Client Alert

Corporate & Securities China February 6, 2015

China's New Policy for Foreign Investment in E-Commerce

Shanghai Free Trade Zone Opens Door for Complete Foreign Ownership in E-Commerce Operations

By David Livdahl, Jenny Sheng and Lisa Li

*Further to the early 2014 policy that relaxed the restrictions on the foreign equity ratio in value-added telecommunications business in the Shanghai Free Trade Zone (**"Shanghai FTZ"**), on January 15, 2015, the Ministry of Industry and Information Technology (**"MIIT"**) promulgated a new policy, i.e., the* Opinions on Lifting Restrictions on the Foreign Equity Ratio for Online Data Processing and Transaction Processing Business in the China (Shanghai) Free Trade Zone *(the **"New Policy"**), according to which, any foreign equity ratio restriction on foreign investment in e-commerce operations (under the category of online data processing and transaction processing businesses) was removed in the Shanghai FTZ. As such, foreign investors are now allowed to establish a 100 percent wholly foreign owned enterprise (a **"WFOE"**) in the territory of Shanghai FTZ to operate e-commerce business. In the New Policy, MIIT authorized the Shanghai Municipal Telecommunication Administrative Bureau to implement the* New Policy, *review foreign investors' applications and issue the relevant qualification/operation licenses to foreign-invested e-commerce companies.*

Background

Foreign investment in the telecommunications industry has been strictly regulated and restricted in China. Foreign investment in the value added telecom services (**"VAT Services,"** including e-commerce operations) must be in the form of a Sino-foreign joint venture (**"JV"**), and the foreign investor is allowed to take only up to 50 percent equity interest in a VAT Services JV. Also, in practice, it has been extremely difficult for foreign investors to obtain the VAT Services license from the MIIT for any such JV. Thus, many foreign investors use the so-called VIE (variable interest entity) structure to indirectly manage and operate their VAT Services business in China through contractual control over a domestic VAT Services license holder.

After the launch of the Shanghai FTZ in September 2013, MIIT and the Shanghai Municipal Government jointly issued *Opinions on Further Opening up the Value-added Telecom Service Sector to Foreign Investment in the China (Shanghai) Free Trade Zone* (the **"2014 Opinion"**), under which, additional VAT Services business were opened for foreign investment in the Shanghai FTZ and it lifted the foreign equity ratio cap related to certain VAT Services business in the Shanghai FTZ. According to the 2014 Opinion, foreign investors were allowed to hold up to 55 percent of the equity interest in an e-commerce operation business (i.e., the foreign equity ownership cap was increased from 50 percent to 55 percent in the Shanghai FTZ). One year later, in January 2015, the New Policy opens the door to foreign investors to establish a 100 percent-owned WFOE in the territory of Shanghai FTZ to operate e-commerce business. This is encouraging news for foreign investors that want to enter into the e-commerce business in China. Currently, the 2014 Opinion and the New Policy allow foreign investors to establish a 100 percent-owned WFOE in Shanghai FTZ to operate the following businesses: (i) App stores under the category of information services; (ii) storage and forwarding services; (iii) call center services; (iv) internet access services (limited to serving users within the Shanghai FTZ); (v) domestic multi-party communication services; and (vi) e-commerce businesses under the category of online data processing and transaction processing services.

Potential Problems and Our Outlook

Despite this far-reaching achievement, several relevant issues should be noted as well.

A. Requirements on Location and Registered Capital

Under the New Policy, only those foreign-invested enterprises established and operated inside the territory of the Shanghai FTZ can enjoy the benefits of this New Policy. On the basis of our no-names telephone consultations with MIIT, we understand that the New Policy only replaces the provision in the 2014 Opinions regarding the capped foreign equity ratio (raised from 55 percent to 100 percent), while all the other provisions of the 2014 Opinions are still in effect. This means that the service facility of the WFOE (such as the server) must be located in the Shanghai FTZ.

Nevertheless, although WFOE e-commerce companies are required to be established in Shanghai FTZ, they can provide services to clients outside the Shanghai FTZ nationwide.

In addition, the minimum registered capital requirements for the foreign-invested VAT Services Companies are still applicable to e-commerce WFOEs in the Shanghai FTZ. Namely, an e-commerce operation WFOE in the Shanghai FTZ must have at least RMB 1 million as its registered capital (the actual capital that the foreign investor must contribute into the WFOE) for carrying out cross-province e-commerce business.

B. Description of Business Scope

Any company registered in China must have a "business scope" which is subject to the approval and registration of the company registration authorities. The company registration authorities (the State Administration for Industrial and Commerce and its local counterparts) have a catalogue of standard terms for the description of the business scopes. For the approval and registration of the business scope of a telecom services company, the company registration authorities will refer to the category of the telecom services specified in the VAT license of such company that is issued by MIIT. In the VAT license, MIIT defines the business scope of a telecom services company in accordance with the current valid 2003 version of Classification Catalogue for Telecommunications Business (**"2003 Catalogue"**). Under the 2003 Catalogue, VAT Services are classified into eight categories and under each category, MIIT lists the typical sub-category services belong to each category.

Under the New Policy of MIIT, e-commerce operation is sub-categorized under the category "online data processing and transaction processing." On the basis of our no-names inquiries with the official at MIIT, we understand that for any new e-commerce companies to be established in the Shanghai FTZ, they should apply to the Shanghai Telecommunication Administrative Bureau for the issuance of a VAT license for "online data processing and transaction processing" services.

However, the current valid 2003 Catalogue does not explicitly sub-list "e-commerce operations" under the "online data processing and transaction processing" category.[1] Due to the lack of guidance in the 2003 Catalogue and according to the company registration authorities' registration practice, the business scope of the majority of existing e-commerce companies was registered as "information services" rather than "online data processing and transaction processing". As such, if an existing e-commerce enterprise would like to increase the percentage of foreign investment as permitted under the New Policy, it must relocate to Shanghai FTZ and change its business scope from "information services" to "online data processing and transaction processing businesses (e-commerce operations)". On the basis of our no-names telephone consultations with MIIT, we understand that the above suggested changes of business scope and relocation of business address are allowed and feasible.

C. Possible Impact on Hong Kong Listing by E-Commerce Companies Using VIE Structure

This New Policy may impact the Hong Kong stock exchange market listings of existing e-commerce enterprises using VIE structures. Given the regulations in the Hong Kong capital market, companies applying to be listed in Hong Kong under VIE structures must indicate the necessity of using the VIE structure. Since the recently promulgated New Policy permits foreign investors to establish a 100 percent directly owned WFOE in the Shanghai FTZ for e-commerce operations, it is unclear whether this New Policy will become a barrier for those e-commerce companies using VIE structures to get listed in Hong Kong.

In conclusion, the New Policy is encouraging news for foreign investors that want to enter into the e-commerce business in China. A WFOE established in the Shanghai FTZ is now allowed to engage in the e-commerce business by applying for the VAT license for online data processing and transaction processing. Our informal inquires with MIIT indicate that such e-commerce WFOEs in the Shanghai FTZ are allowed to provide services outside the Shanghai FTZ. It is possible that many telecom service entities may try to use the New Policy to categorize their services as e-commerce. We expect that the regulatory authorities will need to further clarify the definition and scope of e-commerce.

[1] Although the 2013 amendment draft of the Catalogue included "e-commerce" within "online data and transaction processing businesses," this new amendment has not been enacted, which means such enterprises still have to follow the 2003 Catalogue.

If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or the authors below.

David Livdahl (bio)
Beijing
+86.10.8572.1122
david.livdahl@pillsburylaw.com

Jenny Sheng (bio)
Beijing
+86.10.8572.1166
jenny.sheng@pillsburylaw.com

Lisa Li (bio)
Beijing
+86.10.8572.1188
lisa.li@pillsburylaw.com

About Pillsbury Winthrop Shaw Pittman LLP
Pillsbury is a full-service law firm with an industry focus on energy & natural resources, financial services including financial institutions, real estate & construction, and technology. Based in the world's major financial, technology and energy centers, Pillsbury counsels clients on global business, regulatory and litigation matters. We work in multidisciplinary teams that allow us to understand our clients' objectives, anticipate trends, and bring a 360-degree perspective to complex business and legal issues—helping clients to take greater advantage of new opportunities, meet and exceed their objectives, and better mitigate risk. This collaborative work style helps produce the results our clients seek.