

BARRIERS TO FOREIGN INVESTMENT IN THE CHINESE INTERNET INDUSTRY

By Peter K. Yu

Introduction

China has the largest population and one of the fastest-growing economies in the world. If only one percent of its population participates in the New Economy, China will provide a market of more than 13 million potential customers for Internet businesses around the world.

Today, China has approximately 22.5 million Internet users, according to a survey released by the China Internet Network Information Center. Although nongovernmental organizations and foreign agencies have questioned the accuracy of these figures, none have disputed that China has the largest Internet user population among all countries in the Asia-Pacific region.

While the Chinese market is attractive, developing Internet business in China is not easy and can be frustrating at times. Due to the different political, social, economic and cultural conditions, foreign investors face significant barriers to establishing Internet businesses in China. Disillusioned from their idealism and tired of the bureaucratic red tape and regulatory hassles involved in investing in China, many investors have exited the Chinese market.

Foreign Investment Law

The current Chinese laws and regulations are unclear as to whether foreign investment in the Internet industry would be allowed. Experts generally maintain that Chinese telecommunications laws forbid foreign participation in the Internet sector. Under those regulations, foreign investment in the telecommunications sector is heavily restricted. Telecommunications services are limited to local providers, such as China Netcom, China Telecom, China Unicom and JiTong Corporation.

With its imminent accession to the World Trade Organization (“WTO”), China is expected to relax its foreign ownership rules. In November 1999, China signed a bilateral accession protocol with the United States, laying out the terms for China’s accession to the WTO. Under this agreement, China will allow 30% foreign ownership of telecommunications firms upon accession to the WTO, 49% after the first year, and 50% after the second year. In light of this agreement, one can optimistically predict that China in the near future would provide a more favorable environment for foreign investment in the Internet industry.

However, depending on interpretation by the Chinese government, this favorable environment may be limited to Internet Service Providers (“ISPs”), which are regulated by the Ministry of Information Industry (“MII”). Such an environment may not be applicable to Internet Content Providers (“ICPs”), which are regulated by the MII and other governmental agencies. Considering China’s stringent information control policy, it would not be a surprise if China places heavier restrictions on foreign ownership of ICPs than on foreign ownership of ISPs.

Stringent Information Control Policy

Since its establishment in 1949, China has adopted a very stringent information control policy. To maintain control over the dissemination of information on the Internet, the Chinese government requires all connections to overseas computer networks to go through the sole international gateway operated by the MII. The government also forbids any individuals or entities from setting up or using other channels for international access.

In addition, the recently released content regulations have outlawed the dissemination of certain information. Such information includes:

- information targeted against the government;
- information threatening national security (such as articles inciting the independence of Taiwan and Tibet);
- stories about political dissidents;
- Internet content inciting racial and ethnic hatred, social disorder, crime or violence;
- information promoting “evil cults,” such as falun gong; and
- pornographic materials.

Because Internet portals funded by foreign investors usually publish news releases and advertisements based on the less-stringent standards abroad, these portals may tread on very sensitive areas. While the Chinese authorities have yet to tighten control over the contents of these portals, the authorities may implement more restrictive regulations should the political situation require them to do so.

Confusing Regulatory Structure

Like the laws governing the Internet industry, the regulatory structure in China is very confusing, especially to foreign investors who are concerned with predictability and stability. So far, it is unclear which ministry has the final say over Internet and e-commerce matters. While the MII is responsible for overseeing telecommunications, multimedia, satellites and the Internet, other government agencies are also involved in regulating the Internet industry.

For example:

- The Ministry of Public Security has authority to prevent the dissemination and use of information and products that are considered harmful to the state and society.
- The State Secrecy Bureau has promulgated regulations concerning state secrecy protection.
- The Ministry of Foreign Trade and Economic Cooperation has authority to examine and approve projects involving foreign investment and import of foreign goods and technologies.

- The China Securities Regulatory Commission is responsible for granting approval to any China-based Internet company that is interested in listing on a domestic or foreign stock market.
- The State Encryption Management Commission is in charge of the regulation of encryption technologies and their commercial use.
- The State Administration for Industry and Commerce is responsible for overseeing business activities of all domestic and foreign-invested Internet companies.
- The State Council Information Office, which is directly linked to the Propaganda Department of the Chinese Communist Party, regulates foreign media operations in China, including Internet media.
- The Ministry of Education is responsible for regulating web sites that provide distance learning.

Laws with Chinese Characteristics

In addition to the ambiguous laws and the confusing regulatory structure, the differences between Chinese and Western laws baffle and surprise foreign investors.

In China, laws are generally considered as concrete formulation of the policies of the Chinese Communist Party. As a summary of the Party's administrative and judicial experience, laws can be incomplete, incoherent or even self-contradictory. They are expected to fall behind policies and may also be formulated on an interim or provisional basis.

To provide flexibility, Chinese laws in general are broadly and vaguely drafted, pending further clarification by and explanation in implementing regulations. Contrary to Western beliefs and expectations, these regulations may sometimes exceed the explicit provisions of the laws they are supposed to define or explain. They may even establish new rights and rules that have not been originally conceived by the legislature.

Finally, due to the rapid social and economic changes within China, statutory provisions that are effective in one year may be outdated in another. Even worse, a law in a particular area may be affected by a new policy or a new statute implemented in another area. Thus, to determine the applicability and effectiveness of a provision, one may have to examine all the laws and supplemented documents, including various administrative rules and judicial interpretations, in all the relevant and related areas.

Inadequate Intellectual Property Protection

In most Internet businesses, intellectual property—such as copyright, trademarks, patents and trade secrets—constitutes the most valuable assets of the companies. A well-functioning intellectual property regime is therefore needed to maintain the continued vitality of the Internet industry.

While China has enacted comprehensive intellectual property laws and has acceded to virtually all the major multilateral intellectual property conventions available, enforcement of these laws and multilateral conventions is still weak and limited. In fact, the general Chinese populace have very limited awareness of intellectual property rights. Thus, intellectual property piracy is still rampant in China today. Every year, the United States loses more than \$2 billion of revenues due to intellectual property piracy in China alone.

Moreover, legislative and judicial developments lag dramatically behind the pace of technological development and the changes that have occurred in the New Economy. For example, the Copyright Act was enacted in 1990, long before the emergence of the Internet and the explosion of e-commerce. Likewise, the copyright and patent provisions protecting original integrated circuit designs were outdated and cumbersome. As a result, the existing intellectual property laws contain many loopholes and administrative burdens that make Internet businesses vulnerable to infringement.

To address the needs of the New Economy, the legislature is considering a revision of the existing intellectual property laws. Such a revision has yet to take place. Even when the laws are revised, the effectiveness of these laws is questionable, given the inadequate enforcement and limited public awareness of intellectual property rights in the country.

Conclusion

In sum, developing Internet business in China may not be as appealing as the market suggests. Nevertheless, it is generally believed that the benefits of foreign investment in the Chinese Internet industry would outweigh the costs of such investment. Indeed, with China's pending accession to the WTO, further deregulation in the telecommunications industry is expected. Such deregulation would not only open up many opportunities that have never been available to foreign companies in China, but it would also broaden the scope of foreign investment in the Chinese Internet industry.

Furthermore, as China is undergoing modernization and is developing its local Internet industry, foreign investment and technology transfer are greatly needed. Thus, although Chinese leaders are eager to control the dissemination of information, they are concerned about stifling the growth of the Internet. In recent years, Chinese leaders have repeatedly emphasized the importance of information technology and the development of e-commerce. Commentators are generally optimistic about the future prospects of foreign investment in the Internet Industry.

Despite these prospects, developing Internet businesses in China is still very risky, especially under the existing regulatory framework.

To minimize risks, foreign investors may want to consider establishing a joint venture with a Chinese partner. On the one hand, a joint venture would allow the foreign partner to understand the cultural differences, the intricacies and weaknesses of the regulatory framework, and the political constraints of transacting business in China. On the other hand, such a partnership would protect foreign investors against losses due to intellectual property piracy, assist in

overcoming local protectionism, and provide “guanxi” (personal connections) that are essential to commercial success in China.

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