China

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A Crackdown on Foreign Involvement in China's Internet Industry?

The Ministry of Information Industry (MII)'s recent Notice Concerning Strengthening the Administration of Foreign-Invested Value-Added Telecommunications Business Operations (the Notice) hints at a potential crackdown on unsanctioned foreign involvement in value-added telecommunications services (VATS). Although it is difficult to ascertain at this time how strictly the Notice will be enforced, at a minimum, it is expected to impact the bigger players in the global Internet industry that have sought to gain a foothold in the China market via informal cooperation with domestic VATS companies. There are reports that MII's concern about the recent activities of such companies in China is the impetus for the Notice, and that any activities in China involving these industry players will face heavy scrutiny from MII as it seeks to enforce the Notice. In this memo, we provide background information on the issues surrounding the Notice, highlight its contents, address its potential effects and provide strategic recommendations for affected companies.

Background

Many foreign investors engage in operations that involve significant online commercial activities in China—which constitute the provision of VATS under Chinese law. The conduct of such online commercial activities requires a telecoms operations license, which is difficult for a foreign investor to obtain. Therefore, many foreign companies and their foreign-invested subsidiaries have elected to outsource this function to domestic companies with the requisite permits. Such domestic companies are usually held by Chinese nationals with close ties to the foreign investors, but the ownership of these domestic entities is separate from and independent of the foreign investor's directly owned/controlled China subsidiaries. The domestic company usually enters into contractual relationships with the foreign investor or its China subsidiaries, with the ultimate objective of channeling a significant percentage of profits from the domestic company to the foreign investor.

This arrangement essentially creates parallel ownership structures that are linked by contractual arrangements established primarily for the purpose of channeling funds to the foreign investor. A number of major VATS providers—most notably the Internet companies—conduct their operations in this manner, and the majority of them fall into one of two categories.

The first category consists of multinational Internet companies that provide VATS services in China indirectly, through friendly domestic companies with which they have established contractual relationships. In such instances, the domestic company may be a standalone entity or part of a parallel domestic/foreign-owned ownership structure, of which the foreign-owned segment has been acquired—in whole or in part—by the multinational company. The second category consists largely of small, early-stage companies in which a parallel domestic/foreign-owned ownership structure was established at the outset, creating a partnership between a domestic VATS provider owned by Chinese nationals (usually some or all of the founders)—to hold the requisite telecoms licenses and conduct day-to-day VATS operations—and a separate offshore company that is the primary investment vehicle through which foreign investors invest. There is some overlap between the two categories. Some of the early-stage companies in the second category transitioned into the domestic partners of the multinationals in the first category upon acquisition by such multinationals, while others matured into public companies listed on NASDAQ and other stock markets. Such companies, in the course of conducting their IPOs, have provided information with respect to the parallel domestic/foreign-owned ownership structure inherent in their operations in their publicly available prospectuses, and, until the Notice was issued, the silence and inaction of MII with regard to the legality of this structure has largely been interpreted as acquiescence and/or tolerance. Foreign investors (whether actual foreign companies or offshore special purpose vehicles set up by Chinese individuals or entities) and/or their China

subsidiaries have thus been able to operate VATS through indirect control of domestic companies held by friendly Chinese investors.

Highlights

The Notice represents an attempt on the part of MII to regulate what it views as unlawful cooperation between foreign investors and domestic telecoms companies by placing restrictions on the use of the parallel structure described above—i.e., a partnership primarily based on contractual relationships between, on the one hand, a foreign company and its China subsidiaries, and, on the other hand, the domestic company that holds the requisite telecoms licenses. The message emphasized is that domestic telecoms companies may not, in any manner, covertly rent, lend, transfer or resell at a profit its telecoms license to any foreign investor. To illustrate how such prohibitions should be implemented, the Notice places restrictions on ownership of domain names and trademark registrations used for the VATS operations, as well as the provision of facilities for the VATS operations. It expressly provides that domain names and registered trademarks used by a value-added telecoms company are limited to those that belong to the subject company or its shareholders, and that the value-added telecoms company must set up premises and facilities in a manner that is consistent with its business scope—which more or less rules out the possibility of the foreign company or its China investors charging hefty service fees to the value-added telecoms company for the grant of licenses and provision of facilities.

The Notice also provides that domestic telecoms companies planning to list offshore must undergo examination for consent by the State Council's department in charge of information industry, (i.e., MII), and obtain approval in accordance with relevant state regulations, but it does not specify whether demonstrating full compliance with the Notice (e.g., ownership of domain name and trademark held by the domestic operational entity or its shareholder) would be required to obtain such approval. We speculate that this ambiguity may be an attempt on the part of MII to leave open the possibility of making exceptions to allow Chinese-founded companies to continue full or partial utilization of this parallel ownership structure in order to preserve their ability to attract foreign investment and/or list overseas in the future.

The Notice also requires telecoms bureaus at the provincial level to issue approvals only to entities that are in compliance with the requirements set out in the Notice. They are also required to supervise the conduct of self-examination and self-correction by existing noncompliant companies to achieve compliance—ostensibly under official supervision as necessary—and to focus particularly on companies that receive heavy attention from consumers. The deadline for compliance is November 1, 2006.

Implications

The issuance of this Notice appears to be an effort by MII to close off this popular avenue of market entry to foreign companies (i.e., establishment of the parallel domestic/foreign ownership structure described above). Pursuant to the Notice, valuable property relevant to the operations (i.e., the trademark and the domain name) must be under the control of the entity with the value-added telecoms license, and this entity must also have actual control over the premises and facilities. In essence, the entity cannot function as an empty shell for the purpose of holding the license, but must engage in substantive operations and have actual control. Going forward, it appears that foreign investors will be limited to providing technical services to these domestic "partners," and the scope of such services may be severely restricted.

The restrictions set out in the Notice essentially close off most avenues by which foreign investors have traditionally channeled revenues from their domestic "partners" to themselves or their direct China subsidiaries. This enhances the power of the domestic partner entity and thus leaves the foreign entity (which in most cases is the listing vehicle) with a tenuous hold on the operational entity that will essentially be generating the bulk of revenues—and without reasonable means of receiving any meaningful returns from their "indirect" investments.

The Notice raises several important questions. Will Chinese-founded companies that plan to go public in the future or have already gone public (e.g., Sina, Sohu, Netease and Baidu) be permitted to adopt and/or maintain the long-established parallel domestic/foreign-invested ownership structure, even if it is in direct contravention of specific requirements set out in the Notice? Or will they be required to make adjustments to achieve full compliance with the Notice? The latter scenario will mean that the domestic company must set up its own premises and facilities, and that ownership of the China trademark and domain name registrations must be held by the domestic company or its actual shareholders, rather than by the offshore listing vehicle

or its subsidiaries. This requirement will significantly decrease the extent to which the domestic company is dependent upon the offshore vehicle and its subsidiaries, thus increasing the vulnerability of the investment vehicle itself. This weakening of the contractual arrangements, coupled with the inherent risks that already exist in the original parallel domestic/foreign-invested ownership structure, is almost certain to make such an investment less attractive to investors in the public markets. This, in turn, will seriously hamper the ability of emerging Chinese companies in the Internet industry to seek investments from foreign investors in early-stage or subsequent investment rounds, as well as impede their longer-term plans to conduct IPOs or subsequent offerings or other financings offshore. The impact of the Notice may vary to some extent depending on how investors view the growth potential of China's telecommunications industry, as well as the appetite of angel investors or venture capitalists for undertaking unusual risks.

As stated in the previous section, one should not dismiss the possibility that MII may grant exceptions to Chinese-founded companies in order to maintain their attractiveness to foreign investors. In fact, the recently revised M&A regulations (issued August 8, 2006, jointly by the Ministry of Commerce and five other departments) expressly require that domestic companies seeking to establish special purpose entities for offshore listings seek prior approval from the Ministry of Commerce. These revised M&A regulations do not provide for the possibility of setting up such vehicles for receiving earlier stage funding from foreign investors (the application for approval requires inclusion of an IPO plan), which may make it difficult for domestic companies to obtain early-stage investments from offshore.

Furthermore, it is unclear as to whether or how the usual restrictions on foreign investment in the telecoms industry will apply. Industry-specific restrictions would subject acquisitions in domestic VATS providers by an offshore vehicle established by a domestic VATS provider to a 50% cap on foreign ownership, as well as a lengthy government approval process with an uncertain outcome. These are all unfavorable factors that are likely to present hurdles and complications in the process of preparing for an IPO, which may ultimately make the investment at issue less attractive to prospective IPO buyers. On the other hand, if such special purpose entities are viewed as mere proxies to the domestic companies they represent and therefore not subject to industry-specific restrictions on foreign investment—i.e., if they are treated as quasi-domestic entities—this would completely eliminate the necessity for a parallel domestic/foreign-invested ownership structure for these Chinese-founded companies, which would allow the domestic telecoms company to be held directly by the offshore listing vehicle.

Unlike Chinese-founded companies that plan to go public in the future or have already gone public, foreign companies that have adopted the parallel structure for purposes unrelated to public listings cannot hope for leniency on the part of MII, but are likely to be required to adopt full remedial measures on a retroactive basis. Our reading of the Notice is reinforced by a public statement made by an MII spokesperson shortly after issuance of the Notice, to the effect that foreign companies wishing to enter the VATS market in China must comply with the relevant regulations by submitting an application to establish a foreign-invested telecommunications enterprise (FITE). According to the statement, foreign companies may not attempt to circumvent the application requirements or seek a shortcut by cooperating with a domestic entity that holds the requisite licenses, even if the acquisition of the offshore vehicle was made for the express purpose of getting access to its domestic counterpart in the parallel ownership structure. This essentially means that a foreign company seeking to conduct business indirectly via a domestic partner with a license—instead of seeking its own license—must transfer its China trademark or domain name registrations to the domestic partner over whom it has no direct ownership control, but only weak contractual relationships within the scope mandated by the Notice.

Will these foreign companies view relinquishment of direct control over their China trademark and domain name registrations to their domestic partners as an acceptable price for market entry? How will this approach affect their market strategies in China? To avoid having the China operations jeopardize a company's operations and market strategies worldwide, a more conservative company may decide to play it safe and forgo the practice utilized by some companies of adopting a uniform trademark and domain name worldwide, and instead utilize different trademarks and domain names for the China market—which may be abandoned if the arrangements with the domestic partner go south and cannot be salvaged.

A foreign investor (whether a multinational or offshore special-purpose entity established by Chinese founders to inject foreign investment) that has direct ownership of a domestic telecommunications company, albeit subject to the current 50% ceiling, would be able to own the domain name

and trademark as a shareholder and license them to the domestic operating entity while fully complying with the Notice. Therefore, establishing a telecommunications joint venture with a Chinese entity, which may be its existing or contemplated Chinese domestic partner, may well be the solution for foreign investors that are not comfortable with the type of indirect control through weak contractual arrangements permissible under the Notice. Although having only 50% control is undesirable for companies that are accustomed to running their operations independently in other parts of the word, obstacles and conflicts that arise in a joint venture can be mitigated through a company's best efforts—by identifying a suitable partner with aligned interests and making clear the goals of the joint venture at the outset. The stability afforded by a FITE offers advantages that may compensate for the inconvenience of having only 50% control.

Presently, however, offshore companies in the telecommunications/Internet industry wishing to operate in China face a situation that is fundamentally unfair. Approvals for establishment of FITEs, while provided for under Chinese law and the terms of China's admission to WTO, are very difficult to obtain. Therefore, setting up such an entity is not viewed as a viable means of entry into China's telecommunications market. Unconfirmed press reports indicate that MII has issued only five approvals for FITE establishments to date, and consequently, many foreign companies—discouraged by the difficulties of obtaining FITE approval—have instead resorted to the parallel ownership structure as a means to an end. Unless China makes some tangible commitments to issue more approvals for the establishment of FITEs, the express MII ban on the parallel ownership structure means that foreign investors will, to a large extent, be shut out of China's telecommunications industry (which includes the provision of goods and services over the Internet). This outcome essentially nullifies China's commitment to open the telecommunications industry to foreign investors in accordance with its terms for WTO accession.

MII must be prevailed upon to provide for a more transparent procedure for the approval of FITEs. Such issues may be raised with the Chinese government collectively via business organizations, or via bilateral/international trade discussions and diplomatic channels. Meanwhile, companies should not passively wait for things for happen. Foreign investors should begin to identify potential domestic partners and prepare to submit applications for the establishment of FITEs. Ideally, there should be a fair and open system whereby MII is obligated to approve any application that is in compliance with the statutory requirements, and applicants whose applications are not approved are provided with the reasons for rejection and permitted to revise their applications to meet MII requirements. Such a system would provide a level playing field for multinationals and the home-grown players in the Internet industry, which would be in line with the principle of national treatment and consistent with China's WTO's commitments in the telecommunications arena.

To view an English translation of the Notice Concerning Strengthening the Administration of Foreign-Invested Value-Added Telecommunications Business Operations, translated by WilmerHale's Beijing office, please click here.

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