Welcome Clarity on Online Sales in China For Foreign Investors From An Unexpected Source But Uncertainty Remains For The VIE Structure

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With a netizenship of over 500 million users and potential for further increases considering its population and demographics, China's online sales market has become too big for international businesses to ignore. Foreign investors have traditionally struggled with investments in China's online industries due to China's *de facto* policy restrictions (which are, in reality, more akin to prohibitions) on foreign investment in the telecoms industry.

In terms of online activities, internet information services (which include internet content providers ("**ICPs**")) are classified as value-added telecoms services ("**VATS**"). In order to engage in VATS in China, foreign investors must:

- set up a foreign-invested telecoms enterprise (a **"FITE"**) which must be in the form of a Sino-foreign equity joint venture, where the aggregate foreign investment does not exceed fifty percent (50%); and
- obtain a licence from the Ministry of Industry and Information Technology ("**MIIT**")[1] in the form of a VATS operating permit (a "**VATS Permit**").

In reality, the number of FITEs which have obtained a VATS Permit has been limited, notwithstanding the opening of the sector promised by China's admission to the World Trade Organisation in 2001 and the letter of the law. To date, there are still fewer than thirty FITEs (including Microsoft and Amazon) which have obtained a VATS Permit. Other foreign investors have, for expediency, timing or regulatory reasons or due to an unwillingness to do a joint venture, had to adopt other structures, such as the notorious variable interest entity ("**VIE**")structure[2] in order to obtain a foothold in China's booming online market.

However, foreign investors in China's online sales market may draw some comfort based on the conditions imposed by the Ministry of Commerce ("**MOFCOM**") for its merger control clearance of Walmart's acquisition of a controlling interest in the offshore holding company of a leading Chinese online supermarket ("**Acquisition**"). Essentially, the conditional approval from MOFCOM clarifies the current position: it appears that foreign investors can engage in online sales business without VATS Permit from MIIT, provided that their online platform is not open to third party vendors.

1. CHINA'S CONDITIONAL APPROVAL OF WAL-MART'S ACQUISITION

MOFCOM is both the foreign investment approval authority and the regulator for merger control in China. The establishment of a foreign-invested enterprise in China either by greenfield establishment or acquisition of an existing entity is typically subject to approval by MOFCOM or its local counterparts in its capacity as the foreign investment approval authority. As the Acquisition was structured offshore and the structure in China was already in place before the Acquisition, MOFCOM's approval wearing its foreign investment approval authority 'hat' was not required. Instead, MOFCOM’s foreign investment approval was required in its capacity as regulator for merger control.

On 13 August 2012, MOFCOM issued a conditional approval with regard to Walmart's offshore acquisition of shares in Newheight Holdings ("**Walmart Approval**"). Newheight Holdings operates in China through its one hundred percent (100%) Shanghai subsidiary ("**NH Shanghai**"). The Newheight Holdings online sales entity is a well-known online supermarket called Yihaodian, which is controlled by NH Shanghai, presumably through a VIE structure rather than direct equity holding[3].

The conditions imposed by MOFCOM for approving the Acquisition include:

1 Please refer to our client note *Draft Issued for Solicitation of Comments to Revise the State Council Regulations on Internet Information Services* dated September 2012 for more details.

2 Please refer to Section 4 below and our client note *China VIE structure for foreign investment under attack from multiple directions: will it emerge (relatively) unscathed or is its very survival threatened?* dated January 2012 for more details on the VIE structure.

3 We make this assumption based on the conditions imposed, as MOFCOM did not disclose the exact structure in the Approval.

(a) NH Shanghai is only entitled to use its own online platform for its own online sales;

(b) upon completion of the Acquisition, NH Shanghai is prohibited from allowing its online platform to be used by other vendors without a VATS Permit; and

(c) upon completion of the Acquisition, Walmart shall not use a VIE structure to engage in VATS through Yihaodian.

The first and second conditions seem to suggest that so long as NH Shanghai (a wholly foreign-owned enterprise ("**WFOE**")) uses its online platform to engage in direct online sales and does not permit other vendors to use its online platform, then a VATS Permit is not required.

As an extension to the first and second condition, 'VATS' as referred to in the third condition presumably is a reference to Yihaodian providing an online platform service through which other vendors can sell their goods and services.

Operators, which operate as FITEs with a VATS Permit, can allow other vendors and individuals to use their online platform to trade include, for example, eBay and Amazon (note that Amazon's acquisition of Joyo.com in China was a rare precedent). On the other hand, international retailers such as Walmart, Carrefour and Metro also engage in online sales, but as they are not FITEs with VATS Permits their online platforms are not open to third party vendors.

As mentioned above, the application to MOFCOM in relation to the Acquisition was for approval from a competition law perspective. However, by analysing the conditions listed above, it can be deduced that a foreign-invested enterprise may be permitted to engage in online sales of its own goods and services without a VATS Permit provided that third party vendors are not allowed to use its online platform to trade. Existing Chinese laws and regulations are actually consistent with this position. Although these laws were in place prior to the Approval, MOFCOM's decision is significant in that it provides degree of clarity and affirmation that foreign investment in online sales not involving a third party platform is lawful without needing one of the elusive VATS Permits from MIIT. We provide below our analysis of the relevant existing laws and regulations to help rationalise the above.

2. EXISTING RULES

The basis for allowing foreign investment in online sales activities is the *Administrative Measures on Foreign Investment in Commercial Sectors* issued by MOFCOM effective 1 June 2004 ("**FICE Measures**"). The FICE Measures actually encompass a broader scope than just online sales. They also cover wholesale, franchising and traditional retail (i.e. physical stores). The FICE Measures clearly allow foreign investors to engage in distribution (i.e. wholesale, franchising, retail and commission agency) by establishing a foreign-invested enterprise which is a WFOE subject to restrictions on the sale of certain goods such as books, magazines, pharmaceuticals and so forth[4]. In fact, the sale of goods via the internet is part of the definition of 'retail' under the FICE Measures, so it can be said that the basis for foreign investment into the online sales market was established back in 2004. However, the conclusion as to the legal position on online sales and the possibility that MIIT approval in the form of a VATS Permit might be required led many foreign investors to adopt the VIE structure for their investments involving online sales operations, notwithstanding the FICE Measures.

Importantly, MOFCOM then issued the *Notice of the General Office on Issues Related to Examination, Approval and Administration of Online Retail and Vending Machine Sales Projects of Foreign-Invested Enterprises* on 19 August 2010 ("**Online Sales Circular**"). The Online Sales Circular further clarified that online sales are only an

[4] Where special products which are separately regulated are involved, such as medical products/equipment, games, books/magazine, electronic publications, audio- visual products, or virtual products (i.e. online music) then there may be other requirements to be met or in some cases foreign investors may not be permitted to engage in online sales of such items.

extension of sales from the physical stores to a different sales channel, namely the internet, so existing approved foreign-invested manufacturers and retailers which are set up as foreign invested commercial enterprises ("**FICEs**") can directly undertake online sales. The clarification implies that it may not even be necessary for existing FICEs to amend their business scope (as stated in their business license) to include online sales, since online sales are not in itself a separate business activity.

Separately, the Online Sales Circular also provided that approval rights for newly-established FICEs engaging purely in online sales (without physical stores) are delegated down from central MOFCOM to provincial level MOFCOM. Approval at the provincial level is generally viewed as a simpler, faster and more straightforward procedure as compared to central MOFCOM approval. This was also another welcome development for foreign investors.

Most importantly, the Online Sales Circular clearly specified that if the FICE allows third party vendors to use its online platform, it will have to apply for a VATS Permit from MIIT. If its online platform is used solely for its own purposes, then only a record filing (备案) will need to be made with MIIT. This explains why so many websites refer to 'ICP 备'. As mentioned above, obtaining a VATS Permit is, in practice, very time-consuming and challenging for foreign investors. A filing procedure however is much more straightforward.

3. IS MIIT APPROVAL REQUIRED?

As mentioned above, notwithstanding the FICE Measures and the Online Sales Circular, there has been some uncertainty as to MIIT's regulatory remit with respect to online sales. The good news is that the Approval seems to affirm the Online Sales Circular in that online sales by FICEs do not require a VATS Permit (although this has to be treated with some caution given that it comes from a body with a vested interest in emphasizing its own regulatory powers; and it would not be the first time that MIIT and MOFCOM have 'crossed swords' in this area). As noted above, for a number of reasons, very few FITEs (which need a VATS Permit to operate) have been established. Moreover, the thirty or so "fortunate" VATS Permit holders hold VATS Permits which are unrelated to online business, e.g., for call centers or IP-VPN services.

We now examine the existing VATS related regulations to see if they can be rationalised and interpreted consistently with the above.

3.1 What is a VATS Permit?

The type of VATS Permit which the Approval and Online Sales Circular are referring to is the ICP license for providing information services over the internet. This was confirmed in our telephone inquiries with central MIIT as well as its counterparts in Beijing and Shanghai. Amazon's Chinese joint venture, for instance, holds an ICP VATS Permit and can therefore bring in third party vendors to trade through its online platform, as this is a big feature of its business model worldwide.

Under the current regulatory regime, there is a distinction between commercial/operational/profit-making ("经营性") ("**Commercial ICPs**") and non-commercial/operational/non-profit making ("非经营性") ICPs ("**Non-Commercial ICPs**"). Commercial ICPs are subject to a licensing (VATS Permit) requirement, whereas Non-Commercial ICPs are only subject to simpler record filing procedures.

The existing regulations distinguish between the two types of ICPs based on whether or not the users of the information provided are charged[5]. Considering the types of services which are provided in today's online world, this test is certainly unsatisfactory and insufficient because the business models and technology have run ahead of

[5] Please refer to our client note *Draft Issued for Solicitation of Comments to Revise the State Council Regulations on Internet Information Services* dated September 2012 for more details on the distinction between Commercial ICPs and Non-Commercial ICPs.

it. From our experience, MIIT officials are notoriously inconsistent in their interpretation of whether a service is 'commercial' or 'non-commercial' in nature, particularly as between different locations in China. In the context of online sales of one's own products, we can find some logic in this by taking the view that the online sales service itself is an ancillary service for a commercial product, rather than a separate, independently-priced service. Essentially, the payment is being made by the user for the commercial product and not for the provision of the information or access to a trading platform. This can be compared to a paid online subscription for an online newspaper, magazine or journal publication to receive online content, or a subscription fee to play online games, where users pay to access the gaming platform; both of these will be caught squarely as a Commercial ICP. Again, the distinction is important as such a finding would mean that a VATS Permit (i.e. ICP license) would be necessary.

Based on the above interpretation, the fact that under the FICE Measures, the Online Sales Circular and the conditions in the Walmart Approval, FICEs established solely by foreign investors (i.e. WFOE FICEs) are allowed to conduct online sales provided that their online platform is not open to third party vendors, is consistent with the existing regulations issued by MIIT. This would then only require a record filing procedure to be completed as opposed to a VATS Permit to be obtained. By definition, a WFOE with a VATS Permit is not possible under the law given the 50% shareholding limit for foreign investors in a FITE.

3.2 Online payment service

Separately, there is also the issue of whether the online sales service includes the processing of payments online. This is not an issue if the online payment operations are outsourced to a properly licensed third party payment operator such as Alipay or Tenpay which are specialised online payment service providers. Pursuant to the *Measures for the Administration of Payment Services by Non-Financial Institutions* issued by the People's Bank of China effective 1 September 2010 ("**Payment Services Measures**"), non-financial institutions providing intermediary payment services between purchasers and sellers are required to apply for a payment services permit from the People's Bank of China ("**Payment Services Permit**"). Arguably, if the FICE is performing the processing of online payments on its own for its own goods and services, it is not an intermediary and so should not be required to apply for a Payment Services Permit.

Notwithstanding the above, if the FICE performs the processing of payments online on its own, potentially a separate VATS Permit is required under the online data processing and transaction processing services VATS category, which, amongst other services, includes banking services (各种银行业务) ("**Online Processing License**"). The same interpretation as for Commercial ICPs can be applied here to argue that an Online Processing License is not required where the online payment service is ancillary to the sale of the commercial product itself and not, of itself, the paid-for service. For third party payment operators, because the Payment Services Permit and Online Processing License are issued by different authorities, technically both are required in order for them to provide intermediary online payment services. In practice however, very few Online Processing Licenses have been issued by MIIT either for domestic or foreign-invested entities. The official we spoke to at MIIT did acknowledge that there is a possibility that the Online Processing License is required for operators who provide online payment services even where those payment services are ancillary to the sale of the operators' own products but the circumstances giving rise to the need for such a license are not entirely clear.

Operators which allow their online platforms to be used by third party vendors and who also provide online payment services for such vendors should be aware of the potential requirement for an Online Processing License. Given the variations in interpretation amongst MIIT and its local counterparts, it would be prudent to closely consult with MIIT and its local counterparts before putting this type of arrangement in place.

4. VIE STRUCTURE

The VIE structure is generally adopted in industries where foreign investment is restricted or prohibited in China. The investment is made offshore and involves a series of contractual arrangements being entered into by the parties. The VIE structure has primarily been used by foreign investors in industries which are highly restricted to foreign investment such as the telecommunications or media industries. In fact, most of the largest offshore-listed Chinese internet businesses have adopted the VIE structure including Sina, Baidu, Tencent and Alibaba (before its delisting).

Under a typical VIE structure relating to VATS activities, the actual operating company is the domestic company holding the required VATS Permit ("**Domestic Company**"). The shareholders of the Domestic Company are usually Chinese national founders who also hold equity at the offshore level in the investment holding company ("**Offshore Company**") with the foreign investors. The contractual arrangements between the parties effectively transfer the actual control and economic benefits of the business of the Domestic Company to a WFOE separately established by the Offshore Company.

MOFCOM's third clearance condition for the Walmart' acquisition of a controlling stake in Yihaodian sends a clear signal that the Chinese authorities may no longer turn a blind eye to the VIE structure. In a rarely seen public announcement of its position on the VIE structure[6], MOFCOM explicitly required that, following the Acquisition, Walmart should not use a VIE structure to provide VATS type services through Yihaodian. In fact, MOFCOM used the term "VIE" in English and without providing a definition or explanation, indicating that the authorities are fully cognisant of this structure. The third clearance condition suggests that the authorities are not favourably disposed towards the general practice of using VIE structures in investing in the VATS sector. However, the Approval certainly does not expressly invalidate VIE structures (including the assumed existing Yihaodian VIE structure), so query how this condition would affect the *status quo* on the general practice of adopting VIE structures. It does send a shot across the bows of those who had become blasé about deploying the VIE structure, claiming that 'everyone was doing it' and that it was 'too big to fail'.

5. CONCLUSION

A number of key take-aways can be gleaned from the conditions imposed in the Walmart Approval. It affirms existing provisions under the FICE Measures and Online Sales Circular that participation in online sales by foreign-invested enterprises and FICEs is permitted provided that the online platform is not open to third party vendors. Importantly, a VATS Permit from MIIT is not required in such circumstances. Whilst perhaps not the result Walmart may have anticipated or expected, the Walmart Approval may, due to the reported last minute intervention by MIIT, have brought some welcome clarity to a historically confused area of the law where there has been considerable potential for regulatory overlap. Unfortunately, the same cannot be said for the area of online payment services licensing, where there appears to be overlap and confusion as to when a Payment Services Permit or an Online Processing License (or both) are needed, where the regulators in question (PBOC and MIIT) really need to issue a clarification on where the demarcation line stands.

[6] Please refer to our client note *China VIE structure for foreign investment under attack from multiple directions: will it emerge (relatively) unscathed or is its very survival threatened?* dated January 2012 for more discussions on the potential risks of the VIE structure.

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