Golden Trails: A Roadmap Leading to China’s Internet Industry

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By Liang Tao

On February 19, 2012, Wal-Mart Stores, Inc. disclosed its additional investment in Yihaodian, a fast-growing electronic commerce website in China, making Walmart’s total ownership stake in Yihaodian to reach approximately 51%. It was Wal-Mart’s second investment for the purpose of controlling Yihaodian, upon its initial investment in it in May of 2011. According to Wal-Mart, closing of the transaction would be subject to Chinese government regulatory approval. Obviously, such approval would be the product of merger control review process administered by the Ministry of Commerce of PRC and its local counterparts (collectively, “MOFCOM”).

Wal-Mart’s aggressive acquisition is not a unique example of foreign investors’ good appetite for China’s promising internet market participants. 360Buy is one of the biggest B2C online shopping platforms in China. Many famous foreign institutional investors, such as Tiger Fund and Digital Sky Technologies which is an international investment firm focusing solely on the internet sector, had attracted strategic foreign investment even when their founders were nobody.

China’s internet industry has been heavily regulated, especially for foreign investors. The internet industry generally falls within the industry of telecommunication. According to the Foreign Investment Industrial Guidance Catalogue newly revised at the end of 2011, telecommunication business (“TB”) belongs to the “restricted” catalogue and is further grouped into value-added TB and basic TB. Foreign investors’ stake percentage is confined to 50% for value-added TB and 49% for basic TB. Exactly speaking, the internet industry is part of value-added TB sector. The Ministry of Industry and Information Technology of PRC and its local counterparts (collectively, “MIIT”) is the competent regulatory authority.

How to operate a website in China?

In order to engage in China’s internet industry, the first thing is to establish and operate a website in China. In practice, a website operator mainly refers to the internet information provider (“ICP”) which is an abstract term cited from the Measures for the Administration of Internet Information Services, a regulation issued by China’s State Council in 2000. Under China’s current internet regulatory regime, websites established or operated by individuals or entities located in China can be divided into two categories: (i) websites with profit-making purpose; and (ii) websites with non-profit making purpose.

For the websites with profit-making purpose, the website operators (which must be companies incorporated within China) are required to apply with the MIIT for the Value-added Telecommunications Service Permit. For the websites with non-profit making purpose, the website operators (which can either be individuals or entities located in China) only need to register with the MIIT at provincial level.

Foreign individuals or entities are not admitted to launch profit-making websites in China, as only companies incorporated in China are allowed to operate the profit-making websites. In addition, such operating companies can either be “pure” Chinese domestic companies, or Sino-foreign joint ventures in which foreign investors hold at most 50% equity. Foreign individuals or entities are also not admitted to launch non-profit making websites in China.

Specific industry requirements

Apart from obtaining the license and permit from the MIIT, internet industry players are also requested to meet specific industry requirements. Prior to applying for an operating permit or registering the internet information services for the record, an ICP whose services relate to information, the publishing business, education, medical and health care, pharmaceuticals, and medical apparatus must first obtain the approval from the
relevant supervisory authorities.

For example, a B2C online shopping company proposing to sell drugs and medicines has to not only apply with the MIIT for Value-added Telecommunications Service Permit, but also submit applications to the State Food and Drug Administration of PRC or its provincial counterparts for approval. In other words, if internet market players’ businesses relate to specific sectors, including publishing business, education, medical services, etc., they need to obtain both special industry approval and MIIT approval. Of course, they also have to go through the routine foreign investment approval procedures with the MOFCOM and company registration procedures with the administration for industry and commerce.

In certain sensitive sub-sectors, foreign internet market players also need to address potential political or public interest concerns. For example, Google adhered to China’s internet censorship policies before March of 2010. On March 22, 2010, after talks with Chinese competent authorities failed to reach an agreement, Google discontinued its services in China, and redirected Chinese customers to its Hong Kong server, which is outside the jurisdiction of Chinese censorship laws. It is reported that Google’s Chinese market share has declined by over 50% since its withdrawal from China’s market. Foreign investors may want to learn a lesson from Google China’s case, and carefully study China’s internet compliance requirements.

**VIE structure**

The “variable interest entity” structure (“VIE Structure”) is an investment structure widely adopted in China’s internet industry. One of VIE Structure’s aims is to bypass the industry restrictions imposed by Chinese government on foreign investors. China has imposed rigid restrictions on the foreign investors proposing to invest in China’s internet-related business. As internet industry falls within value-added TB industry, foreign investors at most can hold 50% shares of China’s internet companies and are subject to rigid and protracted scrutiny and review. That’s why most of the foreign investors have adopted VIE Structure when investing in Chinese internet companies. To bypass the industry restriction, foreign investors will establish a wholly foreign owned enterprise (“WFOE”) as a bridge to connect the offshore holding company with the onshore operating company. The onshore operating company is a “pure” Chinese domestic company. A series of contractual agreements will be entered into by and between the WFOE and the operating company, with a view to empowering the foreign investor to control the management of and enjoy the profits of the operating company.

According to Liu Qiangdong, Chairman of 360Buy, all of China’s internet companies receiving offshore investment have adopted the VIE Structure. Mr. Liu’s comment is made against the backdrop that China’s regulatory authorities are trying to challenge this market practice after Alibaba’s Chairman Jack Ma triggered a debate regarding VIE Structure. Recently, China’s relevant competent authorities have expressed their concerns over the VIE Structure. It casts a cloud on the future of the popular VIE Structure. Foreign investors may want to take a more risk-averse approach in future or try to mitigate the risks of existing VIE Structure, for example, transferring assets and businesses from the operating company to the WFOE to the extent permitted by law, perfecting the corporate governance to enhance ties between the WFOE and operating company, etc.

**New rules to regulate fierce competition among ICPs**

We also would like to draw foreign investors’ attention to the fierce competition in China’s internet market. A bitter dispute between Qihoo and Tencent is a vivid example. Such dispute was triggered by the fact that Qihoo’s “360 Safeguard” becomes not compatible with Tencent’s major product “QQ”. Finally, both Qihoo and Tencent submitted their complaints to the MIIT for judgment. This high profile dispute spurs the MIIT to issue new measures to crack down on unfair competition in internet industry.

On December 29, 2011, the MIIT issued the Several Provisions on Regulating the Market Order of Internet Information Service (“Several Provisions”) which came into force on March 15, 2012. The Several Provisions are designed to regulate the bloody competition among ICPs, end the negative sum game, and finally protect customers’ legitimate interests. We have summarized the major points of the Several Provisions as below for your reference:

- Prohibiting ICPs from maliciously making their products incompatible with the services or products of their competitors;
- Prohibiting ICPs (who run platforms with a view to rating internet services or products) from manipulating the rating results or misleading customers regarding the rating results;
- Prohibiting ICPs from engaging in any acts (which may damage customers’ legitimate interest), for example, misleading or deceiving customers, changing customers’ setting without customers’ consent, and delay in the provision of services without justification;
- Requesting ICPs to provide customers with options to uninstall any portion of the bundled software packages;
- Requesting ICPs to highlight the function button which is used to close the pop-up advertisement; and
- Requesting ICPs to duly protect customers’ personal information, and prohibiting ICPs from utilizing customers’ personal information for any purposes other than the purpose of providing internet services.

Behind the big transactions or fierce competitions above-mentioned, there is a large Chinese internet market with well over 500 million potential internet customers. With a continually expanding economy, rapidly modernizing infrastructure, emerging business community and customer base, China will provide enormous business opportunities to foreign investors. However, when initiating their investments, it is advisable for foreign investors to do an overall research and get a deep understanding of China’s internet regulatory environment. In a word, obtaining an informative roadmap is definitely a critical step for a gold rush journey.

(Author: from an international law firm)