NEW CHAPTER FOR FOREIGN TELECOM INVESTMENT IN SHANGHAI FREE TRADE ZONE

The telecom industry has traditionally been highly regulated and restricted in terms of foreign investment in China. China tightly controls what types of telecom business including basic telecom services (**BTS**) and value-added telecom services (**VATS**) are open for foreign investment. China has not yet allowed foreign investment in BTS, but has had three types of VATS open for foreign investment including: information services, store and forward services, and on-line data processing and transaction processing services pursuant to its WTO commitments[1].

However, the national telecom regulations have imposed a 50% foreign equity ownership cap on VATS. This means, foreign investors cannot set up a wholly owned subsidiary (**WFOE**), but must find a Chinese partner to set up a 50/50 joint venture (**JV**) for engaging in VATS businesses. Despite the route of JV offered under the national regulations, in practice it has been extremely difficult to obtain the VATS license from the Ministry of Industry and Information Technology (**MIIT**) for actually establishing a JV[2]. This has led many foreign investors to adopt the so-called VIE structure for operating a VATS business in China.

With the launch of the Shanghai Free Trade Zone (**FTZ**) in September 2013, for promoting the FTZ, China has opened additional VATS businesses for foreign investment and lifted the foreign equity ownership cap concerning some VATS businesses in the FTZ. We highlight below the key points of interest under the recently issued FTZ telecom rules[3].

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[1] Additionally, China has allowed WFOE in offshore call centers on a pilot basis in 21 pilot cities since 2010. Also, Hong Kong and Macau investors may invest in additional types of VATS business under CEPAs.

[2] According to the statistics published by MIIT, as of March 31, 2014, of the more than 2,600 companies holding VATS licenses issued by MIIT or its local counterparts, only about 30 more are JVs, or roughly about 1.2% of the total licensed telecom companies.

[3] MIIT and the Shanghai People's Government jointly issued the *Opinions on Further Opening-up of Value-added Telecommunications Services for Foreign Investment in Shanghai Pilot Free Trade Zone* on January 6,

Additional VATS Businesses Opened for Foreign Investment

- Call center services (呼叫中心业务)
- Domestic multi-party communications services (国内多方通信服务业务)
- Internet access services (因特网接入服务业务)
- Domestic internet virtual private network services (VPN) services (国内因特网虚拟专用网业务)

Higher Foreign Equity Ownership Allowed

For VATS businesses opened for foreign investment in FTZ, the foreign equity ownership cap in the following specifically named categories of VATS business is either raised to 55% or lifted completely:

- WFOE Allowed (that is, no cap on foreign equity ownership)
    - App stores under information services (信息服务中的应用商店)
    - Store and forward services (存储转发类业务)
    - Call center services (呼叫中心业务)
    - Internet access services (因特网接入服务业务) (Note: limited to serving users within the FTZ)
    - Domestic multi-party communications services (国内多方通信服务业务)

- 55% Foreign Controlled JV Allowed (that is, the foreign equity ownership cap is increased from 50% under the national telecom regulations to 55% in FTZ)
    - E-commerce business under on-line data processing and transaction processing services (在线数据处理与交易处理业务中的经营类电子商务)

2014, and then the *Administrative Measures for Pilot Operation of Foreign Investment in Value-added Telecommunications Business in Shanghai Free Trade Zone* on April 15, 2014.

Relaxed Approval Requirements

The VATS license can be issued by the Shanghai Communications Administration (**SCA**) without going through MIIT, which can significantly save the approval time. Correspondingly, the sanction authority in FTZ is also delegated to SCA.

The minimum registered capital for foreign invested telecom companies is universally set at RMB 1 million (approximately USD 167,000), compared to the national telecom regulations where a minimum registered capital of RMB 10 million (approximately USD 1.67 million) is required for carrying out cross-province telecom business.

COMMENTS

Overall, the FTZ telecom rules have opened a new door for foreign investors to incorporate a WFOE or a 55% foreign majority JV in the FTZ for carrying out the specifically named VATS business, whilst still being able to reach users nationwide (except for the internet access services).

This relaxation in the FTZ may have given greater expectation around further general relaxation on foreign investment in the telecom industry. However, to the contrary, we even expect some kind of tightened control in the immediate future. The recent establishment of two task forces at the central level (the Committee on National Security and the Central Internet Security and Informatization Leading Group) has signaled that China is going to pay increasing attention to internet security. In such an atmosphere, any further opening for foreign investment in telecom business nationwide would not be realistic. This therefore would make FTZ a more attractive area for foreign investors to tap into the Chinese VATS market.

When considering the VATS investment in the FTZ, it's important to remember that under the FTZ rules, a company must first incorporate a company in the FTZ without a VATS business scope, and then apply to the SCA separately for the VATS license. Once the VATS license is issued, the company is required to go back to the business registration authority to amend its business license for incorporating the licensed VATS business. Therefore, in theory, there is a risk that if the VATS license was not granted by the SCA, the foreign investor would be stuck with a WFOE or JV in the FTZ, which is not qualified to carry out the VATS business. To minimize such risk, potential investors shall consider sufficient advance consultation with the SCA before incorporating any company.

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