

MEMO

From: APCO Worldwide

Date: October 26, 2009

Re: **Foreign Online Gaming Companies Face Uncertain Prospects in China's Market**

Executive Summary

- Foreign online gaming companies face uncertainty as a key Chinese government agency, the General Administration of Press and Publications (GAPP), publicly stated on October 10th that foreign investment is prohibited in the domestic gaming sector.
- Chinese agencies are engaged in a bureaucratic turf war over the management of online gaming.
- New indications are emerging that GAPP is aggressively moving to assert power and influence over new markets as traditional print media declines.
- Foreign companies need to understand and attempt to influence key stakeholders in order to preserve opportunities in the world's biggest online gaming market.

Background

China has rapidly become the fastest growth market for online games globally, with 55 million users and revenues topping USD 2.8 billion in 2008, according to official statistics. With so much revenue at stake, agency jockeying for authority to regulate the industry has heated up in recent months. Several weeks ago, the behind-the-scenes maneuvering among various agencies burst forth in a surprise announcement by GAPP.

In order to operate an online game in China, an online game provider must go through a complex regulatory approval process with multiple Chinese agencies. Beyond the traditional commercial approvals (dealt with by the Ministry of Commerce and the State Bureau of Industry and Commerce), licenses needed include an Internet Content Provider (ICP) license from the Ministry of Industry and Information Technology (MIIT), Content Approval License from the Ministry of Culture (MOC), and an Internet Publication License (IPL) from the General Administration of Press and Publications (GAPP). It is commonly held that there is a large degree of overlap among these licenses, as no single regulator has had the breadth and power to overcome its bureaucratic rivals and consolidate licensing activity. Among the above licenses, foreign enterprises can only apply for an ICP license through a joint venture (JV) with a domestic partner.

The current round of bureaucratic tussling is between GAPP and MOC, and was triggered by a move by Blizzard Entertainment Inc., licensor of the immensely popular World of Warcraft (WOW) game, to switch Chinese partners earlier this year. Blizzard's move unfortunately created an opening for GAPP and MOC to attempt to assert their respective authorities over the industry, as Blizzard's new domestic partner Netease was obliged to re-apply for licenses. WOW has over a million users in China.

In an attempt to clarify the existing regulatory regime after problems emerged during the Netease re-application process, the State Council Central Staffing Department on September 14th published a circular defining the role and relationship between MOC, the State Administration of Radio and Television (SARFT), and GAPP. While the circular states that the regulation of online gaming in China is administered by MOC, GAPP was delegated the authority to review and approve *content* that is *published online*. GAPP's interpretation of the State

Council circular is that online games are considered “online published content,” and thus must also obtain content approval licenses.

MOC believed the State Council had clarified its leading role in administering the online gaming market and gave the green light for World of Warcraft to commence trial operation even though it had not yet obtained proper GAPP licensing. This move along with the fact that MOC openly dismissed GAPP’s licensing role as irrelevant, infuriated regulators at GAPP, who in response directly challenged MOC by announcing GAPP would audit over 200 internet games that were unlicensed and or deemed inappropriate, after which GAPP shut down more than 45.

After China’s October 1st National holiday week, both MOC and GAPP heated up the inter-agency battle, each publishing statements on their respective websites arguing their positions. This included an explicit statement from GAPP that foreign investors are completely prohibited from operating online games in China via any form including a wholly owned foreign enterprise, joint-venture, commercial cooperation, or technical support. To date MOFCOM, a key supporter of foreign trade has not voiced its opinion, preferring to remain neutral.

APCO Analysis

Such aggressive behavior from GAPP comes at a time when it is under pressure from senior leaders in the State Council and China’s Propaganda Ministry to inject market-based mechanisms into the publishing sector, for which it is primarily responsible. This in turn implies that GAPP is facing a shrinking regulatory mandate, as traditional press and media is liberalized and confronting further challenges as the industry goes digital. GAPP’s mandate to promote the creation and dissemination of “Chinese” content is also a factor here, as the most popular online games in China are foreign creations. GAPP is taking a page from the SARFT playbook, which restricts the number of foreign movies shown in Chinese theaters, the amount of non-Chinese television programming allowed during prime-time, and so on.

For an agency looking to redefine its regulatory role in a changing market, online and new media certainly are an obvious target. The ability to put a vise over such a large and growing market space would give GAPP increased authority, a larger mandate, and additional funding. GAPP is also looking at creating a new regulatory regime for all mobile-based content including music, images, audio, and search engines. This development should also be a red flag to foreign companies, as it’s all but certain that GAPP would also seek to restrict foreign investment in this highly lucrative market.

It is difficult to predict who will emerge a winner. Both MOC and GAPP are entities of the “thought-leadership” regime in China which is ultimately under the control of the Central Propaganda Ministry and Politburo member Li Changchun. Some analysts predict senior leaders, under pressure to assuage the outrage of millions of Chinese online gamers, could force a compromise between the two agencies. In the end, the clear loser has been the foreign gaming industry, which is currently a pawn in the wider battle between GAPP and MOC. Foreign industry is also more or less helpless as few companies have a physical presence here, and apart from their Chinese licensees, no true allies who can advocate for their interests with the relevant ministries.

Impact on Foreign Invested Enterprises (FIEs)

GAPP has made an explicit statement that foreign investors are completely prohibited from operating online games in China via any investment vehicle. This is a potentially devastating ruling that will impact all foreign online gaming companies. When facing regulatory uncertainty of this magnitude, APCO recommends foreign online gaming companies already in the Chinese



market ensure their existing domestic partnerships are stable, given any disruption would require re-application for licenses with GAPP. It is also important for foreign online gaming companies to understand and audit how their local partners are perceived by key regulators, in order to gauge how insulated they are from a potential GAPP audit.

For FIEs that are contemplating market entry, or are looking to expand product offerings and services, it is essential they have effective channels into relevant government regulators (especially GAPP and MOC), and both foreign and local parties fully understand the licensing process. Having a well-connected local advocate (not necessarily the gaming operator) can be beneficial in reducing unneeded exposure, by providing an indirect line of communication with the regulators.

The bad news for foreign companies is that at present they are simply pawns in a bureaucratic turf fight. The good news is that with regulations still very much evolving, there's an opportunity for engagement to help influence the long-term development of policy and regulations in the sector. The cost of not engaging could be the closure to foreign companies of the world's largest and fastest-growing market.

CONTACT INFORMATION

For further information on how APCO Worldwide can help your organization to understand China's online gaming regulations and implications for your organization, please contact:

APCO BEIJING

Chris Murck, Vice Chairman Asia
16th Floor, NCI Tower
12 A Jianguomenwai Avenue
Chaoyang District, Beijing, China 100022
Phone: +86.10.6505.5127
Fax: +86.10.6505.5257
cmurck@apcoworldwide.com

APCO SHANGHAI

Ken Jarrett, Vice Chairman Greater China
2102 CITIC Square
1168 Nanjing Road West
Shanghai, China 200041
Phone: +86.21.5298.4668 Ext. 228
Fax: +86.21.5298.4669
kjarrett@apcoworldwide.com