Corporate & Securities

Corporate & Securities - Technology   China

November 14, 2012

Will China's Transition of Power Threaten Foreign Internet Content Providers?

By Thomas M. Shoesmith

China is tightening enforcement of a wide range of rules and regulations affecting foreign business in advance of this month's transfer of power. This is not unusual but it can catch foreign companies off guard. It's a good time to be sure your papers are in order.

Thousands of companies do business in China either entirely or partly through their websites. If the website is hosted on a server located in China – whether the domain name is .com, .cn or something else – it almost certainly requires the operator to hold an internet content provider (ICP) license. And only Chinese nationals can hold ICP licenses.

This is not new, but it poses several challenges. If the uncertainty that always comes with a transfer of power means Beijing is tightening the screws, those challenges could be serious. Foreign companies should review their operations and operating licenses to be sure everything is as tight as possible.

The VIE Structure

ICP licenses are for all practical purposes available only to 100% Chinese-owned companies or Chinese individuals. This forces international internet-reliant companies to use a variable interest entity (VIE) structure in which the ICP license is held by an affiliated but independently owned Chinese company, tied to the foreign company by a web of contracts.

The VIE structure for internet companies goes back to the late 1990s, when SINA pioneered the approach. Since then it has been used by hundreds of companies, public and private. But because the structure exists in a "gray area" under PRC law, there has always been some uncertainty about its viability.

Six years ago, Beijing sent a chill through the internet community when the PRC Ministry of Information Industries (MII) issued its *Notice Concerning Strengthening the Administration of Foreign-Invested Value-Added Telecommunications Business Operations*, suggesting it would be taking a close look at VIE structures used by internet companies. The industry took this as a cautionary signal, but not a prohibition, and the use of the structures continued. In fact, the 2006 M&A Rules, issued at about the same time, may have driven even more companies into VIE structures by prohibiting "round trip investments," which up until then were a part of the venture capital financing for hundreds of PRC startups, many of them internet companies.

The second warning shot came in the internet game sector. In September 2009, the PRC General Administration of Press and Publication (GAPP), the National Copyright Administration and the 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 [relating to] Internet Games, etc.* That Notice was perhaps the clearest official confirmation that the PRC government was well aware of VIE structures and their use, and knew exactly how to prohibit them when it wanted to: the Notice flatly prohibited the use of technology support or other agreements to give foreign investors control over internet game operations services in China.

Still, the use of VIE structures continued to mushroom. By 2010, more than 100 Chinese companies listed in the U.S. used the structure, along with dozens if not more foreign companies operating in China.

Then came the scandals among U.S.-listed Chinese companies, followed by the lawsuits and the SEC investigations. Sometimes the VIE structure was at the heart of the problem. Sometimes it was an innocent bystander. In either case sensitivities were heightened in Beijing as attention was focused on a structure that seemed to exist in the legal shadows.

In 2011, Beijing issued new regulations imposing a "national security review" requirement on foreign investment in China. By itself this was not alarming; the U.S. has a similar requirement through the Committee on Foreign Investment in the United States, or CFIUS. But the hundreds of internet and other companies relying on the VIE structure saw ominous portents in the clear language of the new regulations which called out "contractual and other methods of control" as equivalent to outright acquisition. And if the two were treated the same, then foreign investment in the internet would be brought to a full stop.

At about the same time that the national security review rules were becoming effective, a memo leaked from the China Securities Regulatory Commission (CSRC) stating without equivocation that VIE structures existed in violation of PRC law. This prompted calming statements, not for attribution, from the Ministry of Commerce, and after several months with no prosecutions the foreign internet community was able to breathe again.

All of this has left companies and their investors – not to mention the markets generally – leery of China-related internet companies. Valuations have been impacted, and executives have had to answer questions about possible enforcement actions, lawsuits by founders as well as the private securities bar, and the risk of regulatory action from Beijing.

Why does the transition of power in China affect this situation? Because for almost 15 years the VIE structure has succeeded because regulators tolerated the arrangement in order to attract foreign investment and permit China to play in the online economy. Discretionary enforcement like this always opens a government to Puritanical critics seeking to embarrass the people in power and gain political advantage. Risk of criticism inevitably leads regulators to discover a new enthusiasm for enforcement.

What can you do?

- *Keep a low profile*. The Japanese saying is, "the nail that sticks up gets pounded down," and this is equally true in China. This is not the time to announce the expansion of your internet operations in China.

- *Maintain respectful relations with the regulators*. The regulators are under pressure from their political environment. Don't add to their pressure.
- *Be sure your VIE papers are in order*. Many internet companies regard the VIE structure as just paper in a drawer. It is true to some extent that the structure is tolerated as "form over substance." But if you do not even respect the form, you are inviting disaster. The structure calls for certain procedures to exercise control over the VIE entity; exercise them and document the exercise. The structure calls for the transfer of pre-tax profits from the VIE entity to the wholly owned subsidiary (WFOE); transfer the money. The structure usually includes a stock pledge; don't let it expire; register it with the government. Don't be the excuse someone else uses to embarrass the regulators who let you exist.
- *Consider improving your VIE structure*. If your VIE documentation is old or ambiguous, tighten it up. Attention to form indicates you respect it. Lack of attention signals lack of respect. After the power transitions in Beijing are over, look at the ownership of the VIE entity. If your entire structure is highly incestuous, it invites criticism. Replace outdated documentation with newer, better versions. Now is not the time to change things, however. See the first bullet point, above.

The Details of the License

Foreign investors often leave the details of regulatory compliance in China to local management. This generally makes sense. Complying with China's hyper-complex regulatory scheme is mind-numbing and very "Chinese." This is a good time to make an exception to your general approach.

Lax regulation, like discretionary enforcement, is a favorite weapon for political opponents. That means the people now in office – the people who are currently looking over your papers – are turning up the gain on their enforcement activity. Now is not the time to discover your license has lapsed, or that it covers only three of the eight domain names you use, or that the names on the license don't match the names of the people now in the company. If something needs updating, get to the regulators before they get to you.

Politically Sensitive Internet Businesses

Finally, keep in mind that the entire internet is a political time bomb for the authorities in China. Beijing has been managing a rocket-like transition from a control economy to the free market, and from totalitarianism to … well, to something; no one knows what or when. Mao Zedong wrote in 1930 that, "a single spark can start a prairie fire," and he went on to prove he was right. The lesson has not been forgotten. The leadership in Beijing continues to keep a close eye on any organization, process or industry that permits rapid and widespread dissemination of information – media, internet, blogging, tweeting, direct marketing, Falun Gong.

The internet continues to evolve in the direction of interaction. E-commerce is gamifying. Social networks are proliferating. All of these developments provide a virtual forum for the spread of information and opinions. This is good for business in China but a problem for politicians.

There is nothing you can do about the political sensitivities in Beijing. But you can be aware of the leadership's concerns and respectful of the political pressure they are under. See the first bullet point above.

Is It Time to Panic?

No. China needs the internet because the global economy, and therefore the Chinese economy, depends on it. Beijing is not going to shut down an entire industry, no matter how difficult a political transition. But that doesn't mean some internet company won't get picked for extra attention, to demonstrate the willingness of the people in power to enforce the law, or as a way to signal the rest of the industry to be more discreet. Your goal is to avoid being that company.

To return to a Japanese saying, "be like the bamboo; when the wind comes, bend with it." The current unease in China around the transition of power is a reminder that the PRC is a complicated place in which to do business, where the unwritten is as important as the written. This time will pass. The internet will not.

If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or the author listed below.

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