The Future of VIEs in China

SVC Wireless & Mobile Conference 2012

Tom Shoesmith
Pillsbury China Practice
Shanghai – Palo Alo

This is a serious topic. Some would say not exciting. Like this person.

But this is a great story. Really.
But first, a word from our sponsor.
Pillsbury China Practice

- Shanghai, (Beijing), Silicon Valley, SF, NY and DC
- Emerging growth, technology and venture capital
- Public capital markets – 30+ public companies
- M&A and complex joint ventures
- Outbound direct investment to the US
- Regulatory and compliance advice
- Internal investigations
- Litigation
VIEs and Wireless / Mobile Investments in China

- The Problem: internet and other value-added telecoms are closed to foreign investment
  - 50/50 joint ventures permitted but expensive and rare (Google, eBay)
  - Entrepreneurs and their investors must be Chinese nationals
- The Solution: “variable interest entities” or VIEs
- Used for more than 10 years
- “Ownership” without ownership
- Hundreds of companies have used them
- Now under attack from within and without
- Are VIEs still viable? Will the market still buy them?
Rule of Law With Chinese Characteristics

- How can something be prohibited but still widely practiced?

- Ancient idea - worked fine for 3,000 years:
  - Rule by decree (as opposed to Rule of Law)
  - Ability to fine-tune the economy
  - Flexibility in regulation
  - Comfort with form over substance

- Allows Beijing to fill in China's underdeveloped private and public equity capital markets - but retain ability to turn off the tap

- Entrepreneurs typically comfortable – investors not so much
Typical VIE Structure

With appreciation to Hogan Lovells 2012
Why It Works: FIN 46r and SFAS 167

FASB Interpretation No. 46
(revised December 2003)

Consolidation of Variable Interest Entities
an interpretation of ARB No. 51

December 2003

Financial Accounting Series

Statement of Financial Accounting Standards No. 167

Amendments to FASB Interpretation No. 46(R)
How it Works: FIN 46r and SFAS 167

- Arose out of ENRON scandal – originally used to keep risk off the books – now we see the law of unintended consequences

- **Old Rule:** VIE not actually owned, but **must** be consolidated for financial reporting purposes – so try to **avoid** being a VIE

- **New Rule:** in China, the owners **want** to consolidate for financial reporting purposes – so try to **be** a VIE

- Indicators of VIE status
  - OpCo (VIE) owners lack power to direct key activities of OpCo (WFOE has control)
  - OpCo (VIE) owners are not directly financially at risk (WFOE absorbs losses)
  - OpCO (VIE) owners do not have the right to receive profits (WFOE takes profits)

- **But** financial consolidation does not equal security of ownership

- Trickier than it looks – lots of considerations
It’s All Good …

But …
Lots of Questions / Issues

With apologies to Hogan Lovells 2012
Trouble in Paradise

- **July 2006 VATS Circular – first warning**
  - Ministry of Industry and Information Technology (MIIT)
  - Warns foreign investors to obey the law in value-added telecoms (internet, etc.)
  - VATS companies may not “lease, lend, transfer or resell operating permits to foreign investors in any disguised form”
  - Classic technique – like a pitcher brushing back the batter – temporarily chilled the industry

- **2006 M&A Regulations – trend accelerates**
  - MOFCOM, SAIC, SAT, others
  - General applicability
  - Prohibited round-trip investments
  - VIE = perfect solution
  - Expanded VIEs to non-restricted sectors (coal, steel, shipbuilding, etc.)
Trouble in Paradise – cont’d

- Sept 2009 GAPP Notice – second warning
  - General Administration of Press and Publication (GAPP) and related agencies
  - Online and mobile gaming
  - A little more explicit: prohibits foreign control or participation directly or indirectly through contractual or technical support agreements
  - Note GAPP does not enforce – this is MOFCOM’s job, and MOFCOM did not sign on to the Notice

- But the market is going gangbusters – acceleration continues
  - Chinese companies going public in US in record numbers
  - 40%+ used VIE structure
  - Huge number of new players (companies and financiers)
  - Fast money and bad actors
  - Market collapse late 2008-2009
Market Downturn Stresses the System

- Problems from the inside
  - 2008 Agria Corp – COO/Founder and VIE owner did not have stake in offshore entity – became disaffected – risk of loss of VIE – dispute settled
  - 2011 Buddha Steel – IPO withdrawn because founder arranged for local officials to declare VIE arrangement illegal – VIE lost
  - 2010 GigaMedia – legal rep and PRC founder refused to step aside – refused to surrender the chop – VIE lost – parent company eventually withdrew from China
  - 2011 Toudou – founder’s wife sought community property interest in VIE equity, threatening loss of control over OpCo – case settled but market disrupted
  - 2011 Alipay – founder “spun off” lucrative PRC operations to himself by terminating VIE arrangement – dispute settled
  - 2012 ChinaCast – similar to GigaMedia – disaffected founder and owner of VIE allegedly “stole” the chops
Market Downturn Stresses the System (cont’d)

- Securities lawsuits
  - *Agria (2009)* – securities fraud based on lack of control over VIE
  - *Orient Paper (2011)* – allegation of securities fraud because company did not actually control the VIE
  - *Alibaba (2011)* – securities fraud based on failure to disclose risks of VIE structure

- Attack of the “shorts” – Muddy Waters, Citron *et al.*
  - Sino-Forest
  - Orient Paper
  - New Oriental Education

- Market freaks out
Regulators Put More Pressure on VIEs

- **2010-2011 SEC investigations**
  - Probably driven by fraud concerns more than VIE *per se*
  - More on this later

- **2011 PRC National Security Review Regulations**
  - Draft released March 2011; final regulations effective September 2011
  - Only applies to national security-sensitive industries – but media, content and telecommunications are at least potentially national security-sensitive
  - Requires voluntary reporting and review for national security implications
  - Calls out VIE-type arrangements: investors may not circumvent rules through “nominee shareholders … control by agreement or offshore transactions.”

- **2011 Hong Kong listing rules**
  - Tougher rules for VIE companies
  - Use of VIE in non-restricted industries thought to be very problematical
Sept 2011 – Leaks in China Frighten the Market

- Leaked memo from CSRC (China Securities Regulatory Commission)
  - May have been a low-level author
  - Acknowledged 40 major PRC internet companies listed abroad
  - Acknowledged lack of capital and inability to access domestic PRC public markets
  - Causes national security concerns + export of wealth
  - Pointed out VIE structure had spread to non-restricted sectors in order to circumvent 2006 M&A Regulations
  - Concluded VIE structures violate PRC law
  - Recommended mandatory joint MOFCOM-CSRC review and approval of all overseas listings

- MOFCOM holds the cards – and they’re not talking
  - Rumors in 2011 – former Yahoo head reported conversation with high official

- Market freaks out again
SEC Investigates EDU

July 16, 2012 – EDU announces SEC investigation into its VIE structure

Standard VIE structure – but not buttoned up as tight as Baidu

Does this mean the SEC will never clear a VIE? Probably not.

SEC could be saying:
- The EDU VIE agreements are too thin and do not satisfy SFAS 167 on their face
- EDU is not respecting its VIE structure – it is a sham
- If it is a sham, the investors don’t really own anything
- There are other non-VIE related problems

Risk is that accountants will start challenging VIE treatment
Lawyers to the Rescue

- VIE structure still viable – in China and in the US
- But it must be done right, and respected in fact
- Do it right
  - Full suite of documents, incl. call option on equity and assets
  - Register the equity pledge
  - Consider using negative covenants rather than voting proxy
  - Choose equity holders of VIE entity carefully – consider diversifying to avoid GigaMedia problem
  - Put as much value as possible in the WFOE
- Respect it in fact
  - Don’t build retained earnings in the VIE – actually pay profits to the WFOE
  - Document corporate actions and votes on key issues
  - Absorb the VIE into the WFOE over time if permitted by law
Take-Aways for Pre-IPO Companies

- This is a legal / accounting / regulatory issue you need to pay attention to as early as possible. Sorry about that.

- VC investors want to know four things about your structure:
  - You understand the VIE problem
  - You’re planning for it intelligently
  - The company they invest in actually owns or controls the value proposition
  - The investment isn’t going to blow up on them

- Late-stage investors and underwriters are even more cautious

- Post-IPO investors are the most risk-averse of all

- Good news: you don’t have to do everything at the outset – but you should have a roadmap
This Story Has It All

- Early period creative entrepreneurs
- Explosive pace of change
- Immediate proliferation of copycats
- Rise of excessive greed and cockiness
- Infighting when the market starts to tighten
- Regulatory crackdown and lawsuits
- Lawyers to the rescue …
- Creative cycle begins anew
One thing for sure …

It’s Never Boring
Thank You

谢谢

Tom Shoesmith
tom.shoesmith@pillsburylaw.com
650.283 4453