

# **CHINA – AN OVERVIEW OF A BURGEONING AND SIGNIFICANT MARKET**

by John McLellan

*"With a population of 1.3 billion, if only I can find a product/service which everyone in China would want ..."*

A quote which could be attributed to any foreign entrepreneur entering into China since Marco Polo!

*"Yes, another black hole for me to pour money into!"*

The response of a senior executive with an international media concern upon being congratulated on his company's latest China initiative.

#### **Introduction**

There is seemingly no place left on earth where you can avoid the buzz that is now China. Since the re-opening of its borders to foreign investment in 1979 and, more significantly, its accession to the World Trade Organisation (WTO) in 2001, foreign capital has poured into the China market.

Having acted for a number of media concerns who have taken the plunge, the pitfalls on this path should not be underestimated. The purpose of this essay is to give an overview of the legal framework through which those in the music industry must navigate, the major obstacles that must be addressed, and some practical insight into the experiences of those who have taken the plunge.

#### **Foreign investment in China**

From a legal perspective, the starting point for any foreign entity looking to invest in China is the Catalogue for the Guidance of Foreign Investment Industries . The Catalogue provides information to foreign investors with regard to those industries that are open to foreign investment and, thereby, the vehicles by which they may invest and operate.

Essentially there are four categories of industries listed in the Catalogue, namely: (a) the encouraged; (b) the permitted; (c) the restricted; and (d) the prohibited. These categories differ in the approval and registration procedures necessary to establish foreign investment enterprises. With regards to the music industry, music reproduction, production and distribution fall within the "restricted" category, whereas publication (which includes music publishing - see later) and the importation of music are within the 'prohibited' category.

In China, foreign investors are only permitted to enter into the music reproduction and distribution industries by way of Chinese-Foreign Contractual Joint-Ventures with local entities. As for music publication and importation, only entities that are sponsored by state-owned enterprises can establish audio and audio-visual publishing companies, and only entities that are designated by Chinese authorities can import finished audio and audio-visual products. Foreign investors who wish to publish or import music into China can only do so by entering into contracts with these state-owned or designated entities.

Hong Kong record companies (who, despite 'one country, two systems', are considered as foreign companies under Chinese laws) are in a slightly better position than other foreign record companies, since the implementation of the Closer Economic Partnership Arrangement (CEPA) on 1 January 2004. CEPA grants various Hong Kong service companies preferential access into the Chinese market. Because of CEPA, Hong Kong record companies will be offered an unprecedented opportunity to hold majority ownership in joint-ventures set up to distribute audio and audiovisual products in China.

Although CEPA is aimed at benefiting Hong Kong companies, CEPA does not restrict the nationality of its investors or shareholders. Thus, foreign record companies may also benefit from CEPA if it either partners with, invests in, or buys out, a qualified Hong Kong company.

#### **Pitfalls ... legal system**

When looking at the legal framework by which China operates, it should be remembered that it is only since 1979 that there was a necessity for China to develop any real concept of commercial laws. Prior to then, all industries were state-owned,

property was state-owned, and there was no foreign investment. The only real laws at that time were criminal laws. With the re-opening of China's borders in 1979, the need for a system of laws to regulate interaction with foreign investors slowly began to develop.

One of the most frequent and frustrating aspects of seeking legal advice in China is that, in many instances, there is no law on the issue; or the law is so vague as to be open to a variety of interpretations. This is too frequent an occurrence for it not to be intended. In being so structured, there are a lot of 'grey' areas within which the Chinese government can operate with discretion on a case-by-case basis.

Equally of concern, judges were purely political appointees rather than legal appointments. Not until 2002 were judges required to possess any legal qualifications.

#### **Pitfalls ... copyright laws**

For many years in China, there was little in the way of domestic development of properties to which intellectual property rights could attach. Rather China survived by riding on the intellectual property creations of other countries. Since the re-opening of the Chinese economy, matters have taken a turn for the better. The inflow of foreign investment has led to an increase in domestic production of intellectual property such as music records. This in turn, however, has attracted pirates to domestic products, causing domestic companies to suffer losses in sales.

In the face of mounting pressures externally and - more recently - internally, the Chinese government amended its copyright law of 1990, implemented new copyright regulations, and supported judicial interpretations of the laws by China's Supreme People's Court.

Under China's amended copyright law, Chinese courts now have the power to order confiscation of illegal gains and pirated copies. Copyright issues relating to the Internet have also been addressed for the first time in the amended law. In addition, the new regulation equalises the copyright protection of foreigners and Chinese nationals and improves the handling of administrative disputes over copyrights concerning foreign parties' ownership.

But, despite these efforts by the government, there are still complaints that the enforcement measures are weak and ineffective, and that many factors still weigh against successful litigation through the Chinese legal system.

#### **Pitfalls ... piracy**

This poor enforcement is clearly evident to anyone visiting large cities in China as pirated CDs, VCDs and DVDs are readily available to consumers in retail outlets and on the Internet for illegal download.

Currently, piracy accounts for 95% of all music sales in China. Piracy is not a new problem - rather its origins go back 20 years. In the 1980s, the Chinese government strictly controlled all forms of expression. Pop music was considered Western and bourgeois. Consumers who wanted to listen to Western music had to buy pirated or smuggled cassette tapes. Due to many factors (principally the lack of legal framework to combat piracy and, more importantly, the lack of will on the part of Chinese officials to prosecute these cases), piracy in China became rampant; to the point where it is now recognised as a real threat to the economic development of China. Thus, the piracy situation in China is unique in that it is not destroying an established record industry (such as in the US and in Europe), but rather the record industry is trying to make its way in a culture where music piracy was the only way to distribute music, particularly Western music.

Since the disregard of copyright is already so deeply engrained in Chinese culture, it is difficult for the Chinese government to eliminate the piracy problem. To illustrate just how deeply engrained it is: Chinese producers and sellers of pirated journals have been linked with some of China's largest and best-known publishers and over half of all copies of academic journals found in university libraries within China are unauthorised copies. Another reason why piracy has continued to flourish for such a long time is that consumers themselves face financial barriers in buying legitimate CDs. A legitimate CD in China costs on average between US \$3-4, whereas a pirated CD only costs US\$1.

The Chinese government recognises the threat which piracy poses to its economy. In 2001, more than 20,000 raids were reported to have been carried out by Chinese authorities and more than 114M illegal audio-visual products were seized during

these operations . These numbers are, however, but a drop in the proverbial ocean. Regardless, even with a 95% piracy rate, China is the fifth largest music market in Asia, and certainly the market with the largest growth potential.

#### Pitfalls ... censorship

All audio and audiovisual products are subject to strict scrutiny by the Ministry of Culture before they are allowed to be published, reproduced or imported into China . Audio and audiovisual products sold in China which comprise content that oppose the basic principles of the Chinese Constitution - such as advocating cults or superstitions or promulgating obscenity - are strictly censored by the Chinese authorities . This censorship policy is far more stringent than elsewhere in the world (e.g. Hollywood).

Before a record is released into the local market, lyrics are required to be approved by the Ministry of Culture. A record company must submit for approval to the Ministry of Culture a translation of any foreign lyrics along with the music sheets for the sound recording. Any lyric that is regarded by the Chinese authorities as unsuitable for public consumption will be rejected. For example, one of Asia's leading pop divas, Faye Wong, was recently requested by the Chinese authorities to remove one of her songs from her soon-to-be-released album as the lyrics referred to opium. Another good example of the extent of the Chinese government's censorship was the case of the Rolling Stones who were ordered to drop four of their best-known songs from their intended concert tour of China . The same songs were also ordered by the Ministry of Culture to be removed from the Chinese release of the band's last compilation album, 40 Licks.

Not only have China's strict censorship policies affected record companies and artistes but also the choice of music available to Chinese consumers on the legal market. Record stores in China are mostly stocked with made-in-China packaged pop bands and some Hong Kong or Taiwan pop. This is not because of the lack of market for Western pop music but because only a few foreign artistes (e.g. Mariah Carey) have been able to pass the government-approved censors.

Some have said that despite the efforts of the Chinese government in protecting its citizens from negative influences coming from outside of China, these efforts are

undermined by the lack of control over piracy: the censorship of content only affects foreign owners and their legitimate Chinese partners; it has no bearing on pirates.

In more recent years, China has heightened its censorship policies to scrutinise the vast content now made available to the Chinese public via the Internet. In fact, China is now said to have the most extensive Internet censorship in the world. Internet cafés are required by the Ministry of Culture to install software onto their computers to block Internet users from accessing blacklisted websites and more than 30,000 people have been employed by the government to keep an eye on websites, chat rooms and private e-mail messages .

Not only, therefore, is censorship a key issue in China for foreign record companies looking to participate in the music market, but it is also a problem which will remain a key barrier to the development of the entire music industry of China.

#### **Pitfalls ... entry barriers**

As briefly summarised above, China's investment laws greatly restrict the ability of foreign media concerns from entering China's music market. Under the current investment laws, a foreign record company can only establish a presence in China to manufacture records by way of a joint-venture with an approved domestic publisher or a local company engaged in the reproduction business . To ensure that foreigners do not have control over such sensitive media markets, the Chinese government further restricts foreign record companies from holding majority shareholdings by imposing a maximum 49% interest in any joint-ventures . With regards distribution of sound recordings in China, similar restrictions are also imposed on foreign record companies . It is opined that these restrictions have prevented foreign record companies from being able to promote their own artistes due to the controlling powers of their local partners . However, despite all such restrictions, foreign record companies still seem to favour joint-ventures over 'one-off' licence deals with local companies as joint-ventures can provide record companies with closer control over the timing of record releases; an essential factor on record sales in a highly pirated market.

As mentioned, importing and publishing of records in China can only be undertaken through contractual relationships with authorised state-owned entities. The Chinese

government further controls the number of music records imported each year by issuing quotas to these authorised state-owned entities. Thus, foreign record companies can only obtain a quota for the publication of records in China after they receive requisite censorship approvals from the government if they enter contractual relationships with those authorised state-owned entities.

Nonetheless, foreign record companies are still in a better position than foreign music publishing companies as foreign music publishers are not permitted to set up businesses in China. This is because the Chinese government does not understand and separately define the business of music publishing from the business of book publishing, which falls within the category of a 'prohibited' activity in China.

#### **Pitfalls ... foreign currency control**

Even if profits are made from joint-ventures, foreign investors may have difficulties taking their money out of China due to strict foreign exchange controls imposed by Chinese laws.

For instance, according to the laws regulating Chinese-Foreign Equity Joint-Ventures and the Regulations on Foreign Exchange Control, foreign investors may repatriate abroad funds received from their joint-ventures after a resolution of profit distribution by their joint-ventures' board of directors has been issued and all relevant documents have been submitted as required by Chinese laws. It might appear that remitting profits abroad would be a straight-forward paper task; however, actual practice suggests differently. Many foreign investors are concerned with submitting documents to Chinese government authorities as they are afraid that such documents may reveal to the authorities aspects of their joint-ventures' financial structure which may not be strictly permitted by Chinese laws. For example, Chinese-Foreign Joint Ventures engaged in the reproduction business must be partnered with domestic publishers or local companies engaged in the reproduction business. In reality, however, many of these local partners are largely dormant or inactive in the joint ventures and may participate in name only.

#### **Market factors ... Chinese consumers' appetite for Western music**

When China reformed its market and opened to the world, it initially intended to focus on improving the economy; but it is now apparent that by so doing, China has



also reformed an entire generation of young Chinese who have grown up influenced by the West. Take a walk through the shopping malls of Shanghai, Beijing and Guangzhou and you will see that Western brands are very well represented – disturbingly, America’s favourite coffee franchise has even managed to find its way into the Forbidden City!

Recently, there has been a huge increase in radio stations broadcasting Western pop music. Western music has also begun to dominate music charts in major Chinese cities, and Chinese newspapers have begun to write about mainstream Western music. Results from a survey of Beijing music retail stores show that American and European pop accounted for seven of the 10 bestselling CDs.

However, some say that these results are misleading as Chinese pop music is still the most popular type of music in China. Much of the appetite for Western music has already been whetted by music from Taiwan or Hong Kong, which produce music that is similar in style, if not identical, to Western music.

#### **Market factors ... local pricing issues**

Music pricing in China is increasingly dictated by income per capita and rampant piracy. China’s spending power is still relatively low. Average disposable income is US\$95 per month; so most consumers cannot afford legal CDs priced as they are.

Many record companies are reacting to this pricing/piracy conundrum. In fact, some record companies put out two versions of the same album – a foreign original version (which sells for US\$14) and a local Chinese version (which sells from US\$1.8 to US\$7). However, results show that none of these pricing strategies match the market’s desire for the US\$1 pirated CDs. It is due to piracy issues that China’s music retail market has now become very price competitive to a point where CDs sell at near marginal costs.

#### **Spread of the Internet and the mobile phone in China – an opportunity or threat?**

One of the key questions currently facing record companies is whether there is sufficient market in China for them to offer music services via phone handsets and on the Internet.

Today, as detailed in the China Internet Network Information Centre's latest biannual report, Internet bandwidth has grown almost 20 times within the last two years. Internet users have also grown at an extraordinary rate. As of January 2003, there were 59.1M Internet users in China, mainly concentrated in China's larger cities. Most of these Internet users go to Internet cafés as the number of home computer owners is still very low and fixed telephone connections in many areas are very slow and expensive.

China has the world's largest mobile phone market (surpassing each of the US and European markets) with 250M mobile phone users. According to George Huang, vice president of Nortel Networks (China) Ltd., the number of users is expected to double to 500M by 2007 with currently four to five million new subscribers per month.

Not only do music industry players in China have to develop strategies that can match the pace of the Internet and mobile phone development, but they also have to deal with problems which have so far prevented them from maximising their profitability in the market. For example, most websites in China contain a high degree of pirated content. A search for "MP3" through a China search engine would render a flood with links to sites offering pirated materials. Even Sina.com and Sohu.com, two of China's leading websites (both of whom are listed on NASDAQ) were alleged to have unauthorised copyrighted materials on their websites.

Record companies have attempted to fight against this particular brand of piracy to secure their foothold in the market. In March 2000, several large record companies successfully sued two Chinese websites for offering unauthorised reproduction of MP3 files. In support of this fight against piracy, the Chinese government has also issued warning notices to local ISPs whose servers have been used for unauthorised file-sharing and website downloads, and has also commenced education programmes to teach the public about the concept of copyright.

It is still doubtful, however, whether these measures will have any real impact in stemming the growth of Internet piracy.

#### **Market factors ... one-way or two-way traffic?**

The picture painted above may not seem very encouraging. However, there is still

confidence amongst record companies in the musical talent within China. Many young Chinese artistes are influenced by Western styles of music. For example, Jay Chou and David Tao both combine R&B and other Western styles into Chinese pop music. They are both currently leading the way in Asia's music industry in terms of popularity and trend. Perhaps the most visible and successful Chinese talent in the international market to date is pop diva Coco Lee. She released an English album (Just No Other Way) on the Epic/550 label in 2000 and performed at the Academy Awards in 2001.

With such a large population, China is definitely one place that is not short on talent. Together with the continuous opening of the Chinese market and the exposure of Western music to Chinese audiences, Chinese musical talents will undoubtedly be, if not already, attractive targets for international record companies.

#### **Current market trends ... record companies' position in the market**

Over the past decade, the Big Five record companies have established representative offices in China. Sony Music is currently the music industry leader establishing the first Chinese-foreign joint record company in China, Shanghai Epic Music Entertainment in 2001. It is estimated that this joint-venture currently holds a 20% market share of legitimate international sales .

EMI is not far behind Sony Music. EMI entered the China market in 1992 by opening a representative office in Beijing and utilised this office to license local companies to sell and distribute products. In 2003, EMI set up a joint-venture in Shanghai to market and distribute all EMI products and to sign, record and promote local artistes.

Foreign music publishing companies, however, have, so far, only been able to take advantage of China's music market by signing non-exclusive agreements with the Music Copyright Society of China (MCSC), a collection society. MCSC offers licences for mechanical rights to original recordings, cover versions, Internet and synchronisation usages in China, and distributes royalties back to the publishing companies.

Today, very few albums - either foreign or local - sell more than 500,000 legal copies in China . Sales have significantly dropped (e.g. an album of Cheung A-Mei, a

Chinese pop diva, sold nearly 1M copies in China back in 1997). In fact, due to the rampant piracy in the Chinese market, on some releases, even sales of 3,000 copies are deemed acceptable.

Not only do record companies today recognise that they have to deal with a volatile market in China, but they also recognise that the music industry has to cope with the evolution of its product format from being a packaged consumer good to a purely digital format. However, any change in strategies by major record companies to address these market conditions in China have, on occasion, been hindered by positions taken by their parent companies in the United States and Europe; markets where broadband and mobile networks may not be as evolved as those in Asia.

#### **Current market trends ... change of strategies**

Rampant piracy and low retail prices in China have caused both record companies to change their business strategies and music artistes to adapt their career strategies, as neither is receiving adequate revenue from record sales. In fact, there are less than 20 local albums produced per year in China. This is not surprising when a label is said to earn only US\$4,831 if a 10-song album sells 100,000 legal copies!

In response to this, foreign record companies have adopted a 'survival strategy' for the China market. They have largely abandoned the classic album format, formal distribution channels and eliminated a Top 40 chart based on sales. Instead of signing an artiste based upon anticipated sales, record companies are now contracting with artistes to manage all aspects of their careers, which include arranging promotional events and negotiating product endorsements. To further counter the piracy, record companies in China are now more inclined to record single songs for radio play instead of albums for consumers.

Artistes are also adapting their career strategies to rely almost exclusively on live appearances (either in concerts or tours) and product endorsements. Concerts in China are now mostly sponsored by large companies who underwrite the entire cost of concerts and pass out tickets to the public for free. Due to this change in focus from records to concerts, records are increasingly viewed as promotional tools.

### Conclusion

As the world's most populous nation, with year-on-year high single digit growth in GDP, and with Beijing hosting the 2008 Olympic Games and Shanghai hosting the 2010 World Expo, it is undoubtedly true that China is on the hit-list for every foreign investor. Whether these investors will ultimately achieve any positive returns remain to be seen. It is clear, however, that for all companies in the music industry, China provides opportunities that cannot be matched anywhere else in the world, especially with the increase in popularity of Western music (particularly with live tours selling well - e.g. the Rolling Stones, Morcheeba, Suede) and the potential growth in the Internet and the mobile phone markets.

The challenge for foreign record companies is to lobby the Chinese government to remove entry barriers and improve enforcement of copyright protections.

From a legal perspective, China today is much more accessible to foreign investors as compared to a decade ago. From a business perspective, however, China's market conditions are such that foreign media companies continue to struggle to capitalise fully upon the large population and exponential industrial growth. The challenge for foreign record companies is to lobby the Chinese government to remove entry barriers, improve enforcement of copyright protections and to build a more favourable environment for Internet development.

Whether or not these aims will be achieved within the near term is questionable. But, one thing is certain: China is moving in the right direction, a direction which should allow foreign record companies greater access to the China market.

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Haldanes

[www.haldanes.com](http://www.haldanes.com) (This article was written with the assistance of Edith Lam.)

### The Sixties and the Seventies

At the height of the Cultural Revolution, Western culture was viewed as spiritual pollution and was banned in China. Musical compositions & performances were also greatly restricted. After the Cultural Revolution ended, musical institutions were reinstated, and musical compositions and performances were revived. Foreign music was also slowly made available to the public after economic and social reforms began in the late 1970s. Piracy began to grow in China. Previously banned Western jazz and rock 'n' roll music were performed and received increasing acceptance among youths.

### From the Eighties onwards

**In 1980**, China became a signatory to the World Intellectual Property Organization (WIPO).

**In 1982**, China passed its first Trademark Law.

**In 1984**, China passed its first Patent Law.

**In 1985**, China joined the Paris Convention for the Protection of Industrial Property.

**In 1987**, the General Principles of Civil Law were passed and intellectual property rights were for the first time clearly defined as part of the civil rights of citizens and legal persons.

**In 1989** - Tianamen Square incident - pro-democracy demonstrators gathered together in Tianamen Square to protest, claiming their right to free speech.

**In 1990**, China passed its first Copyright Law.

**In 1991**, China passed its first Software Protection Law.

**In 1992**, the Music Copyright Society of China was established and became the only officially recognised collection society in China.

**In 1992**, China joined the Berne Convention for the Protection of Literary and Artistic Works, the Geneva Phonograms Convention, and the Universal Copyright Convention.

**In 1993**, China passed its Unfair Competition Law. Its objective was to safeguard the socialist market economy, to encourage and protect fair competition, and to protect rights of businesses and consumers.

**In 1993**, the Chinese government established special courts in China's major cities specifically to handle intellectual property cases.

**In 1993**, China became a member state to the Convention for the Protection of Producers of Phonograms Against Unauthorised Duplication of Their Phonograms.

**In 1994**, China joined the Patent Cooperation Treaty.

**In 1994**, China's Criminal Code was revised, establishing "the crime of infringement of intellectual property."

**In 1999**, China became a party to the Trade-Related Aspects of Intellectual Property Rights Agreement.

**In 1999**, the Chinese authorities severely cracked down on piracy and confiscated 20M pirated works, 4M of which consisted of pirated audio - visual products and electronic publications.

**In 1999**, the "Administrative Measures on Import of Audio - Visual Products" was introduced. It standardised the procedures to the import of audio-visual products and enhanced the protection of intellectual property rights in audio-visual products of foreign countries.

**Between 1997-2000**, the number of cases handled by the National Copyright Administration (NCA) in China increased by 80% (NCA regulates copyright and handles all administrative copyright infringement issues), and the number of copyright suits accepted by the Chinese courts jumped by 175%.

**In 2000**, the Chinese government increased censorship policies due to the development of the Internet, and announced new restrictions on websites offering news reports and required chat rooms to use only officially-approved topics.

**In 2000**, Chinese and foreign record companies jointly issued a "declaration on protecting copyright and opposing piracy." Twelve record companies, both local and foreign, announced a campaign against violations of music copyrights on the Internet and listed offending Websites in China.

**In 2001**, China became a member of the World Trade Organization.

**In 2001**, China amended its existing copyright & trademark law to strengthen the protection of rights owners and China's enforcement measures.

**In 2001**, Chinese authorities seized more than 114M illegal audio-visual products, including 48M copies smuggled from overseas.

**In 2002**, China implemented new regulatory regimes for copyright & trademarks in support of its newly amended laws.

**In 2002**, the Chinese government introduced administrative regulations to monitor the foreign investment activities in China and revised the Catalogue for the Guidance of Foreign Investment Industries, which widened the industry sectors that were open to foreign investors in China.

**In 2002**, music piracy accounted for 95% of the total music sales in China.

## COMMENTARY

By John Kennedy - President/COO of Universal Music International

This article on China by John is a comprehensive and fascinating introduction to the problems, perils and opportunities in this market. As I read through his words and he reminded me of the restrictions, the inadequate laws, the potential inefficiency of the judicial system, the piracy and the censorship, I was reminded of a child being told by its parent not to put its hand in the flame.

I know that I may well get burnt but it is impossible to resist this market. Piracy and low prices suggest that it is difficult to make any money but how can any businessman ignore a population of 1.3B people, 370M households, a middleclass of 300M people and the children of that middle class with lots of disposable income.

The optimistic commercial operator sees the glass half full. I think of the 250M mobile phones (five times the UK and twice the US) and the 75M Internet subscriptions - seven times the UK and half the US and I just can't resist.

It may be that the biggest solution to piracy in China is for music companies to harness the mobile phone and Internet billing relationships. It is also a market which has huge potential for TV promotion and perhaps the most commercial opportunity will be the music reality TV shows in the Popstars/Pop Idol genre. Last but not least China offers huge potential, public performance and broadcast revenues - just imagine if the music industry could license those 400,000 karaoke bars at €500 per year!

With all the woes the music industry is facing, the potential of the Chinese market and the creative talent that is surely there to be discovered means that even the most cautious operator will want to put his/her hand in the red flame. The risk/reward ratio makes it worth the gamble - but it is undoubtedly a gamble. However - nothing ventured, nothing gained!



## COMMENTARY

David Munns, Vice-Chairman EMI Music

For any venture to be successful in China there needs to be a great understanding of their culture - or an honest admission that you don't understand it. Local management involvement is vital not only because of local custom but also in the lobbying effort. The Chinese government needs to change the laws protecting intellectual property and, more importantly, make more of a commitment to enforcing them.

I am always amazed about the lack of cross industry cooperation towards China as piracy there is a menace to so many. The US government and Brussels need to be more determined with sanctions as we lead up to the Olympics when the world spotlight will be on China's behaviour.