as a way to allow foreign investment into sensitive industries. However, recent developments have called into question whether or not VIE structures will have a lasting place in the Chinese investment world.

Background

In January 2015, China's Ministry of Commerce (MOFCOM) circulated a new draft law on foreign investment that would regulate the use of VIE structures (the Draft FIL). More recently, the policy response of the HKEx to the Draft FIL indicates that companies using VIE structures will need to meet certain requirements in order to list on the HKEx.

The Draft FIL, which was issued only for public comment and has yet to be enacted, would require one of three options for companies using VIE structures in industries with foreign ownership restrictions. They would need either to make a declaration that their actual control is vested with Chinese investors, apply for and receive certification from the relevant authority that their actual control is vested with Chinese investors, or apply to the relevant authority for permission to continue to use the VIE structure.

For these purposes, "control" is broadly defined to include situations in which a person or entity holds less than 50 percent of the entity but is otherwise able to exert material influence over decision-making bodies, such as the board or shareholders' meetings, or over operations, financials, staffing and technology matters.

New Challenges

The HKEx's policy response to the Draft FIL complicates matters for companies with VIE structures by requiring them to ensure that their controlling shareholder is a People's Republic of China (PRC) national if they seek to list on the HKEx.

Despite these potential challenges, the education sector has experienced an increase in the number of companies with VIE structures that are in the process of applying to list on the HKEx. This uptick follows the listing of China Maple Leaf Educational Systems Limited, which came shortly before the release of the Draft FIL — fortunate timing for Maple Leaf given that it has a non-PRC national controlling shareholder. Prior to Maple Leaf, an operator of nonprofit schools was not thought to be able to list on an exchange and "monetize" its investment through the capital markets. The precedent Maple Leaf has set has opened up that possibility for other school operators.

Unlike prior VIE listings, in which companies had no choice but to adopt VIE structures due to foreign ownership limits, Maple Leaf also needed certain VIE agreements for other reasons. In particular, the schools operated by Maple Leaf elected to be schools of which the sponsors (equivalent to the shareholders) did not require a "reasonable return." While as a matter of PRC law such schools are permitted to make a profit, any such profit cannot be paid out to shareholders — the benefit of the no "reasonable return" election being that the schools are generally eligible for a full exemption from PRC profits tax. In other words, even if Maple Leaf directly owned its schools, the only way it would be able to ensure shareholders could enjoy the profits earned by those schools would be to extract them by way of services/management fees in a manner simi-

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lar to the services agreement that routinely forms a core component of the standard VIE structure. The alternative — changing the election to require a reasonable return — would require sorting out applicable PRC laws and regulations to determine what level of return would qualify as "reasonable," a process with unclear timing and that in many provinces and regions of China is without precedent.

For proposed listings with VIE structures that have come after the circulation of the Draft FIL, the HKEx has begun to require companies to meet the above-mentioned requirement regarding PRC control. For example, in the case of Virscend Education Company Limited, which listed in early 2016, the HKEx extracted an undertaking from the controlling shareholder that he will remain a PRC national and retain a level of ownership no less than an amount sufficient to constitute control under the Draft FIL. While the shareholders of the wave of VIE companies that listed prior to publication of the Draft FIL weren't required to give such undertakings, recent experience suggests that the compliance unit of the HKEx may still feel inclined to play the role of de facto PRC regulator by requiring them to justify how they are compliant with the Draft FIL if there is a major change in their shareholder base.

For companies looking to use the capital markets to diversify their shareholder base, raise funds for expansion, use equity as a currency for M&A, or provide equity-based incentives to management and employees, an undertaking along the lines given by Virscend's controlling shareholder may significantly reduce the appeal of a listing. It also may mean that investors discount the valuations of such companies to remove any potential M&A/takeover premium.

Implications

Few PRC lawyers believe that the Draft FIL will be enacted either in its current form or in the near future. Most expect some kind of grandfathering provision that either expressly exempts companies with existing VIE structures or provides them with a period of time to bring their ownership structures into line with the new law. Absent any such concessions, the legality of the ownership structures of numerous companies that are already listed on Hong Kong and U.S. markets (many with no single dominant shareholder) would be called into question immediately and would create immense disruption to capital markets.

Unfortunately for Hong Kong, current HKEx policy may dictate that many of the larger and more promising technology companies that are considering a listing, and in particular those that have undergone several rounds of investment and have no shareholder or group of shareholders holding a clear controlling stake, will have no option but to list on U.S. or other markets that do not have PRC-control requirements. Even those with shareholding structures that comply with the HKEx's policy may nevertheless still choose either to list on another market because of the scarcity of comparable companies in Hong Kong or remain private to avoid having to commit to limiting their future capital-raising options.

In the meantime, given the uncertainties surrounding the enactment of the Draft FIL, including with respect to timing, other options may be open to Hong Kong's regulators if Hong Kong is to be a viable choice for listings of Chinese technology companies. Among potential options to address regulatory skepticism about VIE structures would be to restrict VIE listings to the Growth Enterprise Market, which was established as a market for companies with comparatively higher levels of investment risk at earlier stages of development, or to restrict initial offerings of securities to professional investors only. Other mechanisms to protect investors could include requiring companies with VIE arrangements to implement further mechanisms for ensuring that shareholders and/or other parties (such as independent nonexecutive directors or even Hong Kong regulators) are in a position to enforce the provisions of the VIE agreements against the onshore shareholders.

While the VIE structure looks set to remain a feature of the Chinese investment landscape for the near future, it is important for investors to be aware of the potential uncertainties around how MOFCOM and Hong Kong regulators will treat VIE companies and plan accordingly.