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## Commentary: Regulations for the Implementation of the Law on the Promotion of Privately-run Schools (Review Draft)

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On August 10, 2018, the Ministry of Justice published on its website the *Regulations for the Implementation of the Law of the People's Republic of China on the Promotion of Privately-run Schools (Revision Draft) (Draft for Review)*<sup>1</sup> (the “**Review Draft**”) for public comment, which the Ministry of Education has submitted to the State Council for deliberation. The current round for public comment will end on September 9, 2018. The Review Draft follows the Ministry of Education's issuance on April 20, 2018 of the *Regulations for the Implementation of the Law of the People's Republic of China on the Promotion of Privately-run Schools (Revision Draft) (Draft for Comment)*<sup>2</sup> (the “**Comment Draft**”) and is the most recent legislative progress in revising the *Regulations for the Implementation of the Law on the Promotion of Privately-run Schools*.

Below, we provide brief comments on several issues that have drawn attention in the Review Draft:

### I. Foreign Investment Access and VIE Control Agreements

The Review Draft at Article 5 stipulates that “foreign-invested enterprises established within the territory of China and social organizations controlled by non-Chinese persons shall not run, participate in or actually control the operation of private compulsory education schools; the operation of other types of private schools shall meet the relevant national provisions for foreign investment.” Compared to the Comment Draft, the Review Draft adds a clause emphasizing that foreign investors cannot “actually control the operation of private compulsory education

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<sup>1</sup> [Circular of the Ministry of Justice on Seeking Public Comment for the Regulations for the Implementation of the Law of the People's Republic of China on the Promotion of Privately-run Schools (Revision Draft) (Draft for Review)] (Min. of Ed.; issued Aug. 10, 2018 for public comment until Sept. 9, 2018).

<sup>2</sup> [Announcement of the Ministry of Education on Seeking Public Comment for the Regulations for the Implementation of the Law of the People's Republic of China on the Promotion of Privately-run Schools (Revision Draft) (Draft for Comment)] (Min. of Ed.; issued Apr. 20, 2018 for public comment until May 20, 2018).

schools.” The emphasis on the prohibition of actual control over investments in private schools is rooted in the foreign investment access restrictions for the education industry. Pursuant to the *Special Administrative Measures (Negative List) for Foreign Investment Access (2018)*,<sup>3</sup> offshore investors are prohibited from investing in compulsory and religious education institutions. Foreign-invested pre-schools, ordinary high schools and institutions of higher education are limited to Sino-foreign joint ventures and the Chinese investor must lead the operation of the schools (the principal or primary administrators are required to be Chinese nationals, and the Chinese investor must have no fewer than half of the seats on the council, board or joint management committee).

Many offshore-listed private schools have employed variable interest entity (“VIE”) structures to avoid these foreign investment access restrictions. That is to say, the offshore-listed entity, through contractual agreements, ultimately controls the private schools located in China through a wholly-owned enterprise established in China (which acts as the main operating entity and is the school operating license holder), so that the financial statements of the private schools can be consolidated into the financial statements of the offshore-listed entity. From the perspective of ownership structure, the foreign-owned enterprise does not directly or indirectly hold any equity or interest in private schools, so as to formally comply with the foreign investment access restrictions. The legitimacy of the use of the VIE structures in this context, however, remains controversial.

The Review Draft responds to the controversy over foreign investment in compulsory education by clearly specifying that actual control structures cannot be used to participate in the operation of private schools at the compulsory education stage. However, Article 5 of the Review Draft still appears to have a loophole as it stipulates that private schools engaged in compulsory education may not be controlled, but it remains silent as to other types of private schools. In fact, the VIE structure also addresses the need to avoid the existing Sino-foreign joint venture requirement for non-compulsory educations.

## II. Related-party Transactions

The *Law on the Promotion of Privately-run Schools (2016 Revision)*<sup>4</sup> stipulates that no for-profit private schools may be established to provide compulsory education. Nevertheless, the compulsory education stage is undoubtedly very important to enterprises in the K-12 education industry, whether it is as a source of enrollment or the proportion of time that compulsory education comprises in academic careers. As a result, many private schools have been unable

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<sup>3</sup> [*Special Administrative Measures (Negative List) for Foreign Investment Access (2018)*] (Nat'l Dev. Ref. Comm., Min. of Commerce Decree [2018] No. 18; promulgated June 28, 2018, effective July 28, 2018) 2018 ST. COUNCIL GAZ. 24.

<sup>4</sup> [Law of the People's Republic of China on the Promotion of Privately-run Schools] (as revised by Standing Comm. Nat'l People's Cong., Pres. Order No. 55; promulgated Nov. 7, 2016, effective Sept. 1, 2017) 2016 STANDING COMM. NAT'L PEOPLE'S CONG. GAZ. 6.

to abandon compulsory education and continue to provide compulsory education in the name of non-profit schools following the effectiveness of the *Law on Privately-run Schools (2016 Revision)*. Many sponsors even choose to classify non-compulsory private schools as non-profit private schools in order to qualify for greater tax incentives and policy support. The sponsors of such non-profit private schools often utilize related-party transactions to obtain profits in the name of non-profit schools. In addition, private schools under VIE structures will themselves have a large number of related-party transactions because the structures often involve exclusive service agreements among the related parties.

The Review Draft retains the Comment Draft's restrictions on related-party transactions between private schools and related parties. The "interested related parties" of a private school refer to the organizations or individuals who are sponsors, actual controllers, directors, supervisors, etc. of the private school and those whose mutual control and influence over the foregoing organizations or individuals would result in transfers of interest in the private school. The Comment Draft only indirectly restricts VIE control by restricting related-party transactions and through information disclosures:

- Related-party transactions shall be open, fair and equitable, and shall not harm the interests of the state, schools, teachers and students;
- An information disclosure system shall be established for related-party transactions;
- When councils, boards of directors, or other decision-making bodies vote on related-party transactions, members who have an interest in the transaction shall avoid voting and may not exercise their voting rights on behalf of other members.

The Review Draft further grants the competent authorities the right to supervise and examine the relevant agreements concerning related-party transactions. The Review Draft at Article 45 stipulates that "[t]he administrative departments of education and the departments of human resources and social security shall strengthen the supervision of agreements signed between non-profit private schools and interested related parties, and examine and audit the necessity, legality and compliance of agreements involving major interests or long-term and repeated implementation." In practice, private schools often transfer profits to related parties in the form of management fees, consulting fees and service fees by signing long-term management consulting agreements or service agreements. If Article 45 of the Review Draft becomes effective, these profit transfer agreements signed between private schools and related parties will be subject to competent authority supervision. The competent authorities will not only be required to examine the legal and regulatory compliance of such agreements, but also their substantive necessity.

In addition, the Review Draft at Article 44 stipulates that "[n]on-profit private schools shall use accounts filed with the competent departments for collecting fees and carrying out activities.

The competent authorities shall supervise the accounts and organize audits together with the relevant departments.” This means that not only will related-party transaction agreements themselves be regulated, but also that financial transactions arising from such agreements will be subject to supervision.

### III. License Classifications

The Review Draft follows the Comment Draft with respect to the operating license classification principle:

Private Education Institution Type	Approval Organ and Level
Private schools providing pre-school education, secondary education and academic education at lower levels	Education administrative departments of the people’s government at or above the county level
Private schools providing higher academic education.	Education administrative department of the State Council and the people’s government of the province, autonomous region or municipality directly under the central government.
Private schools providing vocational qualification training and vocational skills training (“ <b>private vocational training institutions</b> ”)	Department of human resources and social security of the people’s government at or above the county level, with a record-filing submitted to the department of education of the same level.
Private training and education institutions set up to enroll children and adolescents of the appropriate age in kindergartens, primary and secondary schools, and to provide cultural and educational activities related to school cultural and educational curricula or supplementary tutoring related to school admissions and examinations.	Examination and approval of the education department of the people’s government at or above the county level.
Private training and education institutions set up to provide language, arts, physical, science and technology, research and other educational and teaching activities conducive to quality improvement and personal development, as well as private training and educational institutions for cultural and non-academic continuing education for adults.	Direct application for legal person registration

The Review Draft at Article 16 establishes different licensing requirements for online education:

- Provision of online academic education: education operating licenses and Internet operation licenses for similar academic education of the same level are required to be obtained;
- Provision of online training and educational activities or vocational skills training: the corresponding Internet operating licenses shall be obtained and a record-filing shall be submitted to the education administrative department of the provincial people's government and the human resources and social security department of the place where the institution is located.

Compared with the Comment Draft, the Review Draft no longer requires online private vocational training institutions to obtain licenses to operate schools, but merely requires record-filing. That is to say, the qualifications for online private vocational training institutions are lower than those for offline vocational training institutions<sup>5</sup>. However, while the Review Draft does not require non-academic cultural training and educational institutions to obtain licensing to operate schools, it is clear that such institutions may not provide educational and teaching activities that would otherwise require a license to operate. In accordance with Article 15 of the Review Draft, training and educational institutions may not provide for the online “enrollment of children and adolescents of kindergartens, primary and secondary school age, and provide other cultural and educational activities related to school cultural and educational curricula or supplementary tutoring related to school admissions and examinations.” But, in practice, the distinction between these two types of educational activities needs to be further clarified, i.e.: “[the provision] of language, arts, physical, science and technology, research and other educational and teaching activities conducive to quality improvement and personal development” (which does not require a school license) and “[the provision] of other cultural and educational activities related to school cultural and educational curricula or supplementary tutoring related to school admissions and examinations” (which requires a school license).

#### **IV. Group Schools**

Article 12 of the Review Draft stipulates that “a social organization which concurrently holds or actually controls a number of private schools and provides for the group school operations shall have legal person status and have suitable conditions, funds, personnel and organizations for the school operating activities that it undertakes, and shall assume the responsibility of management and supervision over the private schools that it operates. In the case of providing group school operations, non-profit private schools shall not be controlled through mergers and acquisitions, franchise chains or control agreements.” In addition to retaining the requirement

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<sup>5</sup> Review Draft, Art. 14: “The establishment of private schools for the provision of vocational qualification training and vocational skills training mainly based on vocational skills shall be examined and approved by the human resources and social security department of the people's government at or above the county level in accordance with the limits of authority prescribed by the state, and shall be submitted to the administrative department of education of the same level for record.”

in the Comment Draft that group schools must possess the corresponding conditions for operating schools and the ability to supervise members of the group, the Review Draft also adds a provision that prohibits social organizations that operate schools in groups from controlling non-profit private schools through mergers and acquisitions, franchising and VIE structures. We understand that this provision will prevent excessive expansion of group schools so as to guarantee the quality of education (especially the quality of compulsory education), and also prevent group schools from profiting through related-party transactions in the name of non-profit private school operations.

We note that the Review Draft does not itself define “group school operations.” The regulatory documents of some provinces and municipalities define group school operations, but the definitions differ. However, from the perspective of Article 12 of the Review Draft, it appears that “holding or actually controlling a number of private schools” is the defining characteristic of the term.

## V. Public Schools’ Involvement in Private Schools

The Review Draft at Article 7 places many restrictions on public schools’ involvement in private schools:

- Public schools shall not operate or participate in operating for-profit private schools;
- If a public school operates or participates in the operation of a non-profit private school, the public school shall be approved by the competent department and shall not make use of state fiscal funds, shall not affect the teaching activities at the public school, and shall not obtain profits by means of brand extension;
- “Six Independences”: private schools run by public schools shall have: i) independent legal personality, ii) separate campuses and basic educational and teaching facilities, iii) independent full-time teachers, iv) independent financial and accounting systems, v) independent enrollment, and vi) independent academic certificates.

The foregoing provisions will restrict public schools from establishing schools-within-schools, and from profiting from the process of operating private schools, and will possibly have an impact on private schools with independent colleges:

- In one respect, what is meant by “shall not obtain profits by means of brand extension”? Pursuant to the *Measures for Establishment and Administration of Independent Colleges*,<sup>6</sup> independent colleges are institutions that offer undergraduate or higher curricula that are run by ordinary institutions of higher learning in cooperation with social organizations or individuals other than state institutions. Ordinary colleges and

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<sup>6</sup> [Measures for Establishment and Administration of Independent Colleges] (Min. of Ed., Decree No. 26; promulgated Feb. 22, 2008, effective Apr. 1, 2008) 2008 ST. COUNCIL GAZ. 26.

universities mainly use their school names, intellectual property rights, management resources, educational and teaching resources to participate in operating the independent colleges, and social organizations and individuals mainly use funds, physical resources, land use rights and other means to participate in operating the schools. If “shall not obtain profits by means of brand extension” means that public schools cannot charge brand licensing fees, it will inevitably affect the enthusiasm of public schools to participate in independent colleges. Of course, provided that this restriction only means that public schools may not simply engage in brand extension, it would become necessary for public schools to invest resources together with brand licensing such as intellectual property, management and teaching resources. In this case, the revenue from brand licensing fees could also be interpreted as encouraging the development of substantive (rather than purely nominal) cooperation in operating schools.

- In another respect, if public school participation makes it impossible for cooperative schools to become for-profit private schools, this will also affect the cooperation between the parties. As a result, the revision to the *Regulations for the Implementation of the Law on the Promotion of Privately-run Schools* may accelerate the transformation of independent colleges into ordinary private colleges.

## **VI. Policy trends for non-profit private schools**

Compared with the current regulations, the Review Draft strengthens the supervision of private schools (particularly non-profit private schools), while also, on the basis of general support, further showing a bias towards non-profit private schools and encouraging the operation of non-profit schools.

- Local people’s governments at or above the county level may, in accordance with a certain proportion of the standard for average expenditures of students in similar public schools at the same level, determine the standard for subsidies for the average expenditure of students in non-profit private schools; among them, subsidies for the funds of non-profit private high schools shall be borne by the people’s governments at the provincial level (Article 52);
- Local people’s governments shall give priority to non-profit private schools in leasing and transferring idle state-owned assets (Article 52);
- Non-profit private schools shall be subject to the tax policies for public schools issued by the financial department and tax department under the State Council, which will reduce or exempt the corresponding tax burden (Article 53);

- For new construction and expansion of non-profit private schools, local people's governments shall, on the principle of equality with public schools, grant preferential land use by means of allocation (Article 55);
- Local people's governments at or above the county level shall include in their budgets funds allocated to the social security of the staff and workers of non-profit private schools, adopt subsidies, fund incentives, and preferential fees in accordance with law, support and reward private schools in establishing occupational annuity systems for their staff and workers, and may adopt government subsidies, rewards in lieu of allowances, etc. to encourage and support the remuneration of private school teachers (Article 59).

## **VII. Conclusion**

The Review Draft responds to certain public calls regarding practices in the education industry. The Review Draft gives further preferences to non-profit private schools on the basis of general support while also strictly regulates school operations, with the top priorities continuing to be the compliant operation of non-profit private schools and the avoidance of abuse of non-profit private school policy preferences.

If the Review Draft becomes effective in its current form, there will be widespread problems from the perspective of capital management of private schools, particularly arising from VIE structures and related-party transactions involving private schools listed offshore. Feedback from offshore capital markets this week indicates that investors have a pessimistic outlook on these potential regulatory changes. Despite this, the impact of the Review Draft on educational enterprises that intend to list on the A-shares market in China will be less severe than for those listed offshore because domestic enterprises do not need to adopt VIE structures and are able to avoid related-party transactions that are inherent in the use of VIE structures. From an education industry perspective, the Review Draft imposes stricter compliance requirements on academic education (especially compulsory education). However, for non-academic training, the overall scope does not change significantly, and some aspects are in fact more generous and favorable.

The quoted legal provisions cited in this article are unofficial translations and are to be considered for reference purposes only.

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