Portfolio Media. Inc. | 860 Broadway, 6th Floor | New York, NY 10003 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Wal-Mart Acquisition Shows China E-Commerce Is Opening Up

Law360, New York (September 17, 2015, 4:34 PM ET) --

Ian K. Lewis

Frank W. Yang

U.S.-based supermarket conglomerate Wal-Mart Stores Inc. announced on July 23, 2015, through its official website that it acquired full ownership of Yihaodian, Wal-Mart's fast-growing online supermarket and shopping mall in China.

Wal-Mart's earlier investment in Yihaodian attracted much attention due to its receipt of only conditional antitrust approval by the Ministry of Commerce ("MOFCOM") based on the VIE arrangements involved[1]. Although details of the further increased Wal-Mart interest remain undisclosed, the conclusion of this further acquisition seems to indicate that Wal-Mart has finally freed itself from the earlier complications that led to the conditional MOFCOM ruling and now wholly owns its online trading business.

In light of the recent relaxations[2] announced by the State Council and Ministry of Industry and Information Technology ("MIIT") with respect to online trading-based e-commerce business, this acquisition is noteworthy as it signals that foreign investment in online trading-based e-commerce business is no longer subject to investment or regulatory restrictions.

Old Restrictions

The online trading-based e-commerce business, in practice, has until now been divided into two categories: (1) a self-operated online trading website which may only involve the provision of self-operated goods and services from the website owner to members of the public and (2) a third-party operated online trading platform through which any business owner may provide goods and services to members of public.

Since 2010, a foreign investor has been allowed to operate a wholly owned, self-operated online trading website without regulatory restriction, except for the need to complete an online filing with MIIT in respect of its provision of nonprofitable Internet content ("ICP Registration").

However, third-party operated online trading platforms have remained highly regulated and foreign investors have been restricted to joint ventures with not more than 50 percent shareholding and a Value Added Telecoms Service Operating Permit ("VATS Permit") from MIIT or its local branch[3]. Due to a lack of clear interpretation from MIIT, online trading platform operators were previously allowed to apply for the Internet Content Provider license (in Beijing) or VATS Permit elsewhere in China, each containing the business item of "profitable internet information services" (collectively, "ICP License") to satisfy this VATS Permit requirement. Such joint ventures have rarely been approved by MIIT. Among the limited number of joint venture value added telecoms business operators disclosed by MIIT on its official website, Amazon-Joyo joint venture is the only foreign invested online trading platform having obtained an ICP License from MIIT.

VIE Arrangement

As an alternative to full compliance, a number of foreign investors (including Wal-Mart) choose to indirectly invest in offshore companies (often established and controlled by the domestic founders) having controlling interests in the online trading platforms established in China through a VIE structure, the key features of which are a series of contracts entered into among a DomCo (which typically holds the required license to operate in a prohibited or restricted industry), its founding (PRC national) shareholders ("Founders") and a foreign invested enterprise ("FIE"), typically in the form of a wholly owned foreign enterprise ("WFOE"). The WFOE is established by an offshore holding company (often established in BVI or the Cayman Islands) owned jointly by the Founders and the foreign investors desiring to invest in DomCo. The WFOE works alongside the DomCo and in essence, the VIE arrangement seeks to ensure the WFOE enjoys control while avoiding the application of foreign ownerships restrictions and/or stringent government approval process that apply in China.

Chinese authorities have been aware of the existence of such arrangements for many years, although the law did not until recently specifically recognize them. These structures become the norm for Chinese investors raising funds overseas.

However there exists much higher risk for foreign companies using such structures in order to invest or participate in restricted or prohibited business areas such as online trading platform. In August 2012, in the conditional antitrust approval issued in respect of Wal-Mart's acquisition of a 33.6 percent interest in the offshore company holding controlling interests in Yihaodian, MOFCOM expressly prohibited Wal-Mart from controlling the online trading platform of Yihaodian through VIE arrangements. As a result, the acquisition allowed Wal-Mart to ultimately own a 51.3 percent interest in Yihaodian to the only extent related to its online supermarket business[4].

New Relaxations

This year has been significant to the e-commerce business sector. MIIT's January announcement fully relaxed the foreign shareholding cap on online data and transaction processing (limited to profitable e-commerce) business (i.e. the online trading platform business) in the Shanghai Free Trade Zone on a pilot basis, in a move to further opening up China's economy to the world. This was followed by the amended Catalog of Industry Guiding Foreign Investment 2015, which further excluded the e-commerce business from the restricted value added telecom services as a nationwide exercise of MOFCOM in

March.

Thanks to the *Opinion regarding Further Development of E-commerce Business to Foster New Economic Growth Drivers issued by State Council* on May 4 ("State Council's Opinion"), which calls for lifting of the foreign shareholding cap in the e-commerce business sector, MIIT as the governing authority of China's telecoms industry, finally issued the *Pronouncement regarding Lifting of Foreign Share Holding in Online Data and Transaction Processing (Limited to Profitable E-commerce) Business* on June 19 ("MIIT Circular 196"). The MIIT Circular 196, following the request of State Council's Opinion, provides that foreign stakeholders may take up to 100 percent equity interest in a company engaged in the online data and transaction processing (limited to profitable e-commerce) business.

Related to the relaxation, the VATS Permit required for online trading platform has also changed. An ICP License is no longer required and is replaced with a VATS permit specifically issued to the online data and transaction processing (limited to profitable e-commerce) business.

According to publicly available business registration information from a government-sponsored database to date, Wal-Mart seems to be indirectly holding 50 percent equity interest in Yihaodian through a joint venture VATS company established in the Shanghai Free Trade Zone. Through the acquisition of the remaining 50 percent interest in this VATS company (which now is fully permitted as above), Wal-Mart will be able to finally have full ownership of Yihaodian.

A Free New World to Come?

Foreign investors wishing to participate fully in China's online trading-based e-commerce sector can be reasonably optimistic in view of the relaxations above. It will become much easier for foreign investors to operate wholly owned online trading based e-commerce business after Wal-Mart's acquisition.

However, the fact that the rules are being simplified does not mean that there are no difficulties or uncertainties. For example, the establishment of a VATS company engaged in online trading is still subject to threshold requirements provided under MIIT Circular 196, which are quite different from those applicable for the Shanghai Free Trade Zone. The main reason is because MIIT Circular 196 requires that all threshold requirements (except for the shareholding percentage) set out in the FITE Regulations should still apply (including the minimum registered capital which remains RMB 10 million, even though the same has been reduced to RMB 1 million if the business is based in the Shanghai Free Trade Zone). In addition, FITE Regulations also require the investor to have sound business records, while the relevant Shanghai Free Trade Zone rules only require the investor to remain compliant with China's telecoms regulations. Details of relevant approval and registration procedures remain to be seen.

Therefore, although China turns to welcome foreign investors to fine fortune in the e-commerce business sector, it is still a little early to say it is now a free marketplace and future developments can be expected.

New to China's E-Commerce Sector?

With the largest population of online shoppers in the world, China is becoming one of the most attractive markets for e-commerce operators. While foreign investors (including those familiar with other markets) may feel attracted to this market by the above relaxations (either through acquisition or greenfield investment), giving thought to the following factors may help a new participant in China's e-commerce sector better understand the regulatory environment:

- Permission allowing for the establishment of a wholly owned trading website does not mean that permission has been granted for a website to trade in any and all goods and services online. If some goods and services themselves are restricted or prohibited to foreign investment, a wholly foreign owned website cannot directly engage in the sales or provision of such goods and services. For example, publishing is prohibited to foreign investment and thus online publishing is also prohibited.

- If a foreign investor seeks to control an e-commerce business involving restricted or prohibited businesses, VIE or similar structures are not recommended. Although the Chinese authorities tend to tolerate VIE arrangement controlled by native Chinese individuals, a foreign-controlled VIE structure would most likely be deemed illegal.

- Many goods and services fully open to foreign investment will require other regulatory permits. For example, online sales of certain specially regulated goods such as pharmaceuticals are subject to separate permits from China's Food and Drug Administration.

- In addition to online trading, if the website also contains such functions as blogs and bulletin board system (i.e. online forum) allowing its users to release comments and communicate with each other, then separate filing and permits will need to be made with MIIT or its local branch regarding enabling of blogs and online forum functions.

- In addition to MIIT, the operation of an e-commerce business is also subject to regulation by other authorities in China to the extent within their respective jurisdictions, including MOFCOM (industry development and supervision), State Administration of Industry and Commerce ("SAIC", online advertising and consumer protection) and even the People's Bank of China (online payment).

Although the relaxation in the e-commerce sector does without a doubt provide new opportunities, there remain numerous legal and regulatory issues to consider.

—By Ian K. Lewis and Frank W. Yang, Mayer Brown LLP

Ian Lewis is a partner and Frank Yang is an associate in Mayer Brown's Beijing office. Lewis was appointed the international law foreign expert member of the China International Council for the Promotion of Multinational Corporations — International Legal Affairs Committee of Experts.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its

[1] VIE is a term used to described a variable interest entity. The structures used to establish a VIE are described below.

[2] Details are introduced below.

[3] Detailed requirements are set out in *the Regulations on the Administration of Foreign Invested Telecommunications Enterprises* ("FITE Regulations") issued by State Council on Dec. 11, 2001, and as amended on Sept. 10, 2008.

[4] Yihaodian not only operates as an online supermarket to directly sell its own sourced goods to the members of public, but also as an online shopping mall allowing third-party business owners to trade.