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Foreign Direct Investment in Digital Media in China: Challenges and Opportunity

Adrian Fisher looks at the challenges and opportunities that come with foreign direct investment in digital media in China.

Foreign direct investment into the People's Republic of China (***PRC***) has traditionally been closely regulated. With the PRC's accession to the World Trade Organisation in 2001, the PRC Government has made moves to open up foreign investment in certain industries. However, foreign investment in traditional and new media industries remains a challenge. Indeed, direct investment in most forms of traditional media (e.g. print news, free to air commercial television and commercial radio) is strictly prohibited. Participation in the digital media space, whether by way of direct investment or the provision of content into the PRC, is more open but foreign investors still face challenges and the sometimes difficult task of obtaining regulatory approvals and licences to operate their businesses in the PRC.

This article summarises some of the regulatory obstacles that foreign companies may encounter when considering investment opportunities in the digital media space in the PRC, and the regulation of the delivery of foreign content into the PRC by way of satellite and Internet broadcast. It also discusses approaches that have been considered by foreign investors entering into the media market in the PRC.

Foreign direct investment regulation generally

When considering an investment into the PRC, the first consideration of the foreign investor should be the application of the *Catalogue of Industries for Guiding Foreign Investment* (the ***Catalogue***). The Catalogue categorises a number of business types as 'Encouraged', 'Restricted' or 'Prohibited' from a foreign investment policy perspective. Business types that are not listed on the Catalogue are considered 'Permitted'. The categorisation of business types in the Catalogue should guide foreign investors as to whether their desired investment is possible at all and, if it is, the restrictions and approvals that are required in relation to the investment.

As the name of the category suggests, a foreign entity may not invest in a business within an industry listed as 'Prohibited'. The Catalogue identifies a number of media-related business types as 'Prohibited', including news agencies and websites, publishing companies, radio and television stations, radio and television network infrastructure owners, radio and television program production companies and Internet service and 'cultural content' providers. This effectively captures all traditional media types and a variety of digital media businesses.

If a business type is 'Restricted', then a foreign entity must obtain approval from the PRC's Ministry of Commerce at either the State or local level. The level of approval required will depend on the value of the investment. If the investment is worth more than US$50,000,000, approval of the Ministry of Commerce must be obtained at the State level. If the investment is worth less than US$50,000,000, approval must be obtained at the local branch of the Ministry of Commerce, which tends to be a less difficult and time-consuming process. The Catalogue identifies a number of media-related business types as 'Restricted', including radio, television and movie production projects, operation of movie theatres and distribution of audio and video products. If a foreign entity chooses to invest in such 'Restricted' media-re-

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Inside This Issue:

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Contents

lated businesses, it must do so by way of a joint venture investment or cooperation with a PRC entity, which in some cases must have a controlling interest in the joint venture vehicle.

A foreign entity must also obtain the approval of the Ministry of Commerce for investments in 'Encouraged' or 'Permitted' business types, however, the monetary thresholds for approval are much higher. Only investments worth more than US$300,000,000 require State level approval. Foreign investors need to obtain local approval for investments worth less than US$300,000,000. The significance of an investment being categorised as 'Encouraged' is that such investments will generally attract tax subsidies and certain preferential treatment. The current Catalogue does not identify any media-related businesses as 'Encouraged'.

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The Catalogue is a live document and was last updated in 2007. The PRC Government is currently reviewing the Catalogue and has issued a revised draft which is expected to be approved in the coming months. From a media perspective there are a number of relevant changes, one of the most interesting being that the provision of music over the Internet has been specifically excluded from the 'Prohibited' category, signalling a potential easing of foreign investment restrictions in the growing online music streaming industry.

Delivery of foreign content by satellite: landing rights

The distribution of foreign television channels by satellite to the PRC is regulated principally under the *Measures for the Administration of the Landing of Overseas Satellite Television Channels* (the ***Satellite TV Measures***) which is administered by the State Administration of Radio, Film and Television (***SARFT***). Foreign satellite television signals may only be broadcast, or 'land', in the PRC with the approval of SARFT. Approved broadcasts are generally limited to hotels that have three or more stars and restaurants, residences and offices that are designated as being 'foreign-related' (e.g. expatriate workers' compounds). Landing rights are generally granted for a one year period and must be renewed annually by application to SARFT.

The Satellite TV Measures outline various technical and content requirements for approved foreign satellite television signals, including that the signal must be transmitted by an 'institution designated by SARFT' and that the broadcast content must not threaten the sovereignty, honour or interests of the PRC or otherwise place the security or stability of the PRC at risk. The Satellite TV Measures also impose numerous continuing obligations on the foreign satellite television channel provider. As an example of these continuing obligations, all corporate and management changes in the channel provider must be previously agreed with the institution that SARFT has designated as the channel's PRC agent.

The Satellite TV Measures require that the foreign entity seeking landing rights must actively assist in the landing of Chinese radio and television programs overseas. This provision seems to have been applied in at least two cases: Time Warner and News Corporation's Fox TV both commenced broadcasting CCTV content into the United States soon after AOL Time Warner and News Corporation's Star TV were both respectively granted landing rights into southern China in the early part of the last decade.

Delivery of content by Internet: ICP licensing

In 2000, the PRC Government approved the *Administrative Measures on Internet Information Services* (the ***ICP Measures***) which regulates the provision of content (referred to as 'information services' in the ICP Measures) via the Internet. The ICP Measures prohibit anyone from providing content via the Internet to end-users in the PRC for money or 'compensation' without a permit from the relevant provincial telecommunications regulator. This permit is generally referred to as an Internet content provider or ICP licence. It is unclear from the language of the ICP Measures whether a service that provides content to end-users for free (such as YouTube) but makes money from advertising or other means is a service for 'compensation'. However, the fact that Google is required to have an ICP licence (which was most recently renewed on 7 September 2011) indicates that the PRC Government may view such services as being for 'compensation'.

If an entity is able to obtain an ICP licence, it will then have continuing obligations relating to the content that it produces, reproduces, distributes and disseminates, including that such content must not impair national security, jeopardise national unity, damage the reputation or interests of the PRC, disturb the social order or damage social stability, insult or slander a person or infringe on a person's legal rights.

An ICP will be liable not only for the content that it transmits via its website, but also for content that any of its users transmit via its website. So, for example, if a user of an ICP's website was to use the website's services to disseminate content that infringes the copyright of a third party, the ICP would be required under the ICP Measures to immediately discontinue the transmission of such information, keep records of the transmission and report on the transmission to the PRC authorities. A failure to comply with this obligation could lead to the revocation of the ICP's licence to operate its website.

Approaches to investment in the PRC: VIE structures

In recent years, many foreign companies seeking to invest in businesses in which foreign direct investment is not generally permitted have explored alternatives to a direct equity investment in the target business. An approach that has become increasingly popular (particularly in the Internet / new media space) has been to set up a PRC business through a variable interest entity, or VIE, structure. Under a typical VIE structure, a domestic PRC company (the equity in which is owned by PRC nationals) is established to carry on the restricted business operation and hold any necessary licences (e.g. ICP licences). The foreign investor, who holds no equity interest in the VIE, will enter into a series of contracts with the VIE under which the foreign investor is given effective control of the VIE. Through these controlling contracts, the economic benefit of the VIE's business in the PRC will generally flow through the VIE and back to the foreign investor.

A key characteristic of the VIE structure is the ability to acquire the shares in the VIE at any time. In practice, this option would only be exercised by the foreign investor if there was an easing of any restriction on foreign direct investment in the relevant business, or if the VIE has acted inconsistently with the foreign investor's interests and the foreign investor wishes to take back and wind-up the VIE.

The VIE structure was pioneered by PRC new media companies such as social networking and portal giant Sina.com and the PRC's largest search engine, Baidu. Putting in place VIE structures has enabled these companies, and many other PRC companies operating in sensitive sectors, to list on foreign exchanges (particularly in the United States) and raise foreign capital where they may otherwise not be able to do so. Various foreign companies have adopted this approach when investing or establishing their own businesses in the PRC.

The PRC Government has not yet sought to regulate, restrict or prohibit the use of the VIE structure, although it is arguably an illegal method to circumnavigate express prohibitions on direct foreign investment. However, the PRC Government has recently indicated that it is aware of the increased use of, and willing to regulate where necessary, VIE structures. On 25 August 2011, the PRC Government released regulations that supplemented a national security review regime that had been promulgated in February 2011. The national security review regime effectively requires an additional review of proposed foreign acquisitions of domestic PRC companies where such acquisitions may have an effect on national security in areas including technology. The PRC Government's latest regulations clarify that this national security review mechanism applies not only to foreign direct investment but also to transactions that result in foreign entities having effective control of domestic PRC entities, such as VIEs. This seems to be a clear message from the PRC Government that it will regulate VIE structures where necessary and desirable to protect the interests of the PRC. The practical implications of these new regulations remain to be seen.

Investors looking at opportunities in the PRC should carefully consider how their intended core business activities in the PRC are characterised under the Catalogue, and whether they should or need to team up with an appropriate local PRC entity in implementing their proposed business structure. Building productive relationships with PRC regulators will be an important factor for any entity considering an entry into the PRC, as all investments require initial and most often continuous regulatory approvals and oversight.

Challenges and opportunities

This article has considered some of the main regulations in the PRC relating to foreign direct investment and the delivery of foreign content into the PRC. It is important to note, however, that there are many other regulations of varying significance and application that will apply to a media business in the PRC. For example, if an investor is successful in obtaining an ICP licence, it may need to obtain approvals from other regulatory authorities in the PRC depending on the nature of the content being delivered. It is always prudent to seek independent advice on how the regulatory environment in the PRC applies to a particular investment.

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There are still opportunities for those foreign companies that are able to successfully navigate their way through the complex regulatory environment in the PRC. While there have been controversies in the United States relating to accounting practices of recently floated Chinese companies, business in the online content streaming space appears to be booming, with the video services provided by companies such as Youku, Tudou and PPTV becoming increasingly popular and (by all publicly available accounts) profitable. There also appears to be increased opportunity in the online music streaming space with Baidu recently signing a major rights deal with Sony, Universal and Warner for Baidu's free online music streaming service 'ting!', and the PRC Government signalling that it will ease foreign direct investment restrictions for online music streaming services.

Although there are great challenges in implementing a potential investment in the PRC, for those companies that are willing to start small, take a long term outlook and persist in building their business and regulatory relationships in the PRC, there is potentially great reward.

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