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Briefing note | April 2013

# China Opens for Mobile Virtual Network Operator

On 8 January 2013, China's telecoms regulator, the Ministry of Industry and Information Technology ("**MIIT**"), published a consultation draft of the Mobile Communication Resale Business Pilot Plan ("**Consultation Draft**") to solicit comments from the public. This Consultation Draft proposes a two-year trial of the "Mobile Virtual Network Operator"[1] ("**MVNO**") model in China. The Consultation Draft forms one part of the government's initiatives to introduce more competition to China's telecoms sector which has long been monopolized by State-run businesses.

## 1. Required Cooperation from the Mobile Network Operators

All MVNOs operate on the infrastructure managed by Mobile Network Operators ("MNOs"). Under the Consultation Draft, the three Chinese MNOs (China Mobile, China Unicom and China Telecom) need to provide the following support to MVNOs:

(a) each MNO should enter into a cooperation agreement with at least two MVNOs during the trial period

(b) the quality of access to the telecommunication infrastructure provided by the MNOs to MVNOs should be no worse than the quality of access for MNOs' proprietary business

(c) MNOs should assign a series of consecutive phone numbers or whole number segments to the MVNOs according to each MNO's own number resources and MVNOs' needs. Chinese customers prefer certain digits over others and they are often willing to pay a premium for the "lucky" digits. This requirement ensures that MVNOs will not be allocated unpopular phone numbers only

(d) the wholesale price offered by MNOs to MVNOs should be lower than the most preferential price of a similar service MNOs offer to its retail customers in the local market

(e) no MNO should require MVNOs to acquire network capacity from it on an exclusive basis.

The Consultation Draft set outs a skeleton of the commercial arrangements between MNOs and MVNOs. Needless to say, the balance of the terms (including the likes of purchase volume guarantee and events of default) are left to the MVNO agreement negotiation.

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1 Referred to in the Consultation Draft as "mobile communication resale business" and defined as "the purchase of mobile communications services from infrastructure telecommunications service operators (also known as mobile network operators) and resale of such services to retail end users after rebranding".

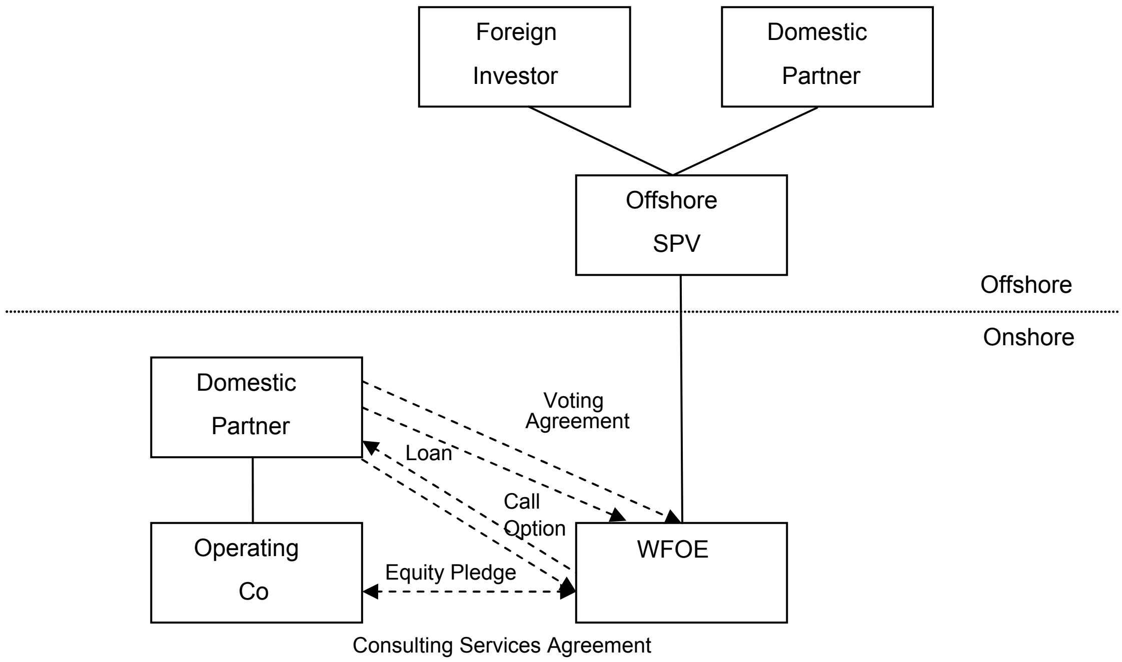
## 2. Entry Requirements and Opportunities for Foreign Investors

According to the Consultation Draft, in order to apply for an MVNO licence, the applicant must satisfy certain key requirements (details of which are set out in Schedule 1). One of the requirements is that an MVNO must be a Chinese-funded private company.

This requirement *prima facie* excludes foreign companies from participating in the MVNO trial. Nevertheless, as there exists a clear distinction between law and practice in many aspects of doing business in China, it could be premature to conclude on the face of the Consultation Draft that foreign investors are *de facto* prohibited from being involved in the MVNO trial in any form or shape.

The Consultation Draft categorises MVNO's business as value-added telecoms. Under MIIT rules, foreign investors cannot own more than 50% of any value-added telecoms business in China. In practice, however, all prominent value-added telecoms business in China (including Tencent, Sina and Alibaba) are wholly-owned by offshore holding companies in a so-called "variable interest entity" structure ("**VIE Structure**").

The VIE Structure is an investment structure which relies on a series of contractual arrangements to enable a foreign investor to control (but not directly own) and obtain economic benefits from a company operating in a sector where foreign investment is restricted (such as the telecom sector). Under a typical VIE Structure as illustrated in the chart below, a foreign investor will establish an offshore special purpose vehicle ("**Offshore SPV**") jointly with a domestic partner to hold interests in a wholly foreign-owned company ("**WFOE**") through the Offshore SPV. The domestic partner will also establish a subsidiary as the operating company ("**Operating Co**") to apply for all operating licenses and permits required for the relevant business. Parties involved in the VIE Structure will enter into various contractual arrangements (including without limitation, service agreement, call option agreement, equity pledge agreement, loan agreement and voting rights trust or power of attorney) which enable the WFOEs (and therefore indirectly, the foreign investor) to obtain control over and economic benefits from the Operating Co.



At the moment, the VIE Structure is the prevailing form of business model for value-added telecoms companies in China. Over a number of years, apart from in limited circumstances, MIIT has tolerated the use of the VIE Structure and has not strictly enforced its foreign ownership restriction policy. With respect to MVNO, only time can tell whether MIIT will have a similar attitude. The risk obviously exists as the MVNO trial is intended to open the monopolized and lucrative telecoms business to Chinese private investors rather than western companies. From a political point of view, it is unlikely to be possible to meet with MIIT and ask for its official blessing on use of the VIE structure in connection with MVNOs as the Chinese officials have always kept tight lipped whenever asked about the VIE Structure in recent years. In drawing a decision tree on whether and how to participate in MVNO business in China, western companies therefore need to factor in the risk of doing business in one of China's regulated industries and keep themselves abreast of the latest market intelligence.

Interestingly, the Chinese press has been speculating that Tencent and Sina could be two of the first applicants for MVNO licenses. Both Tencent and Sina use the VIE Structure to keep their value-added telecoms licenses under foreign ownership and have publicly disclosed such use in their IPO prospectus.

## Schedule 1 MVNO Eligibility Requirements

| Item | Requirements |
|---|---|
| Applicant | A Chinese-funded private company (i.e., not state-owned, as opposed to unlisted). |
| Capitalisation | Registered capital of no less than RMB1 million (for a regional MVNO business) or RMB10 million (for a national MVNO business) and sufficient capital for the contemplated business. |
| Staff | (i) the person responsible for technology shall have more than eight years of experience in the information and communication sector and possess a senior technical qualification or equivalent<br>(ii) the person responsible for finance shall possess an intermediate accountant qualification or equivalent<br>(iii) at least five of the management shall have more than five years of experience in the information and communication sector<br>(iv) no less than 30 personnel with a junior or higher qualification in the information communication and management sector (for a regional MVNO business) and 50 of such personnel if the applicant operates a national MVNO business. |
| Premise | A fixed office space and business premise or distribution channel which is suitable for the resale business. |
| Customer service | The applicant must have a customer service department with professional staff and service quality management system and a customer complaint hotline, dealing with customers' complaints.<br>The applicant must formulate service quality guarantee measures and solutions in the event of its withdrawal from the market. |
| Network security | The applicant must have a security management department, identify a responsible person and contact, establish network and information security management system and emergency programs and formulate sound information safety technical guarantee measures. |

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