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權亞律師事務所

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MEASURES ON THIRD-PARTY PAYMENT SERVICES INTRODUCED

Introduction

On 14 June 2010, China's central bank, the People's Bank of China (**PBOC**), finally released its long-anticipated *Administrative Measures on the Payment Services of Non-Financial Institutions* (**Payment Measures**), which will enter into effect on 1 September 2010.

It has been 5 years since the first draft of the Payment Measures was released for public comment. Entitled the *Draft Measures for the Administration of Payment and Settlement Organizations,* it was amended by the PBOC several times but never officially released (together with such amendments, **2005 Draft Measures**). As a result, there has been no clear or comprehensive legal framework in place for the Chinese third-party settlement and payment industry to date.[1]

Key Provisions

Definitions and Licensing Requirement

1. "Payment services of non-financial institutions" (**Payment Services**) are defined in the Payment Measures as the provision of capital transfer services by non-financial institutions acting as intermediaries. They include services rendered in connection with network-based payments, issuance and settlement services for pre-paid cards, and acquiring services for bank cards. "Network-based payments" refer to transfers of funds through public or private networks – such as remittance and cashing business – and payments made over the Internet, mobile phones, fixed-line telephones, and digital television networks.

2. The Payment Measures require all non-financial institutions engaging in Payment Services to obtain a Payment Services License (**Payment License**) from the PBOC. This license confers on its recipient the status of a lawful "Payment Institution". A Payment License is valid for 5 years, and can be renewed for a further 5-year

[1] For more details, please refer to our newsflash on 15 May 2009: *New Regulatory Movement by China's Central Bank in the Online Payment Sector*.

term within 6 months before it expires.

The PBOC's Jurisdiction

3. The Payment Measures confirm that only the PBOC is authorized to issue Payment Licenses. Applications for such licenses must be submitted to the PBOC's local branches for preliminary review and approval, before the PBOC examines them at the central level and issues its final approval decision.

4. The PBOC – and its local branches – are also responsible for supervising the operations and general legal compliance of Payment Institutions. This includes conducting onsite investigations into their corporate governance, commercial operations, internal controls, risk management and anti-money laundering systems, and other activities.

Grace Period

5. Non-financial institutions that currently engage in Payment Services will have a grace period of 1 year as of 1 September 2010 during which to procure a Payment License, failing which they must cease providing any such services immediately.

Capitalization

6. The minimum registered capital for a Payment Institution wishing to operate nationwide (*i.e.*, providing cross-provincial services) is RMB 100 million. For a Payment Institution intending to operate within a single province, autonomous region, or directly administered municipality, it is RMB 30 million. However, the PBOC has the discretion to increase this threshold on a case-by-case basis.

7. Under the Payment Measures, Payment Institutions must reserve and set aside capital totaling at least 10% of the sum of their average daily customer deposits (often referred to as "**reserved capital**", although the Payment Measures do not specifically adopt this term).

Criteria for Principal Shareholders

8. As a pre-condition to applying for a Payment License, the applicant's controlling shareholder or ultimate beneficiary, as well as each holder of 10% or more of the applicant's equity interest or shares, must:

   - have been providing data processing-related support services to financial institutions or e-commerce businesses for over 2 years;

   - not have been found guilty of any illegal or criminal activity relating to such services during the 3 years prior to the application date; and

- have been profitable for 2 or more consecutive years.

Reliance on Banking Services

9. The Payment Measures specifically emphasize that:

   - capital transfers between Payment Institutions must be carried out through banking financial institutions;
   - without special approval, Payment Institutions cannot transfer capital between financial institutions;
   - Payment Institutions can only open designated custodian accounts for reserved capital at 1 commercial bank; and
   - the commercial banks operating custodian accounts for Payment Institutions must monitor the use and transfer of the reserved capital therein, and report any illegal or suspicious use of the same to the local branch of the PBOC.

Observations and Commentary

Milestone for Third-Party Payment Law

1. Currently, companies engaging in the business of network-based payments in China are only required to hold a business license and a value-added telecommunications services license from the Ministry of Industry and Information Technology (the regulator of the Chinese telecommunications industry).

   While these companies are arguably providing services akin to financial institutions, the law does not actually categorize them as such, and they are thus not subject to supervision by any financial authority. Moreover, the volume of business undertaken by these operators has outstripped that of small-to-medium commercial banks in terms of both the volume and the monetary amount of the transactions that they handle.[2] To many government officials and consumers, the PBOC's supervision of Payment Institutions, and the introduction of the new licensing system, will be a welcome change for the health and development of the entire industry.

[2] In fact, the top 9 online payment companies (including Alipay and Tenpay) accounted for 98% of the market share during the first quarter of 2010.

2. The release date and contents of the Payment Measures are generally consistent with industry expectations based on the 2005 Draft Measures. By introducing a code of conduct for the third-party payment industry and confirming the PBOC's jurisdiction over it, the Payment Measures go a long way to addressing the ambiguity and uncertainty which has faced market participants to date. However, they have also raised several important questions, and lack certain key provisions.

Scope of the Payment Measures

3. The definition of "network-based payments" in the Payment Measures is vague, and could therefore be interpreted to apply to an excessively broad range of operators, including online game companies and supermarkets that issue prepaid coupons or gift cards. However, the principles reflected in the Payment Measures (*e.g.*, the restriction on the use of reserved capital, and the qualifications required of Payment License applicants and their shareholders) indicate that such an all-encompassing interpretation is not intended by the PBOC.

4. It is less clear how the PBOC will interpret the term "intermediary" when determining which service providers fall within the scope of the Payment Measures. The term is generally understood to refer to independent, third-party companies providing payment and settlement services to multiple payers and payees (*e.g.* by means of network-based payment services and prepaid cards). However, this issue remains unclear.

Foreign Investment

5. The Payment Measures state that the PBOC will issue separate legislation that will be subject to State Council approval, and will address the scope of services which may be provided by foreign-invested Payment Institutions, the criteria foreign investors and their shareholders must fulfill when applying for Payment Licenses, and any limitations which will be placed on foreign investment in this sector. The PBOC's approach is understandable given the complexities involved in regulating foreign investment in this field.

6. Most of the market leaders in China's third-party payment industry have directly or indirectly obtained foreign investment from venture capital funds and private equity funds. Indeed, the ultimate controlling entity and/or beneficiary in these structures often has foreign elements. The supplementary regulations on foreign investment will therefore be of critical interest to many key players.

Money Laundering

7. The Payment Measures set forth the general principle that all Payment Institutions must adopt anti-money laundering measures, failing which their licenses could be confiscated and administrative or criminal penalties could be imposed. However, the precise requirements of the PBOC are unclear, and the relevant provisions of the Payment Measures will be difficult to implement as a result.

8. The transactions being processed by Payment Institutions (*viz.*, the injection, transfer or withdrawal of funds) can only be conducted through their designated commercial custodian bank and their customers' respective house banks, in accordance with the requirements discussion above. As financial institutions are thus already involved in such transactions, industry players and observers are questioning whether it is necessary - or reasonable - to impose anti-money laundering obligations on Payment Institutions as the Payment Measures propose.

Interaction with Commercial Banks

9. The Payment Measures provide that the reserved capital maintained in custodian accounts may only be used for specific purposes, and is not the property of the Payment Institutions who open those accounts. However:

   - there is no clear definition of "reserved capital" in the Payment Measures, and no specific rules for commercial banks to follow with regard to opening custodian accounts; this makes the Payment Measures difficult to implement for Payment Institutions and custodian banks alike; and

   - the Payment Measures are silent on whether – and how much – interest may be paid by commercial banks on the reserve capital held in custodian accounts. Depending on the amount of money involved, the interest could obviously be sizable. Calculating what amount of interest is attributable to which customer's deposits on an ongoing basis would also be very difficult. This could explain why the PBOC has chosen not to address this issue in the Payment Measures.

Conclusion

Despite their broad provisions and the uncertainties which exist with regard to their practical implementation, the Payment Measures constitute a critical piece of new law. Most importantly, they introduce a legal framework and a system of accountability for the Chinese third-party payment services industry. The Payment Measures also establish the PBOC as the key industry watchdog, and give comfort to government agencies and consumers in China who are concerned about the current lack of supervision over non-banking financial institutions.

The PBOC has announced that it is in the process of drafting implementing rules for the Payment Measures, along with detailed guidelines on various types of Payment Services (especially the issuance of pre-paid cards, the settlement of pre-paid card transactions, and acquiring services for bank cards). The rules are expected to be issued before the Payment Measures enter into effect.

The release of the Payment Measures has been applauded by key industry players, who have publicly announced their intention to comply with them as soon as they enter into effect. Alipay and Tenpay have also revealed that they are already preparing their applications for a Payment License. However, as many of the 300-plus operators in the industry will be unable to satisfy the criteria for obtaining such a license, a significant and widespread consolidation is expected. Some industry observers anticipate that as much as two-thirds of the current operators will be forced out of the market.

This newsflash was written by senior associates Ronald Gu and Helen Sunderland, under the supervision of partner Philip Qu (pqu@TransAsiaLawyers.com).

Beijing
Suite 2218 China World Office 1
1 Jianguomenwai Avenue
Beijing 100004, China
Tel: +86 10 6505 8188
Fax: +86 10 6505 8189

Shanghai
Unit 1101 Platinum
233 Tai Cang Road
Shanghai 200020, China
Tel: +86 21 6141 0998
Fax: +86 21 6141 0995

http://TransAsiaLawyers.com

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