

GAPP Issues Notice Further Restricting Foreign Participation in China's Internet Gaming Industry

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INTRODUCTION

On September 28, 2009, the PRC General Administration of Press and Publication (“GAPP”), National Copyright Administration, and National Office of Combating Pornography and Illegal Publications jointly published the *Notice Regarding the Consistent Implementation of the “Stipulations on ‘Three Provisions’” of the State Council and the Relevant Interpretations of the State Commission Office for Public Sector Reform and the Further Strengthening of the Administration of Pre-examination and Approval of Internet Games and the Examination and Approval of Imported Internet Games* (Xin Chu Lian [2009] No. 13, “Notice 13”). Notice 13 restates the general principle espoused in recently promulgated regulations that foreign investment is not permitted in Internet game operating businesses in China. In addition, Notice 13 expressly prohibits foreign investors from using contractual or other control arrangements to gain control over domestic Internet game operators.

This is the first time that Chinese authorities have expressly prohibited the contractual and other control arrangements that have been used to facilitate foreign investment in certain industries in China. To date, it has been common for foreign investors to employ a series of operating, technical service, and share pledge or call option agreements to address domestic ownership requirements and other restrictions on foreign investment in these industries. Investment structures in the Internet sector have typically used such arrangements between a wholly foreign-owned domestic subsidiary and a domestic license-holding operating entity to help ensure control of the latter so that the operating entity's revenues can be consolidated for financial accounting purposes based on “variable interest entity” status with those of the foreign-owned subsidiary (the “VIE Model”).

Prior to the publication of Notice 13, PRC regulators had tacitly permitted use of the VIE Model in a number of industries where foreign investment is restricted, such as advertising, tourism, and businesses requiring value-added telecommunications licenses (including Internet-related businesses, and in particular, online gaming). No Chinese laws or regulations expressly prohibited use of the VIE Model, and it has been possible to obtain reasonably qualified legal opinions from PRC law firms confirming the legality of VIE arrangements in connection with offshore listings of companies operating domestic businesses in such restricted industries. As a result, a significant number of Chinese companies have utilized the VIE Model to structure offshore pre-IPO financings and later become listed on U.S. and Hong Kong stock exchanges. The enactment of Notice 13 on its face calls into question the feasibility of the VIE Model in the Internet gaming industry and potentially other industries in China where foreign investment is restricted. We highlight below key aspects and certain regulatory background relating to Notice 13, and consider its effect on foreign investment in China going forward.

1. Notice 13 Highlights

- Article I of Notice 13 defines “Internet games” as “all Internet game products provided to the public for mutual online use or for downloading through the Internet (including cable and mobile Internet).” The definition includes “without limitation” MMORPG games, Web games, casual games, downloaded stand-alone games, games with interconnecting functions (multiplayer games), web-based war game platforms, and mobile phone Internet games. “Imported” Internet games are defined as those licensed by overseas copyright owners.
- Article II states that GAPP is “solely” responsible for pre-examination and approval of Internet games as authorized by the central government and State Council, and that the provision of Internet games either online or on a downloaded basis constitutes Internet game publishing, which is subject to pre-examination and approval by GAPP. Under Article II telecom operators are further prohibited from providing Internet access for Internet games that have not been pre-approved and examined by GAPP, and GAPP is authorized to issue an order suspending operations with non-pre-approved games, as well as to conduct investigations and impose legal sanctions. In extreme cases, GAPP is authorized to revoke the relevant licenses and registrations of non-compliant Internet game operators. Interestingly, other government departments are prohibited from re-examining games that have received GAPP pre-examination and approval. It is generally understood that Article II seeks, among other things, to prevent Internet game operators from relying on Internet publishing licenses held by third parties, a practice that was widespread during a period of time when GAPP was not granting such Internet publishing licenses. It is also understood that GAPP has recently resumed issuing such licenses, and therefore GAPP intends to enforce the requirement that Internet game operating companies obtain Internet publishing licenses directly from GAPP.
- Article III confirms that GAPP holds authority for examination and approval of imported Internet games, and that central-level GAPP approval is required before imported games can be offered to the public by Chinese game operators. Under Article III, GAPP holds similar sanctions powers with respect to imported games as those noted above.
- Article IV of Notice 13 expressly prohibits foreign investors from participating in Internet game operating businesses via wholly owned, equity joint venture or cooperative joint venture investments in China, and from controlling and participating in such businesses directly or indirectly through contractual or technical support arrangements. Article IV further prohibits the use of user registration, account administration or point-cards to enable access to Internet games or war game platforms which are de facto controlled or owned by foreign investors, as a means of permitting foreign investors from controlling or participating in online gaming operations and services.

2. Regulatory Background

It is generally understood that Notice 13 represents GAPP’s response to the enactment of the *Regulations on the Main Functions, Internal Organization and Staffing of the PRC General Administration of Press and Publication* issued by the State Council on July 11, 2008 (“Regulation”), the corresponding interpretation thereof issued by the State Commission Office for Public Sector Reform on September 7, 2009 (“Interpretation”), and public comments thereon by Ministry of Culture (“MOC”) officials last month.

The Regulation and Interpretation were expected to dispel uncertainties as to which Chinese agency had jurisdiction for approving the establishment of Internet game operators. Before the enactment of the Regulation and Interpretation, MOC and GAPP had both claimed jurisdiction over Internet gaming operations and separately required applicants to file applications with their respective departments to operate online gaming enterprises.¹ These overlapping application procedures had been in existence for a number of years and were seen as redundant and burdensome by some applicant companies. The Regulation and Interpretation streamlined the process by authorizing the MOC to regulate the online gaming industry overall, while granting GAPP the authority to grant licenses for the Internet publication of online games.

Notice 13, which GAPP appears to have promulgated without involvement from MOC, continues the debate regarding jurisdiction over the Internet gaming industry by suggesting that GAPP not only has the authority to grant licenses for the

Internet publication of online games, but also jurisdiction to regulate aspects of online game operations, including prohibiting the use of the VIE Model.

3. Implications of Notice 13

While Notice 13 appears on its face to prohibit the VIE Model frequently used for investment in the Internet gaming industry, its implementation in practice raises a number of questions:

- First, while GAPP has the authority to grant licenses for the Internet publication of online games pursuant to the Regulation and Interpretation, it appears that the Regulation and Interpretation do not give GAPP authority to regulate the operational aspects of online gaming enterprises, since MOC retains overall administrative authority thereunder. To that extent, Notice 13 may conflict with the Regulation and Interpretation. As a result, it is unclear whether GAPP holds the administrative jurisdiction to enforce the prohibition of the VIE Model that it contemplates.
- Second, Notice 13's restriction of the use of the VIE Model is unprecedented, and it bears noting that other Chinese government agencies whose participation and assistance would be critical for effective enforcement of its prohibitions, such as the Ministry of Commerce, the National Development and Reform Commission, and the Ministry of Industry and Information Technology, did not join GAPP in issuing the Notice. The views of these bodies will be important in clarifying the scope of implementation and enforcement of Notice 13.
- Third, it appears that the promulgation of Notice 13 was, to a significant extent, a reaction to recent actions by certain foreign gaming companies in cooperation with domestic industry players. The restrictions on foreign investors (外商) are broadly written and on their face do not distinguish between strategic industry players and financial investors. As a result, it is unclear whether Notice 13 is intended to target primarily foreign game companies, or also the private equity and venture capital investors who continue to invest actively in the Internet game sector in China. In either case, however, investment or licensing arrangements that give rise to de facto control or participation in Internet game operation services by the foreign party are likely to present issues under Notice 13.

4. Conclusion

If applied literally and uniformly, Notice 13 would render the VIE structure used by gaming portals and many other Chinese companies that are listed overseas invalid and illegal. However, the Notice has not yet been endorsed by other PRC government authorities, most importantly MOFCOM, whose support will be necessary for meaningful implementation and enforcement. Consequently, it would be premature to write off the VIE Model at this stage. Notice 13 is one in what is likely to be a continuing series of regulatory pronouncements in this area, and further regulations/notices are needed to clarify the issues it presents. We will continue to monitor the situation on behalf of our friends and clients. For a full version of the Chinese text and an unofficial English translation of Notice 13, please visit this [website](#).

If you would like further information regarding the issues discussed in this update, please contact:

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¹ MOC claimed its approval jurisdiction under the Provisional Measures on Administration of Internet Culture issued by MOC, which became effective in July 2003. GAPP claimed its approval jurisdiction under the Provisional Measures on Administration of Internet Publications issued jointly by GAPP and the Ministry of Industry and Information Technology; this came into effect in August 2002.

The information made available herein is for informational purposes only. While we hope and believe the information will be helpful as a background matter, please note that it is general in nature and does not purport to cover the many issues that can arise in each specific transaction, and may not apply to particular factual or legal circumstances. The information does not constitute legal advice and should not be relied on as such.