

New Rules Provide a Framework for Shanghai Free Trade Zone to Open the Doors on Value Added Telecommunications Services: A Cause for Optimism?

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Since the establishment of the Shanghai Free Trade Zone ("**Shanghai FTZ**"), investors have been closely monitoring the liberalization policies in the telecommunications sector. Historically, given the highly sensitive nature of the telecommunications sector, foreign participation has been very limited in this highly regulated industry. In the People's Republic of China ("**PRC**" or "**China**"), telecommunication services are divided for regulatory purposes into basic telecommunication services ("**BTS**") and value-added telecommunication services ("**VATS**"). The provision of either BTS or VATS in China requires the service provider to obtain a BTS operating permit ("**BTS Permit**") or a VATS operating permit ("**VATS Permit**") respectively, each of which is issued by the Ministry of Industry and Information Technology ("**MIIT**") at the central level or by its local branches. MIIT is the main regulator of the telecommunications and Internet industries in China. The types of telecommunication services falling under BTS and VATS are listed in the *Circular of the Ministry of Information Industry on the Readjustment of the Classification Catalogue of Telecommunication Services* ("**Telecoms Catalogue**") issued by the predecessor of the MIIT, the Ministry of Information Industry ("**MII**"). The most recent version of the Telecoms Catalogue was issued on April 1, 2003 ("**2003 Telecoms Catalogue**"). MIIT has issued a draft version of the 2013 Telecoms Catalogue, but the final version has not been issued as of the date of this note.

Under existing telecommunications laws and regulations, in order to apply for a VATS Permit, a foreign investor must establish a foreign invested telecoms enterprise ("**FITE**") in the form of a Sino-foreign equity joint venture ("**EJV**") with a Chinese partner in which the foreign shareholding is capped at 50% (the foreign shareholder is capped at 49% in applications for a FITE holding a BTS Permit). Notwithstanding the letter of the law, MIIT and MII have historically taken a very protectionist stance in opening up the telecommunications industry to foreign investment. Since China became a member of the World Trade Organisation ("**WTO**"), it appears that only

20¹ or so FITEs have been formed, all in the VATS area. The reluctance of MIIT to open up the telecommunications sector to foreign investors accounts at least in part for the large number of Variable Interest Entity structures which have been adopted in this area.

Following the issuance of the *Opinions on Further Opening Value-added Telecom Business Sector to Foreign Capitals in the Shanghai FTZ* (the "**Opinions**") by MIIT and the Shanghai municipal government on January 6, 2014 which removed the foreign shareholding caps for certain VATS (i.e. Internet Information Services delivered through app store platforms, store and forwarding services, call centres, domestic multi-party communications and internet service (access) provider services) and increased foreign shareholding caps in others (i.e. online data processing and transaction processing (operational e-commerce) and domestic IP-VPN) (the types of VATS specified in the Opinions being the "**Liberalized VATS**")², investors have been waiting patiently for specific rules to be issued by MIIT to clarify the requirements and procedures in order to apply for a VATS Permit in the Shanghai FTZ. The wait ended on April 15, 2014 when MIIT released the *China (Shanghai) Free Trade Experimental Zone Foreign-Invested Operational Value-Added Telecommunications Services Administrative Procedures for Trial Operation* (the "**Pilot Measures**").³

With the issuance of the Pilot Measures, the hope is that MIIT will finally open its doors to foreign participation in the VATS industry. Given the publicity and attention that the Shanghai FTZ has attracted worldwide, investors are optimistic that this will happen, particularly with the strong central government support which the Shanghai FTZ has received to date.

¹ There may in fact be more than this, but the FITEs listed on MIIT's website stops at 2008, for reasons unknown to us.

² Refer to our article "Shanghai FTZ shows its hand on telecoms opening up – could this be the long-awaited breakthrough in VATS?" in the 2014 Winter Edition of TMT Developments in China Note.

³ Our in-house English translation is available on request from christina.wu@hoganlovells.com.

Expectations are that at the very least, foreign investors will be able to set up FITEs in the Liberalized VATS sectors. We set out below an analysis on the key provisions under the Pilot Measures.

Shanghai MIIT steps in but MIIT is still in charge

It was hoped that the Shanghai government's aggressive drive to promote the liberalization policies of the Shanghai FTZ was an early indication that MIIT would grant the Shanghai Municipal Communications Administration Bureau ("**Shanghai MIIT**"), the Shanghai counterpart of MIIT, the authority to determine the scope of foreign participation in the telecommunications industry in the Shanghai FTZ. The hope was that Shanghai MIIT, if granted the authority, would be more aggressive in opening up the VATS sector to foreign participation compared to its central counterpart, MIIT. In general, central government authorities (such as MIIT) across different industries have taken a more hawkish line in allowing foreign participation in regulated industries. Local authorities on the other hand have been more aggressive in seeking to attract foreign investment in their jurisdictions particularly from larger and more sophisticated investors.

To some extent, this has been achieved. Under the Pilot Measures, foreign-invested enterprises (which comprise EJV, co-operative joint ventures and wholly-foreign owned enterprises ("**WFOEs**")) within the Shanghai FTZ will submit applications for a VATS Permit to Shanghai MIIT. Pursuant to Article 6 of the Pilot Measures, the applications are reviewed and decided upon by Shanghai MIIT, not MIIT. Approved applications only need to be record filed with MIIT pursuant to Article 7⁴. However, MIIT retains ultimate control on decisions regarding the types of VATS which are open to foreign investors and the amount of foreign participation allowed. According to Article 2 of the Pilot Measures, the types of VATS which foreign investors are permitted to operate within the Shanghai FTZ and the foreign investment ratio (i.e. foreign shareholding caps) are to be determined by MIIT.

The end result for foreign investors is bitter-sweet. They may have won the battle in that applications are no longer being vetted by MIIT (the hope here being that Shanghai MIIT will be more efficient and less restrictive in reviewing applications for VATS Permits) but the all-important decision on which VATS sectors are open to foreign investors and the foreign

shareholding caps (if any) in the Shanghai FTZ continues to rest with MIIT.

Applications to be made by existing companies in the Shanghai FTZ

The key PRC laws and regulations in relation to foreign participation in the VATS sector are the *PRC Telecommunications Regulations* issued by the State Council effective September 25, 2000 ("**Telecommunications Regulations**"), the *Provisions on the Administration of Foreign-Invested Telecommunications Enterprises* issued by the State Council effective September 10, 2008 ("**FITE Provisions**") and the *Measures for the Administration of Telecommunications Service Operation Permits* issued by MIIT effective April 10, 2009 ("**Telecoms Permit Measures**", together with the Telecommunications Regulations and FITE Provisions, the "**China Telecoms Rules**"). Under the China Telecoms Rules, it is not entirely clear whether an application for a VATS Permit has to be made by an existing legal entity⁵. Our view is that there is no need for the applicant to be an existing legal entity, and that it was possible for an application to be made as part of the establishment process of a FITE. This is because the China Telecoms Rules refer to the Chinese joint venture partner submitting the application (keep in mind that outside of the Shanghai FTZ, a VATS Permit can only be granted to FITEs in the form of EJV due to the 50% foreign shareholding cap). Furthermore, Article 8 of the Telecoms Permit Measures states that one of the documents which needs to be submitted is the business license of the applicant (i.e. its certificate of incorporation) but it goes on to say that if the applicant has not obtained its business license (meaning it has not been legally established), it can submit the notice of enterprise name reservation ("**Name Reservation Notice**") instead. The Name Reservation Notice is

⁵ According to the *Decisions of the State Council on Temporarily Adjusting the Administrative Examination and Approval Items or Special Access Management Measures Prescribed by Certain Administrative Regulations and State Council Documents in the China (Shanghai) Pilot Free Trade Zone* issued by the State Council effective December 21, 2013 ("**Temporary Adjustment Decision**"), a number of provisions under the FITE Provisions relating to the foreign shareholding ratios, processes and penalty provisions have been suspended for the purposes of applications in the Shanghai FTZ. For example, Article 2 of the FITE Provisions which requires that FITEs to be established in the form of EJV is, according to the Temporary Adjustment Decision, temporarily suspended in the Shanghai FTZ. This is necessary to allow the lifting of foreign shareholding caps in the Liberalized VATS sectors which allow FITEs to be established in the form of WFOEs. However, until the issuance of the Pilot Measures, the suspension of these provisions left investors unclear as to the steps and requirements to be taken in order to establish a FITE and apply for a VATS Permit within the Shanghai FTZ.

⁴ Article 7 states that "Where the Shanghai Municipal Communications Bureau issues a Trial Approval Letter to the applicant enterprise, it must record file with the [central] Ministry of Industry and Information Technology within 10 days".

issued as a first step in establishing a legal entity in China which is completed upon the issuance of the business license to ensure that the name of the entity is available for registration. This clearly points to the fact that both scenarios were contemplated.

The Pilot Measures clarify that applications can only be made by existing companies which have been established in the Shanghai FTZ (Articles 3 and 4). Under the list of materials to be submitted to Shanghai MIIT pursuant to Article 4 (described below), the applicant (i.e. the FITE) will need to submit its "Foreign-invested Enterprise Approval Certificate or its China (Shanghai) Free Trade Experimental Zone Foreign Investor/ Hong Kong/ Macao/ Taiwanese-invested Enterprise Record Filing Certificate, its Enterprise Legal Person Business License official duplicate and a photocopy". These are essentially the documents and certificates issued on establishment of the company. Importantly, where the application is for a VATS Permit which imposes a cap on foreign shareholding (i.e. the applicant must be an EJV and cannot be a WFOE), our understanding from inquiries made with Shanghai MIIT is that the applicant must be an existing EJV with the foreign shareholding not exceeding the applicable foreign shareholding cap. As a result, where there is a foreign shareholding cap requirement for the relevant VATS, an existing WFOE cannot apply.

As a follow on from this, it would mean that where the application is for a VATS which imposes a foreign shareholding cap, the Chinese joint venture partner must already be identified so that an EJV can be established to apply for the VATS Permit in question. Based on our understanding, the requirement for the applicant to be an existing legal entity is in fact the preferred market practice. The Pilot Measures reaffirm this practice which essentially involves establishing a 'shell' company (preferably in technology services or technical consulting which are activities not on the *Special Administrative Measures (Negative List) on Foreign Investment Access into the China Shanghai FTZ (2013)* and with a business scope which does not include regulated telecoms services or other services requiring approval (for example from MIIT) so as to speed up the application process) which must be an EJV if the VATS Permit applied for imposes a foreign shareholding cap, but which can be a WFOE if there is no foreign shareholding cap. The 'shell' company applies for the VATS Permit and once this has been obtained, the 'shell' company will then apply for a change of its business scope with the Ministry of Commerce and a new business license with the Administration of Industry and Commerce. Importantly, the 'shell' company must be established within the Shanghai FTZ (which is specified in Article 3).

Taking the analysis one step further, where the application is for a VATS Permit which does not impose any foreign shareholding cap (i.e. one of those mentioned in the Liberalized VATS which has no cap on foreign shareholding), an existing WFOE within the FTZ can therefore apply for the relevant VATS Permit. The process involves setting up a WFOE to provide technical consulting or technical services. The setting up of such WFOEs is a straightforward process and can be completed in less than two weeks in our experience.

Combined process

The process for obtaining a VATS Permit has been simplified and as a result, requires significantly less time than under the existing regime as provided under the China Telecoms Rules. Currently, under the FITE Provisions, in order to apply for a cross-provincial VATS Permit, the applicant has to go through a 'pre-approval' process with MIIT which can take up to 90 days to complete. The process for obtaining the actual VATS Permit is separately provided under the Telecoms Permit Measures whereby another sixty (60) days is allocated for the approval process. Both of these processes have been combined under the Pilot Measures so that only sixty (60) days is allocated to Shanghai MIIT. Specifically, this is provided under Article 6 which states that Shanghai MIIT must complete the review and make a decision on whether to grant the approval within sixty (60) days of accepting the application. If approval is granted, a China (Shanghai) Free Trade Experimental Zone Foreign-invested Operational Value-added Telecommunications Services Trial Approval Letter (with a validity period temporarily fixed at three (3) years⁶) ("**Trial Approval Letter**") shall be issued. Where approval is denied, the applicant must be notified of the reasons for the rejection in writing.

The combination of the pre-approval and VATS Permit application processes is a positive change as it reduces the review period from a lengthy one hundred and fifty (150) days to just sixty (60) days. The purpose of having a pre-approval and then a separate VATS Permit application process has never been entirely clear. For example, the documentation requirements are worded broadly under both the FITE Provisions and the Telecoms Permit Measures and as a result, there appears to be some overlap between the two procedures. Combining them into one under the Pilot

⁶ The three (3) year validity period is because the Shanghai FTZ is generally viewed as a three (3) year pilot project pursuant to the *Master Plan for the China (Shanghai) Pilot Free Trade Zone* issued by the State Council effective September 18, 2013.

Measures simplifies the process and is certainly a welcome change.

Separately, Article 5 of the Pilot Measures states that upon receiving the application, Shanghai MIIT must carry out a review of the application materials and if they are complete and comply with the formal legal requirements, Shanghai MIIT will issue a notification of acceptance to the applicant. However, if the application materials are incomplete or do not meet the formal legal requirements, Shanghai MIIT must notify the applicant within five (5) working days of receiving the application of any supplementary materials which needs to be submitted. The Telecoms Permit Measures impose a similar requirement but refer to a five (5) day timeline as opposed to five (5) working days.

Unfortunately, the Pilot Measures provide little in explaining the previous requirement to have facilities established within the Shanghai FTZ. It states that the "service facilities" must be within the Shanghai FTZ, and hence we presume that at the very least, the client-facing facilities must be physically located within the Shanghai FTZ.

Similar requirements and conditions with an increased focus on protection of personal information

The Pilot Measures list out the requirements and conditions in order to apply for a VATS Permit. These are, in general, the same as those provided under the existing China Telecoms Rules, except for additional requirements on location, network security mechanism and personal information protection as listed below:

- (a) the operating entity (i.e. FITE) must be a company that has been established in accordance with law within the Shanghai FTZ – refer to our comments above regarding the requirement for an existing entity to be the applicant for the VATS Permit;
- (b) it has the funds and specialised personnel commensurate with engaging in operational activities;
- (c) it has the credibility and ability to provide services to users over the long term;
- (d) its registered capital is no less than RMB 1 million - the registered capital requirement is consistent with the China Telecoms Rules which states that if the VATS are limited to within a single province (Guangdong, Zhejiang and Fujian for example), autonomous region (Xinjiang, Inner Mongolia, Ningxia, Guangxi and Tibet) or municipality

under direct central government administration (Beijing, Shanghai, Tianjin and Chongqing), the minimum registered capital is RMB 1 million. The RMB 10 million requirement applies to where the VATS are provided across provinces, autonomous regions or municipalities under direct central government administration;

- (e) it has the necessary premises, facilities, technical plan as well as network and information security safeguarding systems and measures, amongst which the service facilities must be established within the Shanghai FTZ – see our comment above on location of service facilities;
- (f) the applicant, its main investors and main operations and managerial personnel have no records of unlawful conduct for violation of the telecommunications supervision administration system during the last three (3) years; and
- (g) other conditions set out in provisions of the State – this is a standard catch all that basically allows Shanghai MIIT to apply its discretion to impose other conditions and ultimately allowing it to reject an application which would otherwise be approved.

In terms of documentation, these are also largely similar to those under the China Telecoms Rules but again with an increased focus on personal data protection:

- (a) a written application executed by the applicant's legal representative which includes the categories of VATS to be operated that have been applied for, the scope of coverage of the services, the company name, the company's communications address, post code, contact person and telephone number, email address and so forth;
- (b) materials relating to the foreign investor(s) (i.e. the shareholder of the applicant), including the registration certificate (i.e. incorporation certificate), basic information and background, most recent audited accounts, certificate of creditworthiness;
- (c) the applicant's Foreign-invested Enterprise Approval Certificate or its China (Shanghai) Free Trade Experimental Zone Foreign Investor/ Hong Kong/ Macao/ Taiwanese-invested Enterprise Record Filing Certificate, its Enterprise Legal Person Business License official duplicate and a photocopy – unlike the

Telecoms Permit Measures, there is no provision allowing the applicant to provide its Name Reservation Notice, suggesting that the application can only be made by an existing legal entity established in the Shanghai FTZ (as discussed above);

- (d) brief overview of the applicant including the basic background and details, the personnel proposing to engage in VATS, place of business, facilities and so forth;
- (e) articles of association of the applicant, and the applicant's shareholder structure;
- (f) the business development, implementation plan and the technical plan for the application to operate telecommunications services;
- (g) measures for the provision of long term services to users, quality safeguards and for the protection of personal information of users – this is a new requirement and is in response to the focus on personal information and data protection which has taken place in the past few years after the issuance of the China Telecoms Rules⁷;
- (h) the system for and measures for network and information security safeguarding;
- (i) relevant materials evidencing the applicant's creditworthiness; and
- (j) letter of undertaking executed by the applicant's legal representative that the applicant will operate telecommunications services in accordance with law.

In terms of the actual application, a website (in Chinese) has already been set up to accept applications for VATS Permits in the Shanghai FTZ (<https://tsm.miit.gov.cn/wlogon/LogonFTA.aspx?sc=47520B4F446E6522D62BD6264A703A55&n=&u=>).

Annual Inspection Requirement

The Pilot Measures also include a requirement for FITEs established within the Shanghai FTZ to undergo an annual inspection system with the Shanghai MIIT. This is consistent with the requirement under Chapter 7 of the Telecoms Permit Measures and the documentation requirements are basically similar.

Under the Pilot Measures, FITEs which have been issued with the relevant VATS Permits must submit the following materials on an annual basis in the first quarter of each year:

- (a) an analysis of operations of telecommunications services for the year in question; business development, personnel and organisational changes; service quality and user personal information protection status; implementation status for network and information security administrative requirements; implementation status for state-level and [local] telecommunication administrative organs relevant stipulations and so forth;
- (b) a photocopy of the FITE's business license; and
- (c) other materials as required by Shanghai MIIT.

The outcome of the annual inspection will be recorded in the Trial Approval Letter, made public (possibly through Shanghai MIIT's website) and reported to the industry and commerce administrative organs. The intention here appears to be that VATS operators who do not follow Shanghai MIIT's requirements will be named and shamed. The Chinese authorities appear to be taking the view that a public relations backlash and negative publicity may be more effective weapons in ensuring compliance as compared to rather modest monetary penalties and fines.

⁷ There are restrictions on the collection transmission and use of personal data in China. China does not have an 'omnibus' privacy law but there are a number of regulations and rules to take into consideration. These include but are not limited to the *Provisions on the Protection of the Personal Information of Telecommunications and Internet Users* issued by MIIT effective September 1, 2013, the *Information Security Technology -- Guidelines for Personal Information Protection within Public and Commercial Services Information Systems* issued by the China's Standardization Administration in January 2013 and the *Internet Information Services Administrative Procedures* promulgated by the State Council on, and effective September 25, 2000. These rules and regulations outline amongst other, the standards specific to and the requirements for the collection and use of personal information obtained by telecommunications service providers and Internet Service Providers in the process of providing telecommunication and Internet services. Please see our Corporate China Alert of August 2013 and updated in March 2014 'China Turns up the Heat in the Battle Against Abuses of Personal Data'.

Conclusion

Except for the combining of the pre-approval and VATS Permit application procedures, the Pilot Measures do not stray very far from the requirements under the China Telecoms Rules. Certain commentators have expressed disappointment: they expected more given the trumpeting of liberalization and free market opportunities by the Shanghai FTZ. In our view, the real test is whether Shanghai MIIT will actually follow through with the granting of VATS Permits to FITEs and allowing foreign participation in the telecommunications industry in practice. The Pilot Measures are a critical piece in the puzzle and the coming months will see a number of foreign telecoms players applying for VATS Permits in the various sectors. The very small number of VATS FITEs established to date, and the fact that China allowed up to 49% foreign participation as part of its WTO commitments but we have yet to see a single BTS FITE announced publicly point to the fact that notwithstanding the China Telecoms Rules, MIIT has been slow to allow substantive foreign participation in the telecommunications industry, so there are obvious concerns that Shanghai MIIT will maintain this policy line, notwithstanding the Opinions and the Pilot Measures. However, as mentioned above, there is optimism that this time things will be different given the need for China to 'move up the production chain' by focusing on technological innovation and development. Opening its doors to foreign players will not only bring in investment and employment, but will also much needed competition and innovation to China's telecommunications market. Unlike in 2001 when China joined the WTO, China's State-owned telecommunications giants (China Mobile, China Telecom and China Unicom) as well as home-grown Internet companies (Alibaba, Tencent, Baidu, Sina, Qihoo 360 and so forth) are now more than capable of fending for themselves in a free market populated by the global giants, so hopefully this time things will be different. We remain cautiously optimistic, but will be measuring our optimism against the VATS Permits (and maybe even BTS Permits) actually granted by the FTZ in the months and years to come.

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