

TMT developments in China

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Editors' Note

Through 2014, the technology, media and telecommunications (“TMT”) space continues to be a focal point in China. Technological breakthroughs – such as the scale of cloud computing, particularly related to “Big Data,” and developments in the machine-to-machine communications area – continue to challenge regulators and practitioners in keeping pace.

The recent TMT developments transcend different practice areas and geographies. This edition of our TMT China Brief contains a number of articles which dive into different regulatory issues covering numerous practice areas – ranging from an update on the liberalization in the Shanghai Free Trade Zone, through privacy concerns in Hong Kong to standard-setting rules for patented technologies in China.

Today, the TMT sector continues to excite and challenge market players and practitioners with cutting-edge developments in technology and business models and practices. This edition of the TMT China Brief provides you with our in-depth analysis into some of the key issues in this field – happy reading!



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New rules on VATS for Shanghai FTZ – a cause for optimism?

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 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 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. 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. The most recent version of the Telecoms Catalogue was issued on April 1, 2003. MIIT has issued a draft version of the 2013 Telecoms Catalogue, but the final version has not yet been issued.

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 operating permit).

Following the issuance of the *Opinions on Further Opening Value-added Telecom Business Sector to Foreign Capitals in the Shanghai FTZ* (“**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”), 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* (“**Pilot Measures**”).

Shanghai MIIT steps in but MIIT is still in charge

Investors had hoped that MIIT would delegate to 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. To some extent, this has been achieved. Under the Pilot Measures, foreign-invested enterprises (which comprise EJVs, co-operative joint ventures and wholly foreign-owned enterprises (“**WFOE**”)) within the Shanghai FTZ will submit applications for a VATS Permit to Shanghai MIIT. Approved applications only need to be record-filed with MIIT. 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.

Foreign investors 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 laws and regulations in relation to foreign participation in the VATS sector are the *Telecommunications Regulations* issued by the State Council effective September 25, 2000, 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 the 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 entity.

The Pilot Measures clarify that applications can only be made by *existing companies which have been established in the Shanghai FTZ*. Under the list of materials to be submitted to Shanghai MIIT (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 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. The process therefore 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. 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 Shanghai FTZ can apply for the relevant VATS Permit.

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 60 days is allocated for the approval process. Both of these processes have been combined under the Pilot Measures so that only 60 days is allocated to Shanghai MIIT. 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 3 years) ("**Trial Approval Letter**") is to be issued.

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:

- the operating entity (i.e., the FITE) must be a company that has been established in accordance with the law within the Shanghai FTZ
- it has the funds and specialised personnel commensurate with engaging in operational activities
- it has the credibility and ability to provide services to users over the long term
- 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
- 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
- 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 years
- 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.

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.

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.

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.

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. 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.



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China issues new rules on patents in domestic standards

On December 19, 2013, the Standardization Administration of China (“SAC”) and the State Intellectual Property Office issued the Regulatory Measures on National Standards Involving Patents (Interim) (“Patent Measures”). Before issuing the Patent Measures, SAC issued draft proposals for public comment in 2004, 2009, and 2012, respectively. This comment-and-revision process culminated in the Patent Measures, which came into effect on January 1, 2014.

The issuance of the Patent Measures is a significant development for standards in China, especially for the telecommunications and electronics industries. The Patent Measures provide much-needed guidance on key issues for Chinese standard essential patents (“SEPs”), such as disclosure and licensing requirements.

Disclosure obligation for standard-setting participants

Under Article 5 of the Patent Measures, organizations and individuals participating in the formulation or revision of a national standard must disclose the SEPs that they own and have knowledge of to the entity responsible for the standard. A participating entity or individual will be liable for its bad-faith failure to disclose its SEPs, but the Patent Measures do not specify what constitutes bad faith or any specific sanctions for failure to disclose.

A participating entity’s SEP disclosure obligation under Article 5 is very general, and more clarification is needed. In January 2010, SAC issued the draft Disposal Rules for the Inclusion of Patents in National Standards (“Draft Disposal Rules”) for public comment. The Draft Disposal Rules provide some guidance on including patents in standards, but they have not yet been implemented.

Who must disclose?

Under the Patent Measures, any organization or individual participating in the formulation or revision of a standard is required to disclose its known SEPs. Under the Draft Disposal Rules, the concept of a “participant” in the standard-setting process includes individuals and organizations that initiated the standardization process, are members of a standard-setting organization’s working groups, or made a “technical contribution.” A “technical contribution” here means technical materials or technical advice officially submitted to the standard-setting organization’s working groups by paper or electronic media.

What must be disclosed?

Under Article 5 of the Patent Measures, all known “essential patents” must be disclosed. Article 3 defines

“patents” to include granted patents and pending patent applications. Article 4 defines “essential patents” as those patents required to implement the standard. The Draft Disposal Rules define an “essential patent” as a patent whose claim(s) will be unavoidably infringed by adopting a commercially-acceptable technical solution as a standard. While the Patent Measures provide only that SEPs and their corresponding information and materials must be disclosed, the Draft Disposal Rules specify that the patent holder should list the SEPs one by one, explain the relationship between the SEPs and the standard, and disclose the SEPs held by its affiliates.

When must disclosure occur?

The Patent Measures state that the participants in a standard-setting process must disclose SEPs “at any stage in the formulation or revision of the national standard” and do so “as early as possible.” The Patent Measures provide no further guidance on the timing of disclosure.


Disclosure right for non-participants

Organizations and individuals not participating in the standard-setting process are not required to disclose known SEPs, but they are “encouraged” to do so under Article 6 of the Patent Measures. Article 8 requires SAC to publish any proposed national standard involving patents and the corresponding patent information for 30 days before approving release of the standard. This is to give the public the opportunity to notify SAC of any patent information relevant to the standard. A non-participant that discloses patent information risks being considered a standard-setting participant by the standard-setting organization, and thus subject to the patent-disclosure and other obligations under the Patent Measures.

Patent licensing declarations from participating patent holders

Under Article 9 of the Patent Measures, participants disclosing SEPs during the standard-setting process should issue a licensing declaration chosen from one of the following options:

- the patentee agrees to license its SEPs free of charge and on fair, reasonable and non-discriminatory (“FRAND”) terms
- the patentee agrees to license its SEPs for a FRAND royalty and on other FRAND terms
- the patentee refuses to license its SEPs under either of the above two options.



The Patent Measures do not provide guidance on how to calculate a FRAND royalty rate in specific cases, other than to say the royalty will be determined through negotiations between the patent holder and the standard implementers. But what if the parties fail to reach an agreement through negotiations? Earlier versions of the Patent Measures suggested that patent holders should offer licenses for their SEPs at significantly lower rates than normal royalties. This approach may have come from a 2008 opinion by the Supreme People's Court in the *Chaoyang Xingnuo* case. In addition, a more recent SEP case – *Huawei v. InterDigital* before the Shenzhen and Guangdong courts – has shown that if the parties cannot agree on a FRAND royalty, the court will assign one.

For non-mandatory national standards, if a patent holder does not agree to option 1 or 2 (i.e., refuses to license), the standard shall not include any provision based on the patent at issue. For mandatory national standards, the general rule is that they should not involve patents. Under Article 15 of the Patent Measures, if a mandatory national standard involves a patent and the patent holder refuses to license the patent under option 1 or 2, then SAC, State Intellectual Property Office, and other relevant departments and the patent holder shall jointly negotiate a resolution. Unfortunately, the Patent Measures are silent on what happens if they fail to reach an agreement. It is possible that the SEPs at issue may be compulsorily licensed under these circumstances, but it remains to be seen how this will play out in practice.

Adoption of international standards as national standards

Under Article 18 of the Patent Measures, if China adopts an international standard formulated by the International Organization for Standardization (ISO) and the International Electro-technical Commission (IEC), the patent licensing declarations made for the SEPs involved in the international standard will extend to the national standard. For standards formulated by other international organizations, it is not yet clear what rules relating to SEPs will be adopted.



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Hong Kong Communications Authority clears *HKT/CSL* merger subject to conditions

On May 2, 2014, the Hong Kong Communications Authority (“CA”) announced its antitrust clearance decision for the acquisition of CSL New World Mobility Limited by HKT Limited.

Antitrust clearance was required under the Telecommunications Ordinance, as both parties have subsidiaries – “HKT” and “CSL,” in short – which hold telecommunications carrier licenses.

Authority’s findings

The CA examined the impact of the transaction in a number of “relevant markets,” and found issues in two of them: retail mobile telecommunications, and wholesale access to mobile network for mobile virtual network operators (“MVNOs”).

In retail mobile telecommunications, the CA found the transaction to raise anti-competitive “unilateral effects” – that is, the authority was concerned that the merged HKT/CSL entity would be able to raise prices unilaterally after the transaction. To reach this conclusion, the CA had to navigate around its own guidelines which stipulate that aggregate market shares below 40% would unlikely lead to a finding of “substantially lessening of competition” – the legal test for merger control under the Telecommunications Ordinance. Indeed, in terms of revenues, spectrum and (total) subscriber numbers, the merged entity’s market share was below 40%, though at times just barely.

In its analysis, the CA focused on narrower segments of the retail mobile telecommunications market, where the parties had somewhat higher market shares, and relied on a study by a group of consultants which had resorted to relatively complex assessments based on diversion ratios, win/loss data, cross-price elasticity and pair-wise correlation of market shares.

Beyond market shares and sales data, the CA held the limited spectrum available for mobile communications – in the long term – to be a factor reinforcing the merged entity’s market power post-transaction.

In turn, the CA did not find negative “coordinated effects” to exist in the retail mobile telecommunications market; it found the risks of coordination between the merged entity and other mobile telecommunications operators to be low,

somewhat incongruently pointing to the dynamic nature of competition in the market.

In the market for wholesale access to mobile networks, the CA also identified anti-competitive effects. The authority considered the transaction a 3-to-2 merger, threatening to cut off access to mobile networks for MVNOs, which it considered to be an important competitive constraint.

In contrast, the CA decision did not find negative effects on competition in other relevant markets including backhaul services, interconnection services, and international roaming services.

Remedies

Perhaps with foresight, the acquirer, HKT, had pre-emptively proposed commitments to address potential concerns the CA may have. The authority accepted the majority of the commitments, and did not request further concessions.

The substantive remedies were formulated as directions upon the merged entity:

- to “divest” certain 3G spectrum by not renewing part of its current spectrum after expiry in October 2016
- not to participate in any 3G spectrum auction for five years
- to inform the CA and competitors of closures of base transceiver stations
- to continue granting wholesale network access to MVNOs
- to respect its existing 3G network capacity sharing agreement with a particular competitor, CMHK.

Takeaways

The *HKT/CSL* merger was a hotly contested transaction. The CA received 27 submissions from third parties, and engaged economic consultants performing detailed studies.

Although the aggregate market shares were below the benchmark level in its own guidelines, the authority found anti-competitive effects to exist. It explicitly stated that the guidelines “do not set out a legal safe harbour” in the particular transaction.

The CA's decision may have an impact beyond the specific case and the application of the Telecommunications Ordinance. As the CA is gearing up to issue guidelines on the enforcement of the Competition Ordinance – jointly with the Hong Kong Competition Commission (“HKCC”) – the *HKT/CSL* decision comes as a timely reminder for market players that guidelines are not “hard law.”

Given that the CA shares the power to enforce the Competition Ordinance with the HKCC in the telecommunications and broadcasting sectors, it may be reasonable to expect similar cases in these sectors – whether mergers or “conduct cases” – with economics-heavy analyses in the future.



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Outsourcing, technology procurement and cloud in Asia – the legal and regulatory essentials

New operating models – new challenges

As businesses in Asia grow in scale and complexity, they are increasingly turning to outsourcing and large scale technology procurement, including the deployment of cloud technologies, to support their operations and gain competitive advantage.

These initiatives reflect both a maturing of operational strategies for businesses in the region and increasing cost sensitivity.

At the same time, electronic data is becoming an increasingly valuable business asset in Asia, as it is elsewhere. “Big Data” does not just mean larger quantities of data – it means higher quality, more useful data derived from increasingly sophisticated analytical tools. With the right investment in technology, it means competitive advantage.

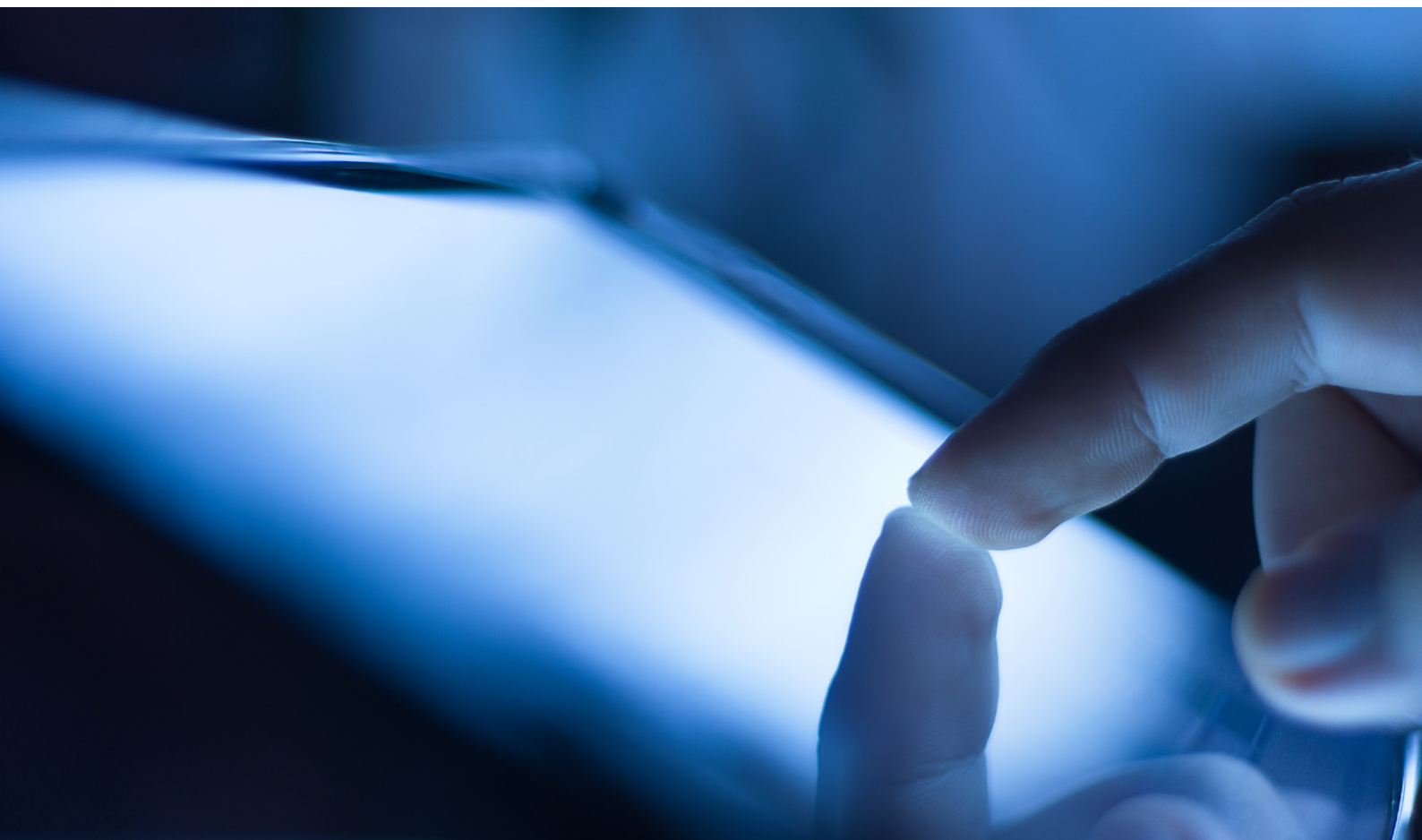
A third pressure point is the marked increase in regulation in Asia, including increasingly detailed material outsourcing and procurement regulations in regulated sectors, and the rapid expansion in recent years of comprehensive “European style” data privacy regulation. While much

remains possible from a regulatory standpoint, stepped-up regulation is forcing Asia’s regional businesses to evaluate their procurement options more carefully, engage in more rigorous tendering and due diligence processes, manage an increased likelihood of regulatory change and enter into more detailed contractual arrangements in order to achieve compliance.

The challenges for legal counsel – increased regulation, increased risk

Legal counsel are faced with a number of challenges in this changing environment, in particular a need to negotiate and manage more detailed and complex contracting structures. This imperative is driven by growth in the scale of business risk, the sophistication of commercial objectives and a need to deal with regulators’ increasingly exacting expectations.

The consequences of not getting the legal and compliance roles right are increasing in Asia. With greater business automation and increased dependency on IT systems, service failure can be highly visible, both externally to customers and regulators and internally to employees



who depend on quality service delivery to get their jobs done. Getting the contractual and regulatory requirements right is taking on a growing importance as a result.

How to prepare?

Legal counsel faced with a large scale outsourcing or technology procurement will want to begin with the basics, firstly by gaining an appropriately detailed understanding of the business requirements. Of equal importance is understanding who the relevant internal stakeholders are for the project and who is (or should be) in the project team.

Operations, IT and procurement will typically be key stakeholders in sourcing and technology projects, but apart from legal and compliance, HR, finance and tax will often play key roles in assessing risk, inputting to the project business case and formulating a structure for the commercial arrangements that optimise the economic benefits of the project. Early engagement with these stakeholders can be critical.

Once the right team is in place, reporting lines and internal approval requirements can be established. Finally, a project management structure that co-ordinates the various workstreams is essential to project success.

Regulation, regulation, regulation

The impact of regulation on outsourced service models (including but not limited to cloud) in Asia is significant and growing. While industries such as banking and financial services are typically the most heavily regulated, data privacy regulation, employment laws and, most recently, the emergence of cyber security regulation in Asia, have extended regulatory oversight across most if not all fields of business.

The threshold Questions – can you outsource?

Can you use cloud?

In the most heavily regulated industries, such as banking and insurance, regulation will typically stipulate that “licensed business” or “core business” cannot be placed into the hands of an unlicensed outsourced service provider. While these restrictions are most immediately relevant in the business process outsourcing context, heavily regulated industries in particular may also have prohibitions against handing over core systems, business data or customer data for third party processing, which may impact in the cloud and IT outsourcing context.

There are plenty of “grey” areas on this front, and part of the value in legal input can be in fine tuning a service description to address the issues that are front of mind for regulators, such as being clear that business discretion and engagement with customers in the promotion of products and services remain in the hands of licensed businesses and explaining how business data and customer data are secure and remain quickly available to the regulator.

Material outsourcing regulations

Once the threshold question of whether or not the service scope and service model is feasible has been answered in the affirmative, there may be regulations or guidelines that stipulate how the business must evaluate and implement a proposed outsourcing or procurement. The material outsourcing guidelines found in the banking and financial services industries across the region are leading examples. There is a threshold question here as well – is the project a “material outsourcing” or is it not? We are at a stage in which the heightened importance of material outsourcing guidelines to regulators threatens to expand the understanding of a “material outsourcing” into areas that would have in the past been considered ancillary business operations. Informed engagement with regulators on these issues can be key.

If material outsourcing guidelines do apply, the focus is typically on risk management, directing the business to carry out an effective evaluation of the service model, the candidate vendors and the agreed contractual terms. Depending on the jurisdiction and the regulator, regulatory approvals or notifications may be required. Completing the regulatory process in good time means effective preparation and an ability to anticipate the questions that are likely to come. A framework for compiling the necessary information and linking contractual requirements to the working draft agreements is key to clearing the regulatory process as quickly as possible.

Data privacy regulations

Recent years have seen an explosion of comprehensive “European style” data privacy regulation across the Asia region, with new laws brought into force in China, India, Singapore, South Korea, Taiwan, Malaysia and the Philippines. Existing advanced regimes, such as those in Hong Kong, Australia and Japan have seen a stepping up of compliance requirements, penalties and willingness on the part of regulators to “name and shame.”

Most critically in the outsourcing and technology procurement context, many of these new laws have data export controls which can raise obstacles or impediments to plans to consolidate databases, or at least require that steps be taken to make data exports compliant.

At the very least, data privacy regulation will necessitate an assessment of compliance risks and the agreement of appropriate contractual protections with vendors. The dynamic regulatory landscape in this area also means that customer organisations are well-advised to agree terms dealing with the possibility that regulations change, for better or for worse.

HR considerations

Outsourcings often involve the transfer of employees and the management of redundancies. The business will want to identify at an early stage any implications for its human resources in order to carefully manage confidentiality and internal communications about the project, to enable due diligence by the vendor and to address the legal and regulatory requirements. The reputational aspects of human resources management should not be ignored.

There are very few “automatic transfer” regimes in Asia that will apply to transfer employment contracts to an outsourced service vendor by operation of law in the same way as Europe’s Acquired Rights Directive. As a result, an “offer and acceptance” procedure will typically be needed.

Asset and contract transfers

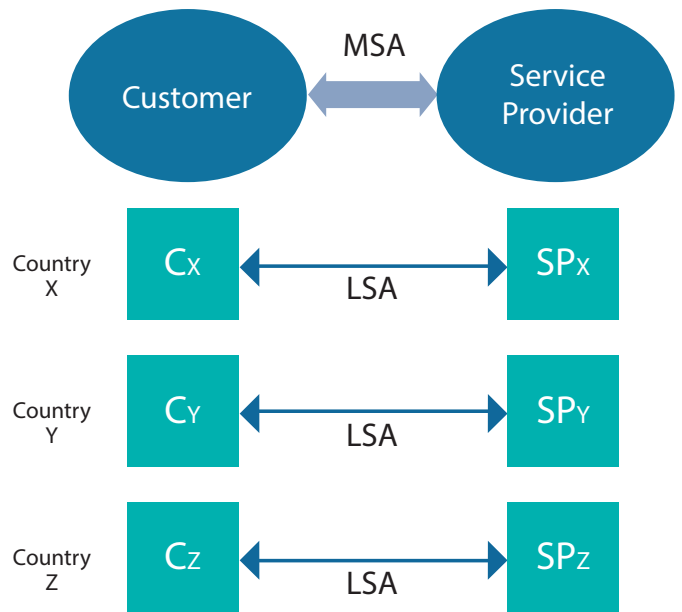
It is not unusual for assets and contracts to transfer to a vendor as part of an outsourced service arrangement. The vendor will need to be in a position to conduct due diligence on these assets and contracts, and the parties will need to agree on commercial arrangements, including responsibility for any third party consents and related costs of transfer.

Likewise, if premises or facilities are to be made available to a service provider, terms will need to be agreed and documented. Depending on the circumstances, landlord consents and land use permissions may be needed.

Structural considerations

Contract structure is critical. Many outsourcing arrangements in the region rely upon a master services agreement – local services agreement structure that involves contracting at a master level (typically

backed up with a parent company guarantee) and also implementing local agreements to establish local “point-to-point” contracting, mainly for regulatory reasons and to generate tax efficiencies.

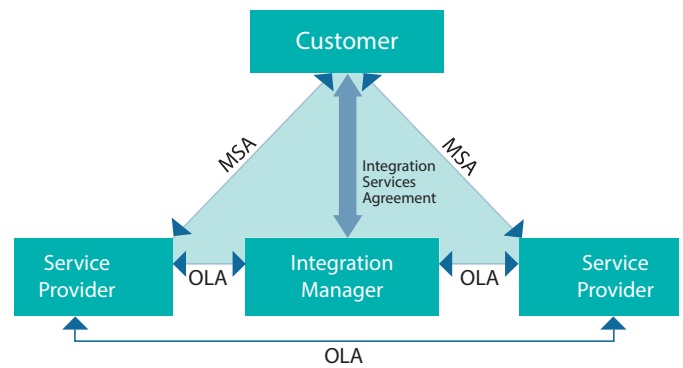


The other feature of contracting structure that needs to be understood is the extent to which the service function is dependent on performance by other vendors. If the outsourcing is a “multi-vendor” solution, then care will need to be taken to ensure that appropriate touch-points are established, perhaps with these formalised through “operating level agreements” entered into between vendors ensuring that they perform dependencies for each other. Going further, the customer organisation may need to engage an integration manager to co-ordinate service delivery across vendors. As the integration manager will not be operating as a prime contractor with “end to end” responsibility for the other vendors’ delivery, there is often difficult negotiation around how the integration manager’s performance will be measured and to what extent it bears responsibility for other vendors.

Above all else, multi-vendor service delivery is dependent on there being a well thought out vendor governance structure.

The right contract

Once an outsourcing or large scale technology procurement project kicks off, there is enormous pressure to reach terms with a vendor quickly. Getting



the right contract starts with the right tendering process. Parallel discussions with a number of vendors will create useful competitive tension that will drive better terms, but there is a need to balance these advantages against the fact that parallel negotiations are time consuming and may strain client organisation resources.

Requiring bidders to mark-up a select set of key legal terms as part of their RFP responses is often a useful middle-ground, providing certainty of negotiated positions on critical issues but without requiring extensive parallel negotiations.

Long form agreements should take advantage of unique market conditions in Asia, which can produce more buyer-friendly outcomes. Similarly, market practice in the region tends to produce shorter "long forms" than are seen in the US context, in particular.

The right price

At this stage in market development in Asia, many outsourcings are "greenfield" projects or otherwise involve instances in which there is inadequate historical data within the customer organisation to support sophisticated transaction-based pricing for outsourced services (the exception being certain cloud-based services or other "commoditised" services that often have a readily determined transaction price).

As a consequence, many services are priced on the basis of either fixed pricing or resource unit-based pricing (whether fixed or variable), often using a full-time equivalent employee basis for the resource units. These pricing models can reward inefficiency, and so are often supplemented with productivity improvement guarantees and commitments by the vendor to move to transaction based pricing within a fixed period of time.

Third party benchmarking reviews and “most favoured customer” commitments are market practice in Asia for outsourced services, accepting that the relative immaturity of the market may mean that reliable comparator data is limited. In relation to benchmarking, the key for the customer is to have a process which, once activated, runs as quickly and as “automatically” as possible. Breaking the service out into “commodity” elements will help make the benchmarked service more easily referable to comparison data.

The right service quality

The dynamics around service quality in outsourced services in Asia tend to track the same concerns as seen with pricing. If the customer organisation has not maintained reliable historic service quality metrics or if the project is “greenfield”, vendors will be reluctant to commit to binding service level standards from the outset and may request a “baselining period” to validate the specific service scope and the infrastructure available to deliver this scope.

Two immediate problems arising from this approach are:

- How will service quality be addressed during the interim before the baseline service levels are agreed?
- If service quality is left as an “agreement to agree”, what leverage will the customer organisation have in future to agree satisfactory service levels and service credits for breach?

The answers to these questions will depend on the specific circumstances. It is clear that there must be some binding service quality standard in place and there must be clarity in the process towards achieving a “steady state” level of service.

Compliance, now and in the future

As noted in the sections above, outsourced service models, including cloud services, raise significant regulatory issues. These issues will not stop with contract signing. The service arrangements must contemplate the likelihood that applicable regulations will change over time.

The extent to which a vendor is held legally responsible for the customer organisation’s own regulatory compliance is typically a matter of fairly intense negotiation. In Asian markets there is, as yet, no concept of regulated third party administrators under which vendors are licensed to carry out regulated service functions. Further, given the relative immaturity of the vendor market in Asia, there is a reluctance amongst

customer organisations in regulated industries to leave the interpretation of the customer’s regulation to the vendor. At the same time, customer organisations will nevertheless expect to benefit from vendors’ growing experience in this area, and the practical reality that there is economy of scale in implementing changes across their platform for multiple customer organisations.

Managing risk

Outsourcings and technology procurement entail significant risk for customer organisations. While vendor liability will never be a complete answer to risk assessment, the starting point is making the vendor sufficiently accountable to drive the right risk management behaviours and provide the customer organisation with adequate financial recourse.

The approach taken to representations and warranties, service levels and service credits, indemnification and other points of risk allocation should be tailored to the customer organisation’s specific business, compliance and risk management requirements.

Limitation of liability is typically an area of intense negotiation. Market practice is in general to permit the vendor to limit its liability to direct losses, subject to key exceptions for indemnified losses and breaches of terms in areas such as intellectual property rights, compliance with policies and applicable laws, breach of confidence, gross negligence and intentional breach.

We recommend that the discussions around liability also take into account areas of the contract that entail higher risk for the customer organisation, such as the transition phase, during which operational risk is typically higher.

Non-financial remedies are also important. Termination is obviously the ultimate recourse, but there is often good reason to construct intermediate remedies that focus on recovering a faltering service arrangement rather than terminating it outright. Step-in rights, under which the customer organisation imposes itself on the vendor to either provide or manage the provision of the services is increasingly common in the Asia market. Other remedies can include a third party intervention, such as having an independent consultant review the service delivery arrangements and make recommendations that the vendor must accept and implement as an alternative to termination. Partial termination may also be useful as a remedy, effectively giving the customer organisation the ability to weed out the underperforming areas of

service, but there are risks here too. A halfway solution may leave the customer organisation with yet more trouble, having to integrate in a new vendor and deal with potential diseconomies of scale arising from pricing services out separately.

Creative solutions

The Global Financial Crisis has added urgency to the need for businesses to think creatively about how they do business, looking to better utilise assets and resources to generate value and competitive advantage, improve efficiency and cut operating costs.

Outsourcing and technology procurement is often associated with these efforts, including:

- **Joint venture models:** A more complex arrangement in which the customer organisation contributes technology, operating procedures, knowledge capital or other IP to a joint venture with the service provider, so as to receive a wider economic benefit in addition to an outsourced service. The critical downside is that the customer organisation will likely be opening its IP up to its competitors and will likely lose control of future development.
- **Incentives to innovate:** Innovation may be encouraged by agreeing concrete incentives for vendors as part of the outsourcing arrangements. "Gain sharing", for example, is where the vendor takes a share of any cost reduction derived from service improvements developed by the service provider, ensuring that efficiency gains enhance the vendor's margins rather than simply reducing its charges.
- **Transformational outsourcing:** Asian businesses are increasingly leveraging outsourcing with a view to bringing about new ways of doing business rather than simply lifting out a static business function and transferring it to a service provider with a view to achieving a reduction in operating costs. Transformational outsourcing may achieve institutional change more quickly and effectively than trying to manage change internally. Service providers may bring more sophisticated technology and more advanced operating procedures from other contexts. Outsourcing may also force a decentralisation of decision-making that may be helpful.

Takeaways

Outsourcing and large-scale technology procurement (including cloud service models) offer tremendous benefits to Asia region businesses. For legal counsel, these opportunities come with significant challenge and a need for careful planning and evaluation.

Key points to bear in mind:

- **The regulatory constraints on outsourcing are significant and growing:** the implications of industry regulation and data privacy, employment and tax laws must, in particular, be properly assessed and managed.
- **Contracting to maximise value and manage risk often gives rise to complexity:** There is a distinct need in Asia to contract for change: change in the customer organisation business, group structure and geographic footprint, changes in applicable regulation and change in the market conditions for service.
- **Creativity can generate its own rewards:** The increasing scale of outsourcing and procurement arrangements in Asia generates opportunities to improve how business is done, explore new business and better capitalise on a business's knowledge capital and data.



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Privacy complaints up 48% in Hong Kong in 2013

In 2013, Hong Kong's Privacy Commissioner for Personal Data received 1,792 complaints, a record high. The figures show a 48% increase in complaints filed and more than a doubling of the number of enforcement notices issued by the Commissioner, with 25 enforcement notices issued in 2013 against 11 in 2012. 78% of all complaints were made against the private sector and, in particular, the financial, telecommunications and property sectors. The Commissioner has confirmed that a key focus for 2014 is to increase its enforcement efforts.

The step change in enforcement activity should most obviously be a cause for concern for businesses that rely on personal data for marketing their products and services. 30% of last year's complaints related to direct marketing (a significant increase). But a close examination of the figures shows that business concerns should be much broader than this. For example, there was a substantial increase in the number of data security breaches reported to the Commissioner (61 in 2013 against 50 in 2012), showing that the growth in investigations and enforcement activity does not just relate to electronic marketing. As businesses become increasingly dependent on their data holdings as a means of finding competitive advantage, and "Big Data" becomes an increasingly valuable business asset, data privacy compliance becomes a business-wide issue that requires board level attention.

The Commissioner's latest policy initiative underscores this point. In February 2014, the Commissioner published guidance calling for businesses to adopt comprehensive Privacy Management Programmes directed at achieving compliance in all aspects of their business. This "best practice" standard of compliance needs to be looked at carefully, as it will likely be looked at in adjudicating future rounds of enforcement action. Every organisation that handles personal data needs to ensure compliance.

If the Commissioner's office receives a complaint, the Commissioner has the power to order an investigation and, where there has been a breach, issue an enforcement notice. There are now substantial penalties under the Personal Data (Privacy) Ordinance for the most serious breaches with fines up to HK\$1,000,000 and 5 years' imprisonment. Quite apart from the criminal sanctions, there are reputational risks for an organisation that is subject to an investigation with the Commissioner increasingly prepared to "name and shame" organisations and publicise the results of his investigations.



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A close-up, slightly blurred photograph of a computer screen. The text 'http://www' is visible in a large, black, sans-serif font. The background is a light blue color with a subtle grid pattern.

SAIC revises rules regarding recognition and protection of well-known trademarks

In a rapidly converging technology, media and telecoms sector, intellectual property protection is considered a high priority concern. In particular, many market players have trademarks that are well known, both domestically and internationally. On August 3, 2014, the revised *Provisions on the Recognition and Protection of Well-Known Trademarks* ("**Trademark Provisions**") became effective. This revision is aimed at providing detailed guidelines to the Chinese Trademark Office ("**CTMO**"), the Trademark Review and Adjudication Board ("**TRAB**") and the Administration for Industry and Commerce ("**AIC**") in assessing and recognizing well-known trademarks.

Principles of recognition

The Trademark Provisions explicitly provide for two principles of recognition:

- **passive protection principle:** this means that the authorities can only 'passively' recognize a well-known trademark, not on their own initiative. Trademark owners will thus always have to explicitly ask the authorities for recognition of their mark as a well-known trademark.
- **case-by-case analysis principle:** this means that a full assessment of whether a mark is well-known will always need to be conducted, independently of any earlier recognition. Therefore, each time trademark owners want to invoke the well-known status of a trademark, they will need to submit all relevant evidence supporting such status.

The principles are not new, but codify existing practice.

Required evidence

The Trademark Provisions detail materials that can be submitted as evidence in support of the well-known mark recognition.

- Materials proving the duration of the *continuous use* of the trademark:
 - In case the mark is *registered* in China, the owner can choose to either prove that the mark is registered for at least 3 years, or that the mark has been continuously used in China for at least 5 years.
 - In case the mark is *not registered* in China, the owner must prove that the mark has been continuously used in China for at least 5 years.
- Materials regarding the *sales revenue, market share, net profit, tax payments and geographical scope*

of the sales of the products bearing the trademark during the past 3 years.

- Materials proving the duration, extent and geographical scope of all *advertisement campaigns* carried out for the trademark.
- Materials proving *previous protection of the trademark as a well-known trademark* in China or in other countries and regions.

The Trademark Provisions define the thresholds of "3 years" and "5 years" for the first time. These thresholds refer to the time prior to (1) the filing date of the opposed mark; (2) the filing date of the registration to be invalidated; and/or (3) the filing date of recognition as a well-known trademark in the AIC enforcement cases.

Principle of good faith reiterated

Consistent with the new Trademark Law, the Trademark Provisions stipulate that applicants must act honestly and in good faith when requesting protection for a well-known trademark. Consequently, the mark owners are liable for the evidence submitted. This means that, in case of fraud of false evidence, the applicant may face a revocation of the recognition as a well-known trade mark by the CTMO.

AIC recognition procedure specified

Another novelty of the Trademark Provisions is that they clearly specify the procedure and time frame for AICs on different levels to handle and report the requests for recognition. Local AICs should report requests which pass the preliminary examination stage to their higher level AIC within 30 days. Once the request is escalated to the provincial-level AIC, it will be submitted to the CTMO, which will carry out the final assessment on whether the mark can be recognized as a well-known trademark.

Conclusion

Under the Trademark Provisions, the CTMO, AIC and TRAB will continue to have wide discretion in recognizing the well-known status of trademarks. However, the Trademark Provisions are welcomed as a noted improvement, codifying previous unwritten practice.



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SAFE issues revamped rules on round-tripping investments by Chinese residents

The State Administration of Foreign Exchange (“SAFE”) issued the *Relevant Foreign Exchange Administration Issues on People’s Republic of China Residents Investing, Raising Finance Overseas and Engaging in Round-tripping Investment through Special Purpose Vehicles* on July 4, 2014 (“Circular 37”). Circular 37 took effect on the same date. It replaces the *Relevant Issues on People’s Republic of China Residents Engaging in Financing and Round-tripping Investments through Overseas Special Purpose Vehicles* (“Circular 75”) which were issued by SAFE almost ten years ago in October 2005.

In order to assess the impact of Circular 37, it is helpful to understand the background which led to the issue of Circular 75 back in 2005. Private Chinese entrepreneurial activity was increasingly robust after the turn of the century, particularly in the Internet and new technology sectors which led to the listing of the tech champions in Mainland China (“China” or “PRC”). Because the funding and investment vehicles were usually based offshore, particularly in the Cayman Islands, the British Virgin Islands and Hong Kong, Circular 75 was issued to allow PRC authorities the ability to monitor and regulate the activities of these offshore funding and investment vehicles.

For almost a decade, Circular 75 has been the centrepiece of regulatory concerns for PRC resident entrepreneurs and investors in any transaction involving the setting up of offshore entities for fund raising purposes. These structures, which commonly take the form of “variable interest entity” (“VIE”) structures, are prevalent in venture capital type transactions particularly in the Internet, telecommunications, media and technology sectors. In these structures, control is effected through a series of contractual arrangements to avoid restrictions on foreign investment, in particular in the above-mentioned sectors, which have been and are still generally off-limits to foreign investors. A registration as required under Circular 75 and now under Circular 37, is generally seen as a must-have in almost all venture capital deals which target a future listing.

Special purpose vehicle and use of offshore assets

Under Circular 37, a “special purpose vehicle” (“SPV”) refers to an offshore enterprise directly established or indirectly controlled by PRC residents (including PRC institutions and PRC individual residents) using the assets or rights and interests which they lawfully own in an enterprise in China (an enterprise in China is defined as a “PRC Enterprise”), or the assets or *rights*

and interests which they lawfully own offshore, for the purpose of engaging in investment or financing activities. This definition is consistent with Circular 75, but there is an added provision allowing offshore assets to be used in establishing or controlling the SPV. The added scope is likely due to the loosening up of the controls on PRC residents keeping their assets offshore, which can therefore be injected into the SPV.

Furthermore, Circular 37 expands the types of activities which the SPV can conduct. Under Circular 75, the SPV was limited to “offshore equity financing” type activities but, under Circular 37, it can now engage in investment as well as financing activities. The allowance for the SPV to conduct investment activities is consistent with the PRC government’s drive to open up outbound investment channels to PRC residents. There has always been uncertainty as to PRC nationals owning shares or securities in an offshore entity, and the expanded scope of activities for a SPV suggests that this is now possible under Circular 37, although this is limited to the circumstances as provided under Circular 37.

Round-tripping investment

The definition of “round-tripping investment” under Circular 37 is broader than under Circular 75, as it refers to the direct investment activities conducted by PRC residents through a SPV, either directly or indirectly, including establishing a foreign invested enterprise (“FIE”) or projects in China by way of new establishment, merger and acquisition and so forth, and obtaining rights and interests therein such as ownership, control, operating and management rights and so forth.

SAFE registration

According to Section 3 of Circular 37, where a PRC resident makes a capital contribution using its *onshore assets and interests*, it must file the application to register with the local SAFE branch having jurisdiction over its place of registration or over the area where his/her/its assets or interests in the PRC Enterprise are located. This is a different concept compared to Circular 75 which required the application be made to the place where the PRC resident is located (which in practice, is where his/her household registration is filed).

Circular 75 required the application to be made prior to the PRC resident establishing or gaining “control” of the SPV. In contrast, Circular 37 requires that the registration with the relevant SAFE branch be completed prior to

the PRC resident using its/his/her onshore or offshore assets to make the capital contribution to the SPV. The difference between gaining control and making a capital contribution may not be material, given that contributing capital into the SPV is encompassed in the definition of Control under Circular 7. However, the question remains as to whether this affects the timing for the establishment of the SPV.

Documentation-wise, both Circular 37 and Circular 75 require the proper forms, approvals, identification and incorporation documents to be provided.

One document explicitly required under Circular 37 is the SPV registration documents and materials evidencing the shareholding of the PRC resident or its/his/her status as the actual "controlling" party (i.e., register of shareholders). This is a key difference from Circular 75, as it suggests that the PRC resident could become a controlling party *prior to application to SAFE*, whereas Circular 75 requires the application to be made *prior to controlling the SPV*. Notwithstanding both interpretations,

in our experience, some local SAFE branches have taken the extreme view of interpreting Circular 75 as requiring registration to be completed prior to the establishment of the SPV in which the PRC residents will hold direct shareholdings. It remains to be seen how SAFE will interpret Circular 37, but the requirement to apply prior to making a "capital contribution" could certainly be interpreted as encompassing shareholding ownership, which would be consistent with existing practice.

Registration of employee incentive plans

Under Circular 75, there was no express recognition that employee incentive plans were registerable, which left a gap as to how employee incentive plans of the SPVs (which in most cases, will be the listing vehicle) were to be dealt with. In our experience, some SAFE authorities did recognise the importance of employees being granted shares in the SPV and allowed the shares reserved for employee incentive plans to be reflected in the registration made pursuant to Circular 75. Others refused to reflect any shares reserved for employee incentive plans altogether.



A welcome change under Circular 37 is that Section 6 allows non-listed SPVs to register employee incentive plans of the PRC Enterprise which it directly or indirectly controls. Section 6 lists the documents required to be submitted which include application forms, evidence of the SPV's foreign exchange registration certificate, and evidence of the employment or labour service relationship between the employees and the PRC Enterprise.

Offshore lending

Section 10 of Circular 37 further states that a PRC Enterprise which is directly or indirectly controlled by a PRC resident may, on the basis of a genuine and reasonable need, lend money to an already registered SPV in accordance with the relevant provisions. PRC Enterprises are only permitted to operate within their approved business scope; in order to conduct lending activities, their business scope will need to expressly include lending particularly in this instance where the loan is made to the offshore SPV. This has led to entrustment loans through banks (commonly known as 'back to back' loans) so it remains to be seen how this provision will be implemented.

Hints of a regulator's crackdown?

The possibility of inter-departmental conflict is hinted at again in Section 4 of Circular 37, where it states that obtaining SAFE regulation does not mean the underlying investment is compliant from the perspective of the department in charge of the industry, a possible oblique reference to leaving room for a MIIT crack down on the VIE structure as such. To date, many of the largest TMT listings and offerings on major foreign stock exchanges involve the VIE structure in some form or another.

In short, SAFE registration is not to be set up as a defence against or a free pass vis-à-vis other regulators. Under Circular 75, our experience has been that whilst SAFE is aware of the common use of the VIE structure in venture capital and private equity investments of a "round-tripping" nature, it has taken the diplomatic approach by not referring to the VIE structure in both Circular 75 and Circular 37.

Remedial filings

Circular 75 imposed a deadline (end of March 2006) for registrations to be completed retrospectively where SPVs and round-tripping investments had been made prior to the promulgation of Circular 75.

Section 12 of Circular 37 states that prior to the implementation of Circular 37, if a PRC resident had already contributed assets within China or overseas to a SPV but had not carried out the proper foreign exchange registration, the PRC resident must issue a letter of explanation explaining the reasons for failing to register and SAFE will carry out remedial registration as well as impose fines accordingly. This may be a positive development as it expressly allows PRC residents to complete remedial filings without a specified deadline.

Conclusion

Overall, there is little in the way of substantive change or simplification of the time-consuming and involved registration processes compared to the prior regime under Circular 75. Under the new Circular 37 regime, SAFE is still imposing a strict registration requirement for round-tripping investments by PRC residents through SPVs and, more importantly, the procedures and documentation are largely the same. As mentioned above, round-tripping investments and VIE structures are commonly seen in TMT investments particularly at the early stage levels in attracting funding from foreign investors, given the restrictions on foreign investment in this area. A key barometer will be to see how the local SAFE branch authorities interpret Circular 37 on the ground, and companies and practitioners will need to keep their eyes on this space closely to see if this affects market practice.



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Beijing releases catalogue banning or restricting 'new addition' projects affecting high-tech field

On July 21, 2014, the Beijing municipal government published the *Beijing Municipality Catalogue of Prohibited and Restricted New Addition Industries (2014 Edition)* ("Beijing Catalogue").

The Beijing Catalogue marks a significant shift towards a more restrictive investment environment, being the first example of an 'investment' catalogue issued in China that does not encourage or specify areas open to investment but whose sole purpose appears to be to specify areas off-limits and restricted for further investment.

It would be easy to dismiss the Beijing Catalogue as being driven by air pollution concerns, but in reality it goes a lot further than just cracking down on polluting industries, with the sectors covered ranging from manufacturing to real estate development through educational institutions and TMT. The theme seems to be more about trimming over-capacity and over-concentration of certain types of facilities and resources. The obvious question it raises and does not answer is whether this is just a local initiative or more like 'the thin edge of the wedge,' and we will see this pattern replicated in other major cities such as Shanghai or elsewhere in China.

Implications of the Beijing Catalogue

Under the Beijing Catalogue, being classified as a "prohibited industry for new additions" means no more fixed asset investments or new entrants will be allowed in that industry; being classified as a "restricted industry for new additions" means restrictions will be placed on new investments in that industry in terms of location, scale, operating processes, or types of products.

The Beijing Catalogue does not apply to on-going projects nor to the reconstruction or upgrading of existing projects, with a few exceptions.

The Beijing Catalogue provides a general exception that if there are special policies provided in laws, administrative regulations or State Council documents or approved by the Beijing Municipal government to apply in "certain areas," such policies shall be followed. "Certain areas" refer to the so-called High-End Industrial Functional Zones, such as Zhongguancun National Innovation Model Zone, Beijing Economic-Technological Development Area, the Central Business District, Finance Street, Olympic Core Area and other such zones and areas. So it would be fair to say that specially designated zones may provide for exceptions and carve-outs, but a silence in the law

in these designated zones would mean the Beijing Catalogue would apply by default.

The Beijing Catalogue on its face is even-handed: it applies across the board to foreign and domestic investors alike, but it also includes a specific reference to foreign investment which remains subject to the *Guidance Catalogue for Foreign Investment Industries* ("Foreign Investment Catalogue"). This reference simply means that in addition to the Beijing Catalogue, foreign investors will also need to follow the Foreign Investment Catalogue. This means that foreign investors seeking to invest in Beijing will be subject to two preliminary layers of feasibility analysis, starting with the Beijing Catalogue and, if this does not impose a ban or restrictions on the sector in question, the Foreign Investment Catalogue.

Structure of the Beijing Catalogue

The Beijing Catalogue is divided into five sub-catalogues, with one generally applicable to the entire area of Beijing, and each of the other four applicable respectively to the Core Areas for Capital Urban Functions, the Extended Areas for Urban Function, the New Areas for Urban Development, and the Developing Areas for Ecological Preservation.

Under the Beijing Municipality Major Areas Functional Plan published in July 2012, the city is divided into four major areas generally based on the distance of an area from the center of Beijing, as well as functional plans for different districts which include: the Core Areas for Capital Urban Functions (Dongcheng District and Xicheng District); the Expanded Areas (Chaoyang District, Haidian District, Fengtai District and Shijingshan District); the New Areas for Urban Development (Tongzhou District, Shunyi District, Daxing District (where Beijing's high tech zone is located) and the other areas of Changping District and Fangshan District) and the Developing Areas for Ecological Preservation (Mentougou District, Pinggu District, Huairou District, Miyun County, Yanqing County, as well as the mountain areas of Changping District and Fangshan District).

Main prohibitions and restrictions

Notable prohibitions/restrictions in the Beijing Catalogues include (1) in general, no new retail or warehousing facilities with a gross (construction) area of over 10,000 square meters, high end residential buildings, golf courses, hotels, office buildings, exhibition centers, hospitals, universities, call centers, and data centers will be approved in



downtown Beijing; and (2) generally no new manufacturing facility will be permitted to be established in the Core Areas for Capital Urban Functions and the Developing Areas for Ecological Preservation. Even in the Extended Areas for Urban Function and the New Areas for Urban Development, there is a long list of products which are no longer permitted to be manufactured.

In contrast, that there are no prohibitions imposed on R&D, design, purchase, marketing, technical services, or financial services in relation to manufacturing industries.

Impact on the TMT sector

The prohibition on construction of new call centers and data centers is significant to market players in the TMT sector. According to the Beijing Catalogue, investments in establishing new call centers are completely prohibited in Beijing. Data centers are also generally banned except for cloud computing data centers with power usage effectiveness (“PUE”) value of under 1.5. PUE value is a measure of how efficient energy use, and a lower PUE value means more efficient power usage.

There has been market speculation since mid-April 2014 that investments in new data centers in Beijing would not be approved due to overcapacity and excessive energy consumption of the industry. However, no official documents have been published to confirm this until the publication of the Beijing Catalogue. The ban on new call centers and data centers appears to be the only two areas in the high-tech industry which have been affected by the catalogue. The carve-out for energy efficient cloud computing data centers illustrates how the central government is trying to balance promoting advancements in technology and energy consumption.

Conclusion

The Beijing Catalogue raises more issues than it answers. While concern over over-capacity in some industries is understandable, the Beijing Catalogue seems to be going in the opposite direction from years of reform that have given greater play to the role of the market in deciding investments. Arguably, it marks a return to central (urban) planning by imposing politically-driven prohibitions and restrictions on key industry sectors in the economy, such as real estate development.

Taking the example of the Shanghai FTZ, the extent of the social and geographical engineering and steering becomes apparent: the Shanghai FTZ has just opened up call centres to foreign investment in the form of

wholly foreign-owned enterprises (although it also bans investment in the sensitive sector of data centres in the Shanghai FTZ), while the Beijing Catalogue simply bans call centres across the entire area of Beijing.

For foreign investors, some prohibitions in the Beijing Catalogue will look familiar. It remains to be seen whether the prohibition in the Beijing Catalogue is just a gesture by the Beijing municipal government in support of the central government's decision or a real policy shift.

On a more positive note, according to comments made by Beijing municipal officials in many news reports but not mentioned in the Beijing Catalogue itself, the Beijing municipal government is encouraging investment in other sectors, including high-tech.

At the end of the day, there is clearly a serious pollution issue to address in Beijing and this is a positive first but significant step towards reducing air pollution and other forms of pollution in the capital (it notably does not address pollution by private cars). The big question that the Beijing Catalogue poses and does not answer is whether it is possible to impose other restrictions that run contrary to market demand and expectations, and whether the policy could backfire by giving rise to attempts to circumvent it; for example, by buying up and expanding existing capacity at inflated prices, rather than spreading investment around more evenly as intended by the drafters and backers of the Beijing Catalogue, leading to the inevitable result of consumers paying ever higher prices for the same goods and services.



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Internet of things – manufacturing companies industry and use of ‘white spectrum’: ghost in the machine?

China has prioritized the development of the Internet of Things (“IOT”) industry over the past few years, as it seeks to develop home-grown innovation in the high-tech space moving away from its reputation as the world’s low-cost manufacturing hub. In China, the IOT space falls chiefly within the regulatory ambit of the Ministry of Industry and Information Technology (“MIIT”). MIIT is the main regulator of the telecommunications and Internet industries in China. However, other central ministries are involved in generating the underlying policies and rules as well.

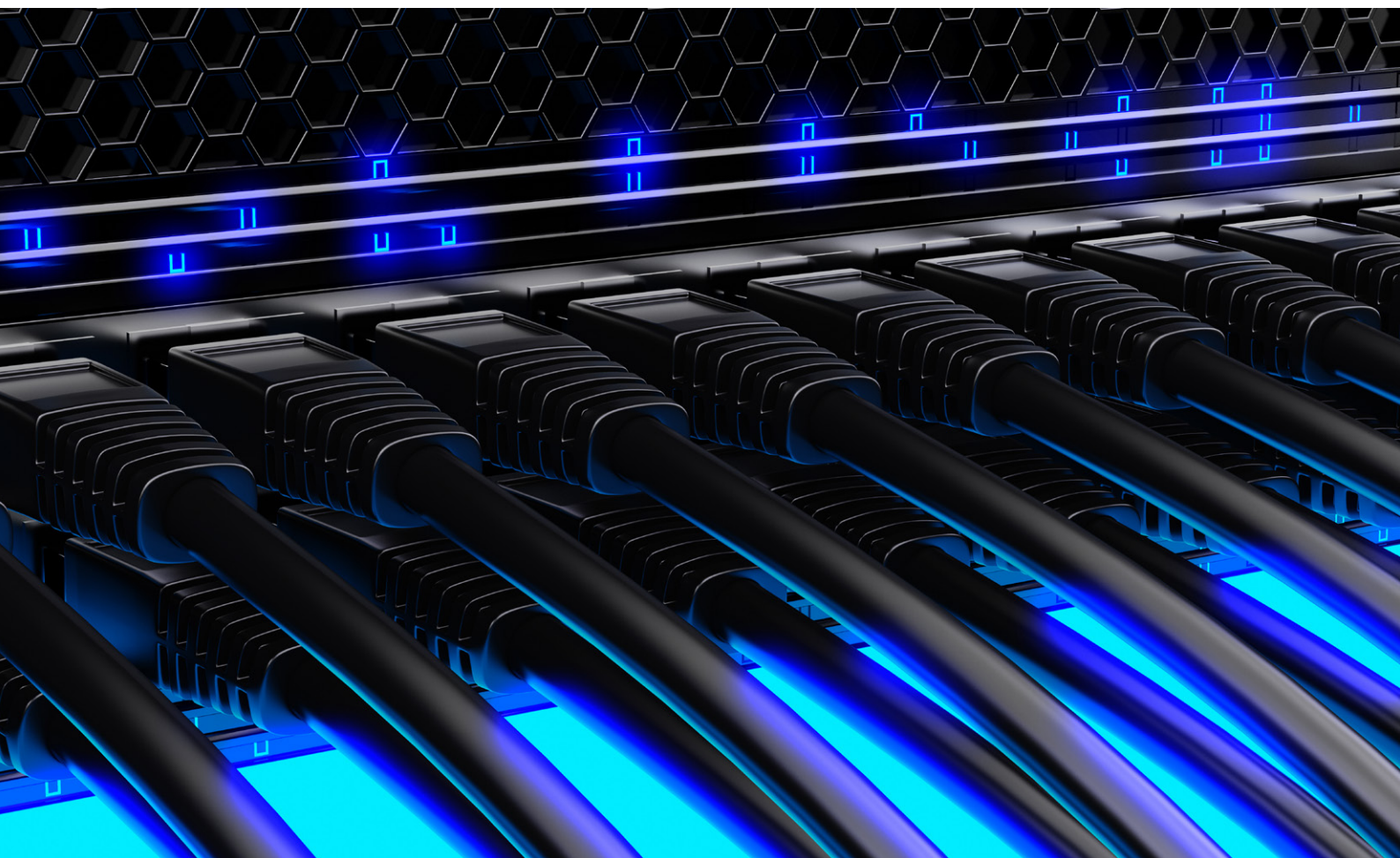
Financial support and resources have been provided by the government to bring China to the forefront of IOT development. Key policies such as the *Guidance Opinion of the State Council on the Orderly and Healthy Development of the IOT* issued by the State Council on February 25, 2013 and the *12th Five-Year Plan on the IOT* issued by MIIT on November 28, 2011 are high-level policies which set up the overall framework, purpose and development of the IOT industry in China. A special fund has also been established pursuant to the *Interim*

Measures for Administration of the Special Fund for the Development of IOT issued by the Ministry of Finance on April 6, 2011 which is a national fund that seeks to promote IOT-related R&D, applications, and services.

The results of China’s commitment to the development of the IOT industry can be seen in the IOT hubs located in Wuxi, Shanghai and Chengdu. In particular, in the city of Wuxi, the local and central governments have worked together to establish the 23-square kilometre Wuxi National IOT Innovation and Demonstration Zone. Government support for the IOT push in Wuxi includes giving priority in government procurement, financial support, simplified and speedy approvals, and easier availability of land. As of February 2014, there are more than 1,000 enterprises established within the zone including more than 30 research institutions. Notable investors include IBM, Siemens, China Mobile and China Telecom.

The case for white spectrum

In simple terms, white spectrum refers to bands of frequencies that has been allocated for use in television broadcasting but are underutilized. The underutilized



spectrum acted as buffers for analog broadcasts to avoid interference between channels. However, as we move towards digital broadcasting, there is less interference between the channels which frees up the spectrum allocated as buffers between the channels. Given the need to transfer large amounts of data wirelessly in the IOT industry, in particular machine-to-machine (“M2M”) applications, white spectrum is seen as a possible solution to the finite spectrum available for IOT usage. Nonetheless, there are numerous challenges facing the deployment of white spectrum for M2M applications including interference between different services and identifying which spectrum to allocate for IOT and M2M usage.

Allocation of frequency spectrum in China

The primary regulation governing the allocation and allotment of frequency spectrum in China is the *Regulations Concerning Radio Administration* which were issued by the State Council and Central Military Commission effective September 11, 1993. As in other jurisdictions, radio frequency is owned by the government. In China, MIIT is the regulatory authority overseeing radio frequency and spectrum management. The State Radio Monitoring Centre (“SRMC”) is an office within MIIT which is responsible for management of radio spectrum, radio stations as well as radio transmitting equipment. The responsibilities and powers granted to MIIT and SRMC are spelt out in the *Regulations Concerning Radio Administration*.

The allocation of radio frequency spectrum in China is determined based on the *Radio Frequency Allocation Rules*. The *Radio Frequency Allocation Rules* were issued based on the *Regulations Concerning Radio Administration*. The most recent version of the rules took effect on February 1, 2014. Under the *Radio Frequency Allocation Rules*, the allocations are categorized based on the radio frequency spectrum ranges and usage for each range. The usage includes fixed communications, mobile communications, broadcasting, satellite communications, radio navigation services and so forth. Our understanding is that, currently, China has not allocated any white spectrum for commercial use. This is consistent with the *Radio Frequency Allocation Rules*, which do not mention the allocation of white spectrum for commercial use (including IOT or M2M).

IPv6 development

Internet Protocol version 6 (“IPv6”) is the latest version of the Internet communications protocol, designed to eventually replace IPv4, which still carries the majority of Internet traffic. IPv6 is seen as critical to the development of IOT and in particular M2M technology, given the ever rising demand for more IP addresses. In the past, China has largely been seen as an observer in the development and adoption of IPv4. Today, the Chinese government is keen to avoid sitting on the sidelines when it comes to major technological developments and innovation. The development of China’s home-grown 3G mobile telecommunications standard, TD-SCDMA, for example is evidence of this.

Given the strategic importance of IPv6, the Chinese government has been aggressively pursuing its development. As early as in 2003, with the State Council’s blessing, the National Development and Reform Commission (“NDRC”) launched the China Next Generation Internet program, which introduced IPv6 in China. At that early stage, IPv6 was largely deployed in universities and research institutes.

More recently in 2012, high-level government authorities including NDRC and MIIT issued the *Opinions on the Development and Construction of the Next Generation of the Internet during the “12th Five-year Plan Period.”* These opinions are a comprehensive policy document outlining a roadmap and agenda as well as concrete action items for the development of IPv6. Pursuant to these opinions, the commercialization of IPv6 will occur in two phases:

- During the first phase, commercial trial by the end of 2013, followed by full-scale deployment and commercial use during 2014 and 2015.
- During the second phase, new types of industrial applications, including IOT, would be assigned with IP addresses under the IPv6 technology.

To facilitate the development of IPv6, in 2013, the Chinese government selected a total of 16 cities, including Beijing, Shanghai and Wuxi, to take the initiative in developing IPv6. The selected cities will build the necessary infrastructure, deploying IPv6 to new types of industrial applications (particularly IOT) and also build up the supply chain.

Direct government subsidies are granted to fund qualified projects. Going forward, the Chinese government is widely expected to put in place more preferential treatment and incentives for the development of IPv6.

Conclusion

The Chinese authorities have so far been very ambitious in promoting technological research and development in the IOT industry. At the same time, the regulators need to provide more clarity and transparency for participants. This will be a difficult task given the potential scope of application of IOT which is virtually limitless. Any regulatory changes may not fit within a continuously changing landscape which will hinder the development of the IOT industry as a whole. The reality is that the authorities will need to strike a balance between regulating an industry, which they have historically watched over closely and allowing innovation and development to flow freely.



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