China: 350,000 LTE Base Stations Planned for 2014; Investors Use “VIE” to Structure Telecom Investments

The Chinese telecommunications market developed rapidly, particularly after China’s accession to the World Trade Organisation. The number of subscribers is in the hundred millions and revenue in the hundred billions (in Renminbi) as of the end of 2011. This article will discuss the general regulatory framework in relation to foreign investments in the Chinese telecommunication industry and its application to the long term evolution (**“LTE”**) standard, which will be followed by a discussion on the impact of LTE on value added telecommunications services.

Overview of the Chinese Telecommunications Market and Industrial Regulations

The Chinese telecommunications carrier market is largely dominated by state owned enterprises, namely, China Telecommunications Corporation (**“China Telecom”**), China United Network Communications Group Co., Ltd. (**“China Unicom”**), and China Mobile Communications Corporation (**“China Mobile”**), which are each issued with telecommunications licences to carry fixed line network services, mobile communications network services (2G and 3G), and data communication network services.

Telecommunications operating permits must be obtained from the Ministry of Industry and Information Technology or its competent local counterparts (**“MIIT”**) in order to provide telecommunications services in China. Telecommunications operating permits are divided into two categories, namely, basic telecommunications services (**“BTS”**) and value added telecommunications services (**“VATS”**). Generally, the market entry criteria for the BTS sector are more stringent than the VATS sector. Telecommunications industrial regulations are applicable to both domestic investors and foreign investors.

Foreign Investments in the Telecommunications Industry

In addition to the aforementioned general industrial regulations, foreign investments in the telecommunications sector are subject to further rules and restriction specifically applicable to foreign investors. Foreign investors are only permitted to set up foreign invested telecommunications enterprises in joint venture with Chinese nationals (also known as **“FITEs”**) and provided that the foreign ownership is limited to 49% for FITEs providing BTS and 50% for FITEs providing VATS. FITE is also subject to a high capitalisation requirement. A FITE must have a minimum registered capital of RMB 1 billion (approximately USD 157.23 million) in order to carry out BTS with nationwide coverage, and RMB 100 million (approximately USD 15.72 million) in order to carry out BTS with province-wide coverage. A FITE must have a minimum registered capital of RMB 10 million (approximately USD 1.57 million) in order to carry out VATS with nationwide coverage, and RMB 1 million (approximately USD 157,233) in order to carry out VATS with province-wide coverage. Given the stringent requirements imposed on setting up a FITE and the regulatory practice which indicates the Chinese government’s reluctance in granting telecommunications operating permits to FITEs , foreign investors have utilised the variable interest entity (**“VIE”**) structure to enter China’s telecommunications industry.

Under the typical VIE structure, foreign investors will engage nominees with Chinese nationality to act as shareholders of the domestic capital company holding the required telecommunications operating permits. The contractual arrangements effectively transfer the actual control and economic benefits of the business of such domestic capital company from the registered shareholders to a wholly foreign-owned enterprise separately established by the foreign investor. The contractual control is normally effectuated through a number of contractual arrangements, such as, the cooperation agreement and technical services agreement, voting proxy, equity pledge agreement and equity option agreement.

While it remains the most widely used structure for foreign investments in the Chinese telecommunications industry, especially in the VATS sector, the VIE structure poses certain legal risks, including but not limited to, possible change of nominee loyalty and uncertainty of the enforceability of the control documents as a whole. In particular, the VIE structure has recently been exposed to increasing government and media attention. However, given the substantial stakes involved with the VIE structure (it is estimated that the market capitalisation of Chinese internet companies listed in the US under the VIE structure is approximately USD 160 billion), careful consideration will be exercised by the Chinese government before adopting any solution in order to avoid causing any serious disruption to the domestic and overseas markets.

LTE
The LTE mobile service system is in a nascent but rapid stage of development in China. MIIT has approved China Mobile to construct and provide pilot LTE services in seven cities in China and the pilot services are being expanded to more than ten cities by the end of 2012. It is reported that 20,000 LTE base stations will be built by 2012 and 350,000 LTE base stations will be completed by 2014 pursuant to the development plan sanctioned by MIIT. In contrast, China Telecom operating on the CDMA 2000 standard and China Unicom operating on the WCDMA standard are focusing on expanding the 3G platform and are not proactive in developing and implementing the LTE standard.

LTE services are classified as 4G mobile services by the industry in China and are likely to be subject to the BTS permit requirement. Therefore, foreign investment in a FITE providing LTE services will be subject to the minority ownership restriction and high capitalisation requirement.

Impact on VATS
The advent of 3G and 4G mobile services has provided a platform offering more customised VATS to the market, particularly the internet content provider services, to mobile device users. The commercialisation of 3G mobile services has made the use of the internet service via mobile devices more popular in China. Commercialisation of 4G

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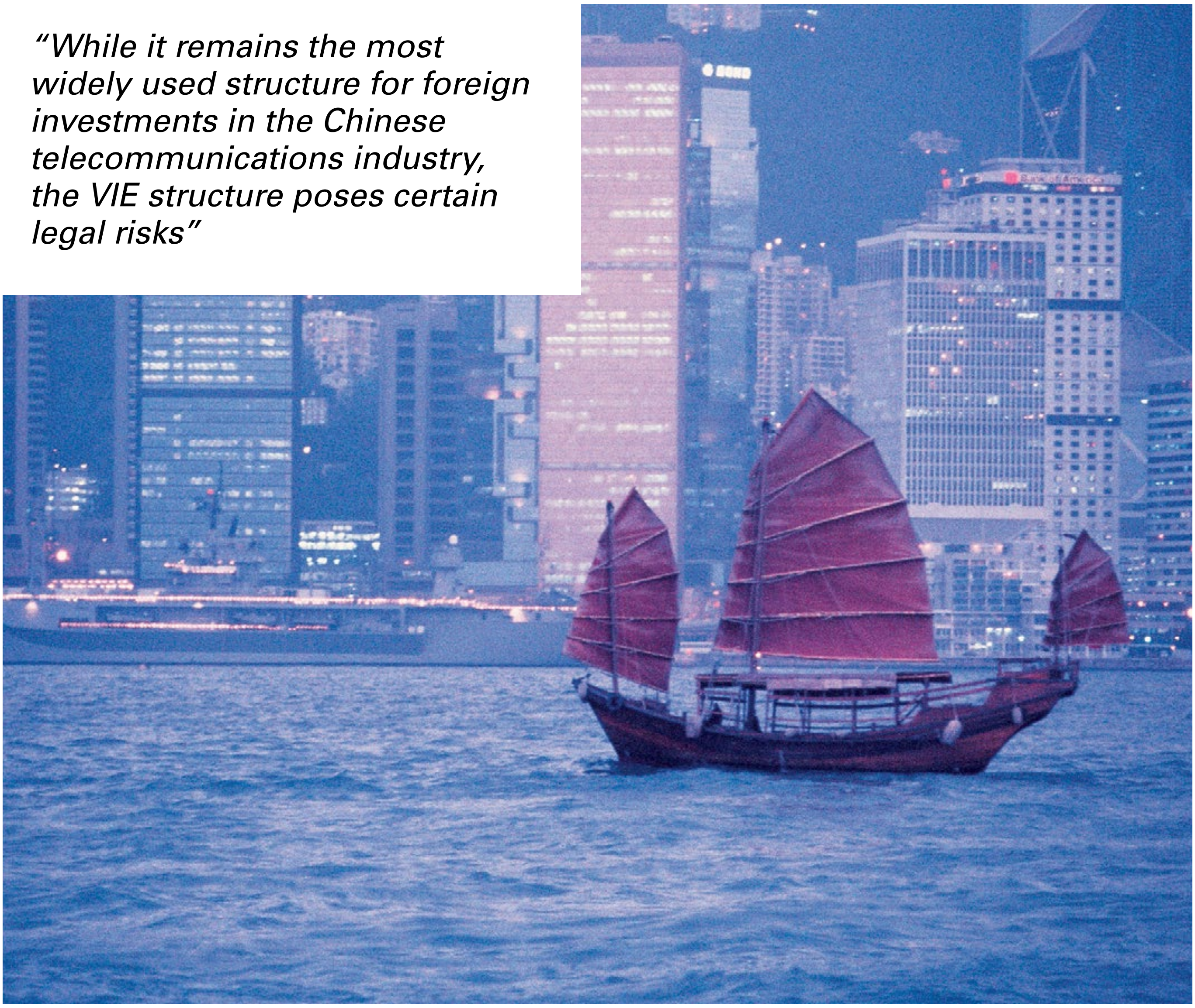

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mobile services will further allow internet content providers to supply faster and more innovative services to internet users which will in turn attract more internet users and commerce via the mobile internet platform in China. Consequently, foreign investors are increasingly active in the VATS sector in China.

Internet content provider services cover internet information services, e-mail service, bulletin board service and the like. Internet content provider services supplied for profits are classified as a VATS and are subject the VATS permit requirement and foreign ownership restriction, although, as discussed above, the VIE structure has been commonly used by foreign investors in relation to the VATS sector.

Conclusion

The Chinese telecommunications industry is one of the fastest developing markets in the world. Due to restrictions on foreign investments in the Chinese telecommunications industry, foreign investors have adopted the VIE structure to pursue business opportunities despite the legal risks associated with such VIE structure.

LTE services are being developed by China Mobile in China, although it is expected that the full scale of investments in the LTE service will not be effectuated until China Mobile, China Telecom and China Unicom have captured satisfactory investment returns in relation to 3G services. Given that LTE will likely be classified as a BTS, it will be difficult for foreign investors to penetrate into the Chinese LTE service. However, LTE services are expected to further nurture the development of the VATS, particularly in the mobile internet sector in which foreign investors have actively pursued business opportunities through the VIE structure.

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