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Foreign Investor Participation in Restricted and Prohibited Areas During Post-VIE Age

By Xun Yang

The Ministry of Justice issued a draft amendment to the *Implementation Rule to the PRC Law of Promoting Private Investment in Education Business* last week. The draft triggered great market concerns and cause a dramatic drop in stock price of these overseas listed companies which invest in China educational business. This is because the draft amendment will no longer permit foreign investment in China compulsory educational business via contractual controls.

In fact, this is not the first time, China attempted to restrict the use of VIE (an abbreviation to “Variable Interest Entities”) structure through legislations. The draft Foreign Investment Law which was issued last year imposed prohibitions on foreign investment, by using VIE structures, in sectors falling within a negative list (i.e., restricted or prohibited areas). If the drafts are adopted in their current forms and, thus, foreign indirect investment through VIE structure is disallowed, can foreign investors participate in restricted and prohibited areas in China?

The answer is positive. The law does not prohibit foreign participation in restricted or prohibited areas in China from all aspects. The question is how foreign investors should enter into the market and how they should participate in such business.

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I. A Historical View of VIE Structure

There has never been a piece of legislation explicitly permitting the use of VIE structure. Nor is there a government agency expressly endorse it. In fact, the creation of VIE structure has its historical background.

During the turn of the century, when the internet business just started to bloom in China, China internet companies wished to have venture capitals from overseas and to potentially get listed offshore. In this context, internet companies, overseas exchanges, and lawyers jointly studied and designed VIE structures vis-à-vis those internet companies which have Chinese-background management and foreign capital, which structures the China government acquiesce to. Through this structure, Chinese internet companies absorb a large volume of overseas capital and develop fast in the China market.

Since then, VIE structures have been used in more areas. For example, advertisement agency, travel agency, e-commerce, etc. With the increasing open market, the scope of restricted areas in China is becoming smaller. Foreign investors are allowed to invest in a majority of business sectors in China through direct investment. The areas where foreign investment is still restricted usually concern national security. Is a VIE structure allowed in these areas?

In reality, different government agencies have different attitudes toward VIE structures. In practice, the Ministry of Commerce and the Ministry of Industry and Information Technology are friendly to VIE structures. However, regulators in certain industries, such as the broadcast and television administration, the publication and press administration, the People's Bank of China, are conservative towards VIE structures. For example, contractual control by using VIE structures are not allowed in third party payment settlement business and filming and publication business.

In light of the above, the restrictions on VIE structures in the draft legislation, is not a change of law but a emphasis that the remaining areas where foreign investment is restricted or prohibited are core sensitive areas of China and foreign controls are not allowed.

This does not mean, however, foreign investors are not allowed to enter into or participate in these areas. The right question is how foreign investors can participate in these areas.

II. Approaches for Foreign Entering into Restricted and Prohibited Areas

Based on prior successful cases, foreign investors may consider participating in restricted and prohibited areas such as publication, media, and education through IP licenses and technical services.

1. Licenses of Contents and Know-how

The most simple and straight-forward approach is that foreign investors grant to their Chinese partners licenses of their contents and managerial know-how. This approach benefits (i) the combinations of

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the advantages of both Chinese and foreign parties: where foreign parties usually have advanced managerial know-how whilst Chinese parties usually know better about the local market and understand local regulations; and (ii) the satisfaction of compliance requirement, where the Chinese parties take charge of censorship of contents and applications of managerial know-how so that they can ensure the compliance of the operations with the applicable laws. In other words, this approach can help segregate foreign investors from compliance risks. A typical example of adopting this approach is that, in a publication business, foreign parties provide Chinese publishers their contents for publications. The relevant license agreements, in addition to the licenses of contents and managerial know-how, may include restrictions on use of contents and areas of use to ensure the integrity of their IP and the goodwill.

2. Franchise

Besides the usual licenses of content and managerial know-how, foreign investors may consider licensing to their Chinese partners the whole model of their overseas operations, such as operational models, brand, and databases, and meanwhile providing long-term management consulting services. This approach furthers the normal licenses of contents and managerial know-how. It retains the advantages of the content and know-how licensing approach and facilitate the integral operations of the operation globally. This approach has been successfully used in investment in schools.

3. IP Joint Management

This approach is a further development from the above two approaches: it is not a one-way license but a closer two-way cooperation. Under this approach, the foreign party, its subsidiary in China, and the Chinese party usually establish a joint management committee, discussing and forming a comprehensive scheme covering the use of background IPs and the development of foreground IPs as well as commercial operations of these IPs. This approach has been successfully used in entertainment and media business: where the Chinese parties take charge of the creation and publication of the contents, the foreign parties take care of the merchandizations, and both parties jointly manage and develop the images contained in the contents. Again, similar to the two approaches above, under this IP joint management approach, the compliance responsibilities primarily sit in the Chinese parties which operate the companies in the regulated areas.

III. Conclusion

It is not surprising that VIE structures will be banned from being used in areas concerning national security. This is an evitable result of national security considerations. However, this does not ban foreign participation in these areas. China still welcomes foreign investors having advanced technology, managerial know-how, and renowned business models so as to help develop the relevant business sectors in China and to share the development achievements. Foreign investors may consider IP licenses and closer cooperation based on IP licenses to participate in restricted and prohibited business in China.

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