Shanghai's Free Trade Zone: investment in net businesses

On 6 January 2014 the Ministry of Industry and Information Technology of the PRC ('MIIT') and the People's Government of Shanghai jointly released Opinions that allow for the set-up of wholly foreign-owned enterprises for the majority of types of internet service sector business in the Shanghai Free Trade Zone, as Dr. Falk Lichtenstein and Ada Tong of CMS, China discuss.

The internet service sector in China has long been tightly regulated and, from a foreign investor's perspective, has been subject to several restrictions. For example, it was impossible for foreign investors to set up wholly foreign-owned enterprises ('WFOEs') in any sectors of internet business. In most sectors, even Sino-foreign joint venture companies with Chinese parties ('JVs') were not permitted.

This has changed in the Shanghai Free Trade Zone ('FTZ'), which was formally opened on 29 September 2013. The MIIT and the People's Government of Shanghai's Opinions regarding 'Further Opening up Value-added Telecom Service Sector towards Foreign Investments in China (Shanghai) Pilot Free Trade Zone' ('Opinions') allow the establishing of WFOEs engaging in access service provider business for internet users and several other businesses of the information technology sector.

Foreign investor restrictions

The majority of internet-related business, including internet access service provider business, are regarded as 'telecommunication services' under Chinese law. According to the Classification Catalogue of Telecom Business ('Category') released by MIIT on 21 February 2003, value-added telecom services are classified into eight categories, outlined in the left-hand column of Table 1. Foreign investors operating in the these sectors need to establish foreign-invested enterprises ('FIEs') in China, either WFOEs or JVs. Details are provided in the PRC Guidance Catalogue for Foreign Investment (version 2011) ('Catalogue') and other regulations. Before the Opinions took effect, foreign investment in these sectors was generally subject to the restrictions described in Table 1, which still apply for foreign-invested projects outside the FTZ.

Table 1: Investment restrictions before / outside the FTZ

Information service business	Permitted for JVs with no more than 50% foreign investment
Store-and-forward type of business	Permitted for JVs with no more than 50% foreign investment
Online data processing and transaction processing business	Permitted for JVs with no more than 50% foreign investment
Call centre business	Not permitted for any FIEs
Domestic multi-party communication service business	Not permitted for any FIEs
Domestic internet virtual private networks business	Not permitted for any FIEs
Internet data centre business	Not permitted for any FIEs
Internet access services business	Not permitted for any FIEs

It is worth noting that according to the Catalogue that in the area of value-added telecom services only, foreign investment of no more than 50% is permitted, while in the area of so-called basic telecom services, foreign investment shall account for no more than 49%.

Categories now open

In the FTZ, instead of the Catalogue, a 'Negative List' applies, determining those businesses that need to go through an administrative approval process. According to the Opinions, except for net data centre business, all the other above categories have now opened up for foreign investment in the FTZ and one new permitted category has been added. Among those eight categories permitted in the FTZ, three categories had already been opened up for foreign investment outside of the FTZ as part of China's WTO commitments earlier, one category has been created and four former categories have opened up in the FTZ for the first time in China. Also, the shareholding ratios for foreign investors in certain categories have been eliminated or raised in the FTZ.

The opening of the information service, store-and-forward and online data processing and transaction processing categories to foreign investment were already part of China's WTO commitments. According to the Opinions, in the FTZ there will no longer be limitations on foreign shareholding ratios in the application store business of the information service category (newly included as a separate category) and the store-and-forward category. The foreign shareholding ratio restriction for e-commerce businesses of the online data processing and transaction processing category is raised from no more than 50% to 55%.

In addition, the call centre, domestic multi-party communication service, internet access services business for internet users and domestic internet virtual private networks business categories have been permitted for foreign investment in the FTZ. Other than the domestic internet the virtual private networks category, which requires foreign participation to be no more than 50%, in the other three categories the relevant limitations on foreign shareholding ratios have been cancelled. This means the restrictions found in Table 2 apply in the FTZ. In short, it is now allowed to establish WFOEs in the FTZ to engage in the application store business of information service business, store-and-forward types of business, call centre business, domestic multi-party communication service business and internet access services business for internet user categories. WFOEs are typically most attractive for foreign investors as they allow investors to run their businesses without the influence of a Chinese partner.

It is to be expected that major features of the FTZ, possibly also the investment relaxations in the internet business sectors set out above, will be extended to the whole of China sooner or later.

Table 2: Investment restrictions in the FTZ

Application store business of information service business	Permitted for WFOEs and JVs
Other information service business	Permitted for JVs with no more than 50% foreign investment
Store-and-forward type of business	Permitted for WFOEs and JVs
Online data processing and transaction processing business	Permitted for JVs with no more than 55% foreign investment
Call centre business	Permitted for WFOEs and JVs
Domestic multi-party communication service business	Permitted for WFOEs and JVs
Internet access services business	Permitted for WFOEs and JVs
Domestic internet virtual private networks business	Permitted for JVs with no more than 50% foreign investment
Internet data centre business	Not permitted for any FIEs

Location requirements

The Opinions require that in order to enjoy the incentives of the Opinions, the FIE must be legally established in the FTZ and its service facilities must be located in the FTZ. Further the service scope of internet access services business is restricted to internet users located within the FTZ. Except the above, the service scope of the other categories can be nationwide.

In general, the above is a big step forward for foreign investment in the telecom sector. With registration and service facilities located in the FTZ, most of the above-mentioned value-added telecom services can also be offered outside of the FTZ, i.e. foreign-invested telecom services providers will be able to offer these services via WFOEs all over China. As always in China, it remains to be seen how this opening up of the sector will be implemented by the authorities in practice.

The Opinions might be a good sign for other sectors. One of the major shortcomings of the new FTZ was that it was unclear whether the liberalisation of services in various sectors only applied to services provided to contract partners within the FTZ or also to those located in other regions of China. The Opinions state that the telecom services mentioned above can be provided nationwide. This offers hope that comparable implementing regulations will also be released for other sectors.

Extension expected

Typically, pilot projects such as the regulatory framework newly established in the FTZ have a chance of being extended nationwide after a trial period, provided they prove satisfactory from the government's perspective. For the FTZ, no fixed trial period is stipulated. However, it is to be expected that major features of the FTZ, possibly also the investment relaxations in the internet business sectors set out above, will be extended to the whole of China sooner or later.

For now, foreign investors might consider establishing a WFOE in the FTZ to take full advantage of this opportunity. However, as to internet access service businesses, it needs to be noted that the services may only be offered to users located in the FTZ, which might be a burden. Foreign investors should monitor further developments, in particular in terms of a possible extension to the whole of China.

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