Worst Seems to Have Passed for Online Game Operators

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Worst Seems to Have Passed for Online Game Operators
Dispute Resolution
— New Development in Governmental Regulation over Online Game Industry of China

By Liang Tao

On August 17, 2010, NetEase.com Inc. ("NetEase"), a NASDAQ-listed company, made an announcement that the Wrath of the Lich King ("WLK"), an expansion pack of World of Warcraft ("WOW"), was available for download by players in mainland China. It indicates that NetEase has gone through all governmental approval procedures for the online operation of WLK which is an updated version of WOW. Such success in online operation of the WLK has a special meaning for the NetEase especially in view of the hard times of the NetEase in connection with the suspension of the online operation of former version of WOW, i.e., The Burning Crusade ("TBC"). The aforesaid suspension finally resulted in a severe public dispute between two competent authorities on their jurisdictions over the online game industry in China.

Furthermore, such success also clarifies the approval procedures required by relevant competent authorities in China and further sets up a clear and positive precedent for other online game operators in China to follow suit in respect of their operation mode and compliance program. The approval regime established by certain Chinese governmental authorities has been revealed by the NetEase case. In this way, other online game operators can handle their business in future on a more certain legal basis.

In addition, foreign investors are explicitly prohibited from investing in the online game industry in China in any way. However, at present, most of the big online game operators in China are controlled indirectly by their foreign holding companies, whose major shareholders are the relatively successful businessmen in the mainland China, through contractual arrangements in order to bypass the foregoing prohibition. What is more important to draw our deep attention is that most of such foreign holding companies have been listed in the stock exchanges of US or Hong Kong and shall fall within the scope of foreign companies under China’s legal system. Therefore, such online game operators may subject themselves to risk of penalties imposed by the governmental authorities. Although facing the risk in future, NetEase’s success in online operation of WLK still reflects that Chinese governmental authorities currently continue to tacitly permit the bypassing activities.

Jurisdiction War: MOC & GAPP

China’s online game industry suffered from the overlapping authority of the Ministry of Culture of the People’s Republic of China ("MOC") and the General Administration of Press and Publication of the People’s Republic of China ("GAPP"). The division of such jurisdictions of these governmental authorities was not clear enough which could be reflected to some extent from the public-known event that the severe jurisdiction war between MOC and GAPP broke out in November 2009. Such jurisdiction war resulted from the online operation of a famous online game, i.e., WOW.

WOW is one of the most popular massively multiplayer online role playing games developed and produced by the Blizzard Entertainment Inc. ("Blizzard"), a company incorporated in US, and currently operated by the NetEase within the territory of mainland China under the license agreement made by and between Blizzard and NetEase.

Since 2004, WOW has been introduced and operated in mainland China by The9 Limited, another NASDAQ-listed company, under a license agreement with Blizzard similar to the
The agreement entered into between Blizzard and NetEase at present. In 2007, The9 Limited was permitted by relevant competent authorities to commence the online operation of TBC. In April 2009, Blizzard announced that it would license the WOW to NetEase instead of The9 Limited. In accordance with relevant regulations issued by relevant competent authorities, the change in the operator of an imported online game shall be subject to the pre-approval of the competent authorities.

In May and June 2009, NetEase filed with the MOC and the GAPP respectively in respect of the foregoing change. In July 2009, the MOC approved the change in operator of WOW. Under the circumstance that GAPP had not approved such change in operator of WOW on September 19, 2009, NetEase initiated the online operation of WOW. On November 2, 2009, the GAPP notified NetEase that NetEase had violated relevant regulations issued by GAPP requiring the online operator to conduct pre-approval if such change in operator occurs. GAPP also suspended the online operation of the WOW upon the issuance of its notification. Such notification triggered a severe dispute between the MOC and GAPP on their jurisdictions over the online game industry. Only one day had passed after GAPP’s notification, on November 3, 2009, MOC held a conference meeting and complained that GAPP’s notification regarding NetEase had reached out of its jurisdiction defined by the State Council. In China, it is rare that two governmental authorities directly under the State Council blame each other publicly.

In a notice promulgated by the Office of the State Commission for Public Sector Reform on September 7, 2009 (“Jurisdiction Division Notice”), MOC was designated as the comprehensive regulator for online game industry and GAPP would be responsible for pre-approving the publication of online game before their launch of online operation. Jurisdiction Division Notice also set forth in detail that the MOC was not entitled to review the online game which had been approved by the GAPP. However, Jurisdiction Division Notice failed to clarify the definition of “publication of online game”. In this regard, MOC had the view that online game shall not be a publication and shall not be regulated by the GAPP. On the contrary, GAPP explained that online operation of the online game shall be a publication action and shall be subject to its pre-approval.

On February 12, 2010, the GAPP announced that the NetEase had obtained its approval and could start the online operation of WOW. It reflects that approvals from both MOC and GAPP shall be necessary although Jurisdiction Division Notice did not agree with dual approval by MOC and GAPP. In addition, according to public available information, NetEase has also obtained approvals from both MOC and GAPP in connection with online operation of WIIK. Hence, notwithstanding the existence of contrary provisions in the Jurisdiction Division Notice, it is advisable for online game operators to apply for approvals regarding the online games from both MOC and GAPP in future practice.

From the jurisdiction war mentioned above, it can be concluded that failing to comply with the requirements of relevant regulators may materially and adversely affect the healthy and efficient operation of the online game in China. Therefore, it is necessary and urgent for the online game operators to have a deep and comprehensive understanding of the current approval regime of online game industry in mainland China.

Approval Regime of Online Game Industry

As Online game industry is highly regulated in China, online game operators have to deal with cumbersome approval procedures prior to commencing the operation of online games and handle legal uncertainty during the operation of the online games. Many governmental authorities, including the MOC, GAPP, the Ministry of Industry and Information Technology of the People’s Republic of China (“MIIT”) and so on, have claimed jurisdictions over such sector.

Different from the companies engaged in business of other fields, the online game operators need to go through series of pre-approval procedures prior to conducting registration with the department of industry and commerce. Such pre-approval requirements can mainly be divided into two tiers: (i) requirements on the online game operators, and (ii) requirements on the online game. Only both of the two tiers approvals have been obtained by an online game operator regarding an online game can such operator start the online operation of such game. Online game operators in China are required to hold a variety of permits and licenses which, among others, include a value-added telecommunications business operating license for internet content provision (“ICP License”), internet culture operation license (“ICOL license”) and internet publishing license (“IP License”). Under current China laws and regulations, an operator providing internet content service for the purpose of making profit shall obtain an ICP License from appropriate telecommunication authorities, i.e., MIIT or local counterparts of MIIT, in order to carry any commercial internet content provision operation in China. In accordance with the Tentative Measure for Administration of Internet Culture, each ICP License holder that engages in the supply of internet culture products and relevant service, including provision of online games service, shall obtain the ICO License from the proper culture authorities, i.e., MOC or the local counterparts of MOC. The GAPP imposed a requirement to acquire the IP License for any company that intends to engage in internet publishing. As set forth, provision of online game was deemed an internet publication activity by the GAPP. Therefore, online game operators need to obtain an IP License in order to avoid the punishment imposed by the GAPP.

Apart from the requirements on the qualifications of the online game operators, MOC, GAPP and MIIT also impose further filing obligations in connection with the online games. According to the regulations issued by MOC, prior to starting their online operation, all imported online games shall be subject to its review and pre-approval and all online games developed by domestic companies shall be registered with MOC. GAPP requires that all online games shall be subject to its pre-approval before such online games are operated, regardless of whether they are imported form foreign countries or developed by domestic companies. Pursuant to the Measures for the
Administration of Software Products

issued and amended by the MIIT, soft-
ware products developed in the territory
of mainland China shall be registered
with the local provincial government
authorities in charge of the informa-
tion industry and filed with the MIIT. Upon
such registration, the software products
are granted registration certificates. In
view of the software nature of online
games, all of online games developed by
online game operators in China shall go
through the registration procedures with
MIIT or its local counterparts.

Feasibility of VIE Structure in
Practice

The Chinese government restricts
the ability for foreign investors to invest
in and operate in the online game busi-
esses. To bypass such restriction, many
foreign investors, which have been listed
in overseas stock exchanges and shall be
definitely classified as foreign compa-
ies under China's legal system, solely operate
online game in China through their vari-
able interest entities ("VIE"). VIE refers
to an entity, i.e. the investor, in which
the investor holds a controlling interest which
is not based on the majority of voting
rights. VIE structure is established for
the purpose of piercing the veil of invest-
ment policy stipulated by the Chinese
governmental authorities prohibiting for-
ign investors from investing into certain
industries.

Upon taking the following steps,
foreign investors can establish VIE struc-
tures and then actually engage in online
game industry which is currently not
permitted to be invested in by foreign
investors. First, foreign investors establish
subsidiaries which are foreign invested
companies and prohibited from operat-
ing online games according to China's
laws and regulations. Second, foreign
investors arrange for Chinese individu-
als or entities to establish companies in
China, i.e. VIEs, which shall be deemed
domestic companies and permitted
to operate online games in China. Last
but most important, the foreign investors
arrange its subsidiaries to enter series of
contractual arrangements with the VIEs.
Though such contractual arrangements,
these subsidiaries obtain the control and
management power of the VIEs and the
VIEs provide their benefits and profits
to these subsidiaries of the foreign inves-
tors. In this way, VIEs can operate online
games in China and then transfer their
revenues generated from the operation of
online game in China to the foreign in-
vester via the subsidiaries of these foreign
investors. At present, such VIE structure
is widely used by most of the major play-
ers in online game market of China, in-
cluding NetEase, The9 Limited, Perfect
World Co., Ltd and so on.

On September 28, 2009, the GAPP
and other competent authorities jointly is-
sued the Notice on Further Strengthening
on the Administration of Pre-examination
and Approval of Online Games and the
Examination and Approval of Imported
Online Games, a notice in connection
with the regulation of online game indus-
try with a document number of 13 ("Notice
13"). The Notice 13 not only restates that
foreign investors are not permitted to in-
vest in online game operating businesses
in China via wholly-owned, equity joint
venture or cooperative joint venture invest-
ments but also further expressly prohibits
foreign investors from gaining control over
or participating in domestic online game
operators through indirect ways such as
establishing other joint venture companies,
or contractual or technical arrangements. It
is the first time that a competent authority
explicitly prohibited the VIE structure that
has been widely utilized in online game
industry of China.

However, the GAPP recently ap-
proved the online operation of WLK which
is operated by NetEase which has adopted
the typical VIE structure to bypass the
foregoing investment restriction on foreign
investors. The NetEase case reflects that
the Notice 13 has not been implemented
strictly in practice yet and further constitutes
a precedent in favor of other foreign in-
vestors engaged in the online game industry of
China via VIE structure.

Opportunities and Challenges

In the event that there is a conflict
between the actual approval requirements
by the competent authorities and the pro-
visions of the governmental regulations,
the former shall prevail and the actual
practice experiences shall be attached
more importance than the results of theo-
retically reasoning.

The NetEase case reveals that ap-
provals from both MOC and GAPP are
required in order to operate online games.
Although the dual approval system is
onerosous, upon the NetEase case, the ap-
proval regime on online game industry
becomes clearer than before and avoids
the ambiguity. It paves the way for other
online game operators in China to seek
for approvals from competent authorities.

Although VIE structure can be
tacitly accepted by relevant regulators,
the foreign investors should better hear
in mind that there has been an obvious
provision prohibiting the VIE structure.
It is advisable for them to keep a close
eye on the development of the laws and
the industry practices in future and try
to adjust their corporate structure timely
in order to avoid being punished for such
reason.

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