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present

Doing Business in China and Hong Kong

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Philadelphia New York Washington, DC Hong Kong



Macro Trends on Doing Business in China

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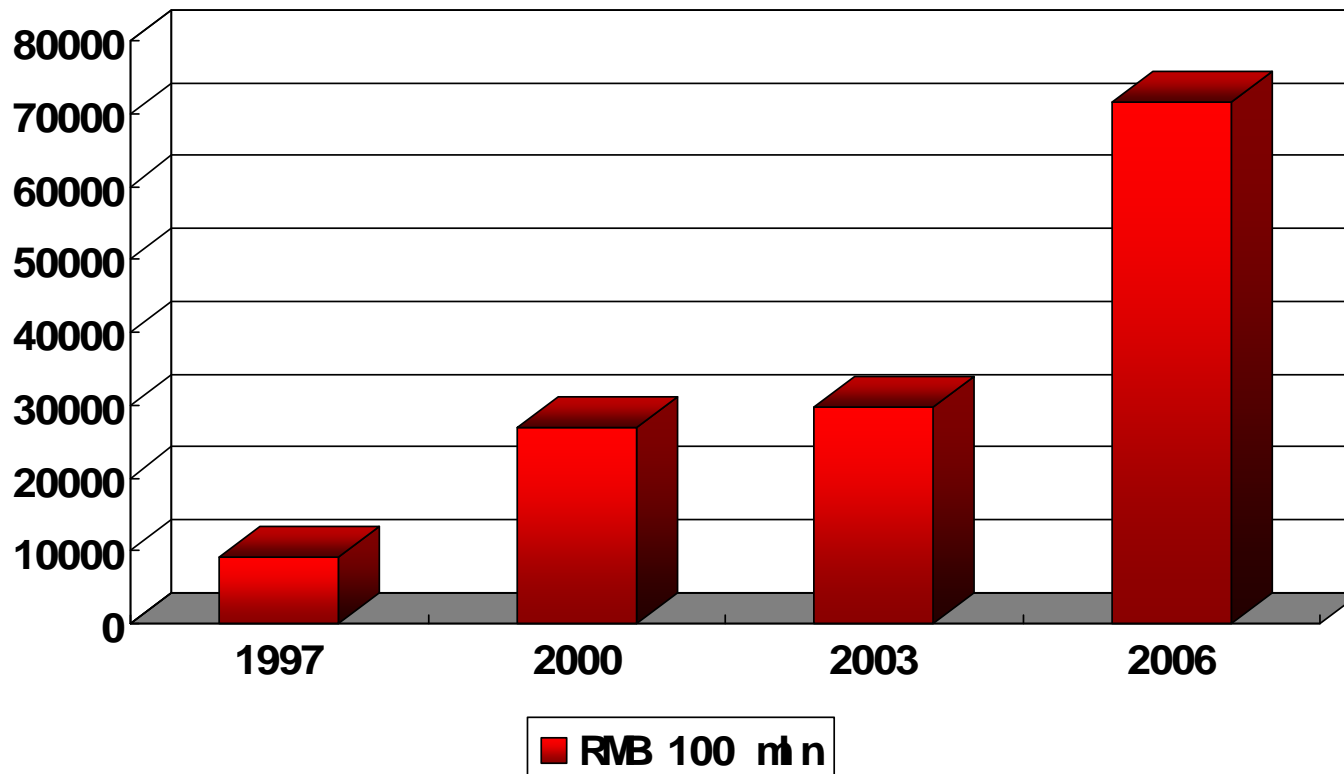
PRC stock exchanges (2008)

- **Shanghai Stock Exchange**
 - \$2.38 trillion market capitalization
 - 71 million total investors
 - 860 companies
- **Shenzhen Stock Exchange**
 - \$122 billion market capitalization
 - 35 million investors
 - 540 listed companies

Source: Shanghai and Shenzhen Stock Exchanges



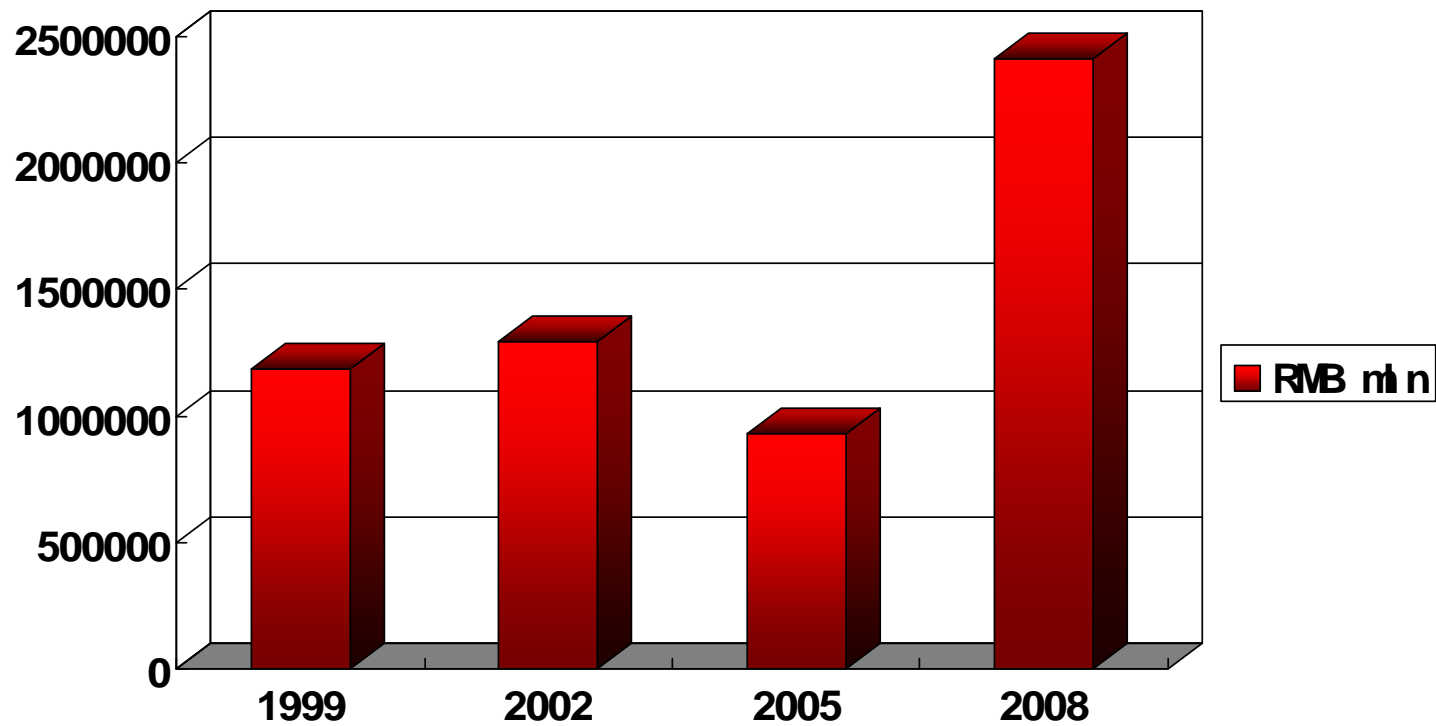
Shanghai Stock Exchange Capitalization



Source: Shanghai Stock Exchange Market Data



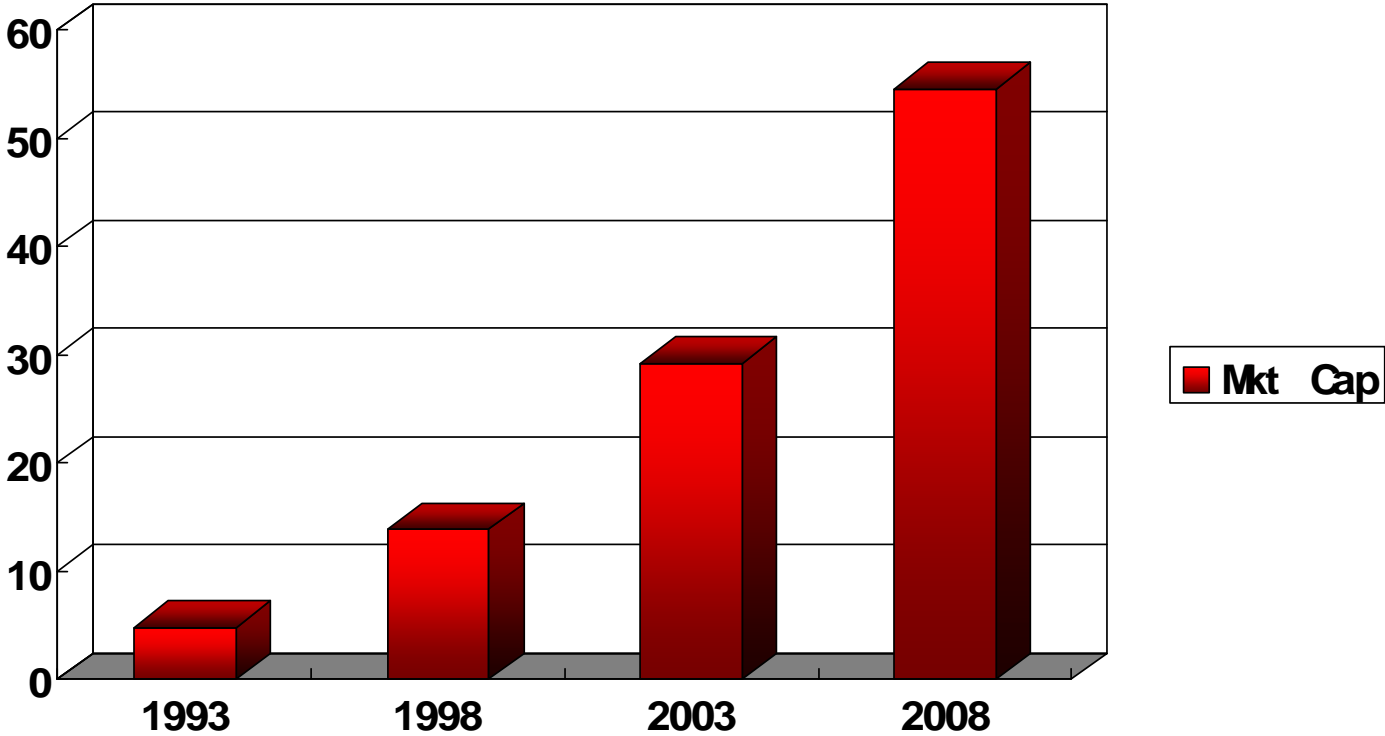
Shenzhen Stock Exchange Capitalization



Source: Shenzhen Stock Exchange Market Data



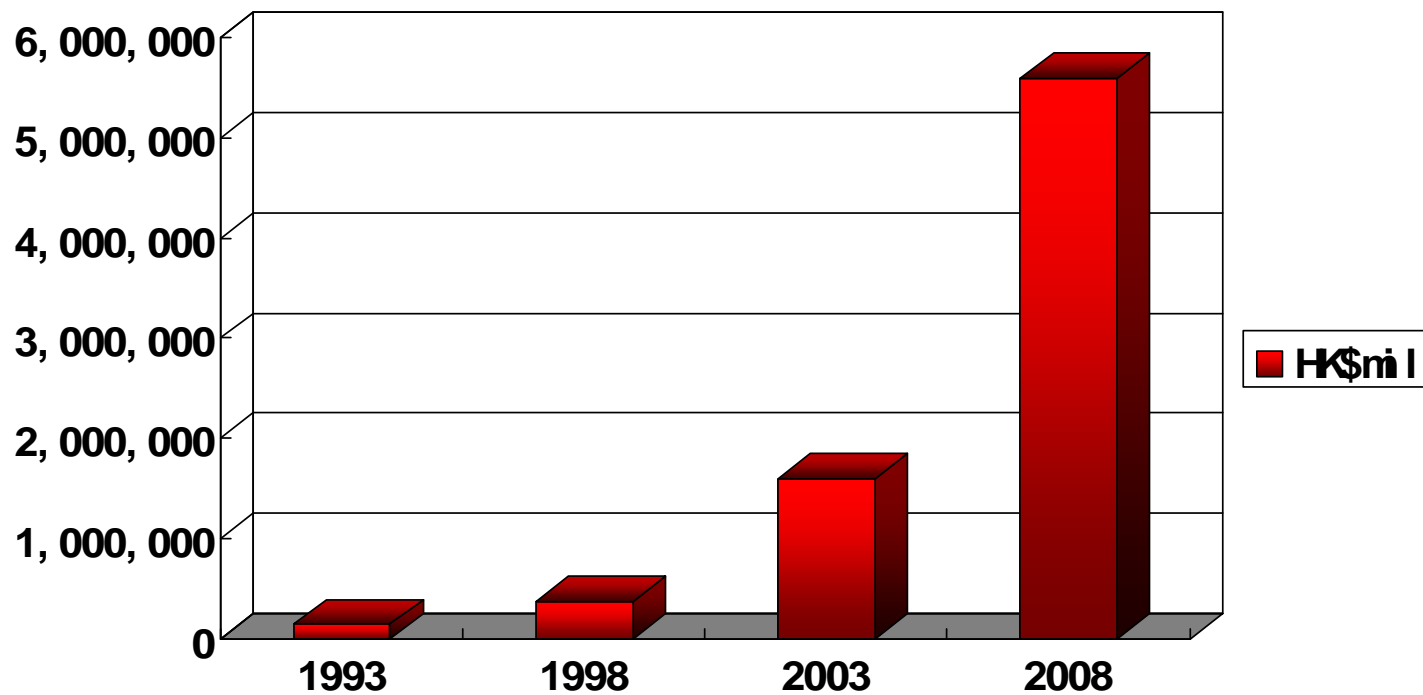
H Shares and Red Chip Capitalization on HKSE (%)



Source: Hong Kong Stock Exchange



H Shares and Red Chip Capitalization on HKSE (HK\$mil)



Source: Hong Kong Stock Exchange



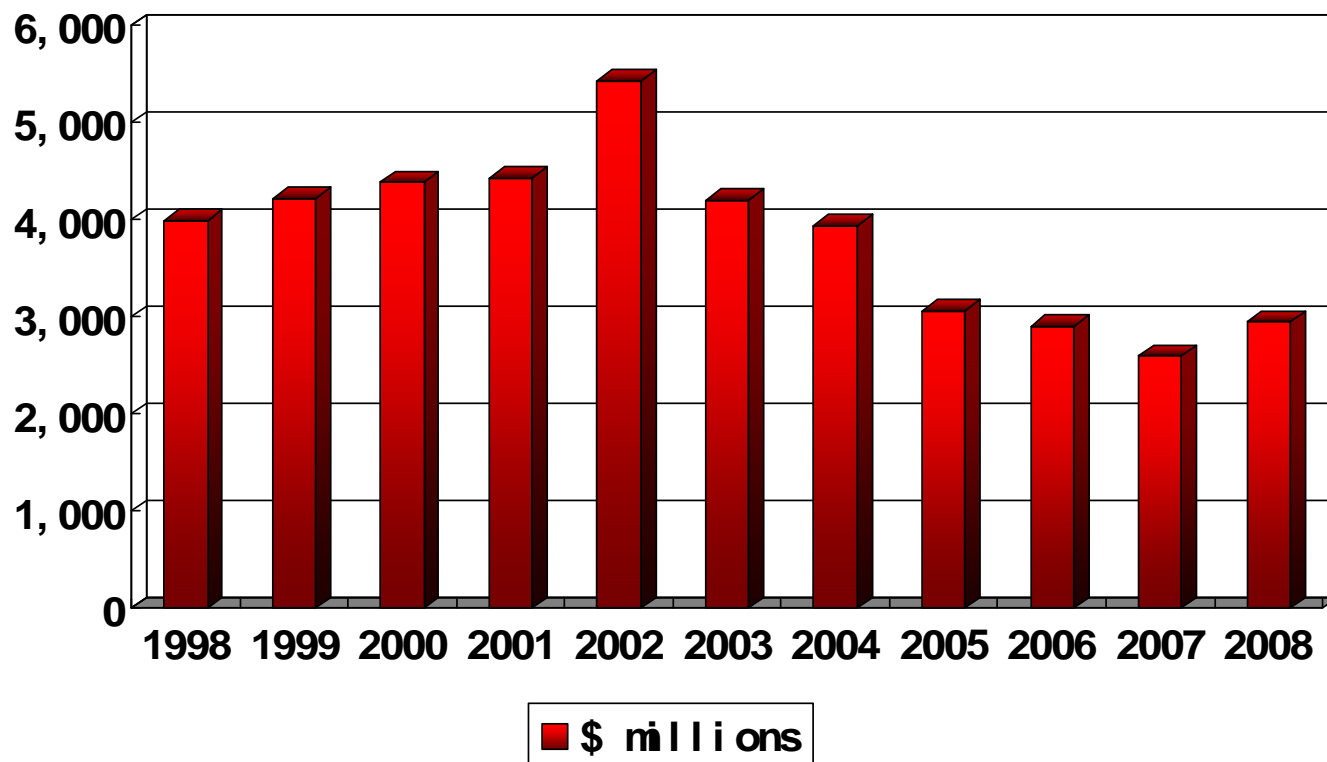
Estimated Cumulative Utilized FDI: 1979-2008 (\$ billions)

| Country | Amount | % of Total |
|-----------|--------|------------|
| Total | 852.6 | 100.0 |
| Hong Kong | 341.0 | 40 |
| BVI | 89.8 | 10.5 |
| Japan | 69.3 | 8.1 |
| US | 64.0 | 7.5 |
| Taiwan | 47.6 | 5.6 |
| Singapore | 37.5 | 4.4 |
| S. Korea | 31.8 | 3.7 |

Source: PRC Ministry of
Commerce

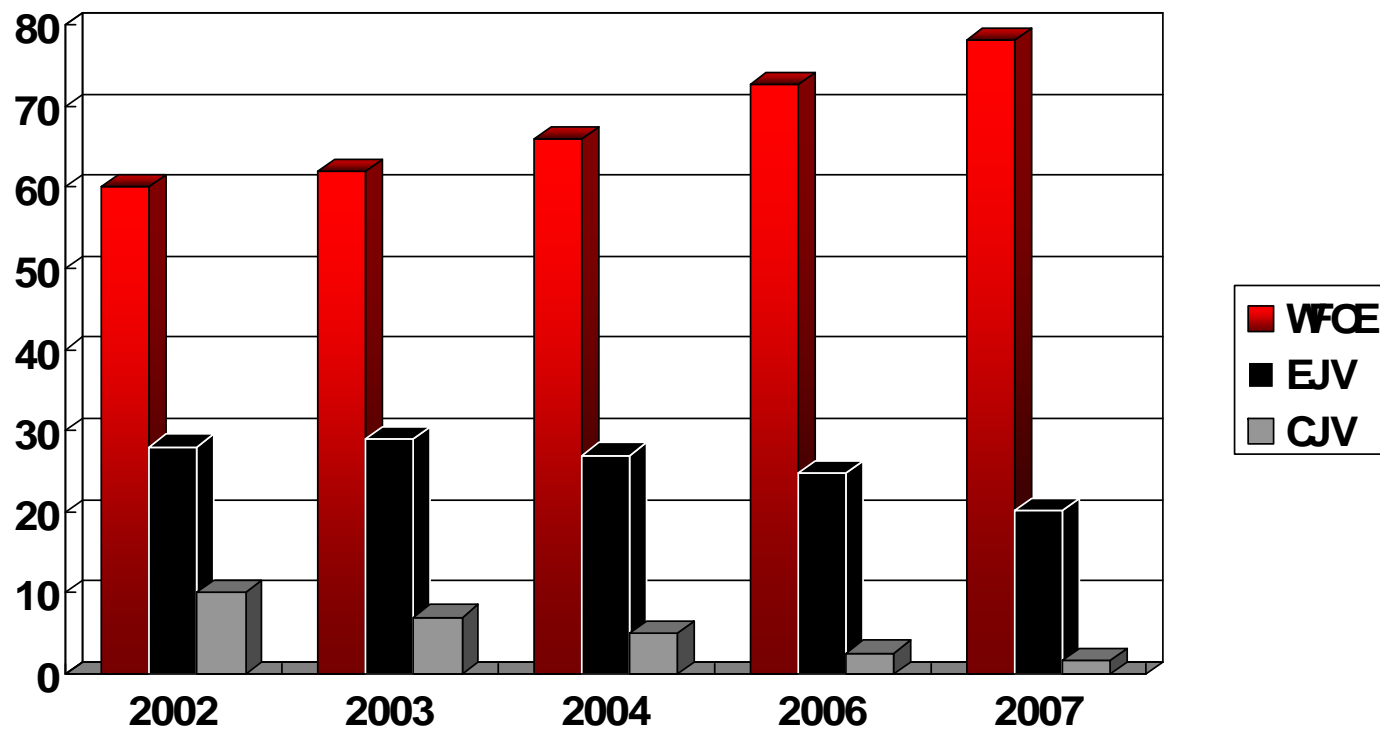


US FDI in China



Source: PRC Ministry of Commerce and China Statistical Yearbook

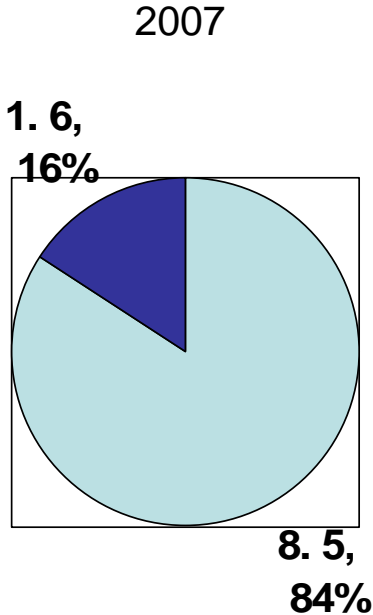
Principal FDI Vehicle Types (%)



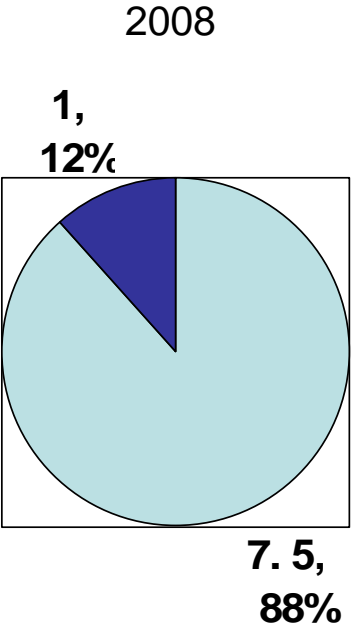
Source: PRC National Bureau of Statistics



Greenfield vs. M&A (\$ billion)



Greenfield M&A

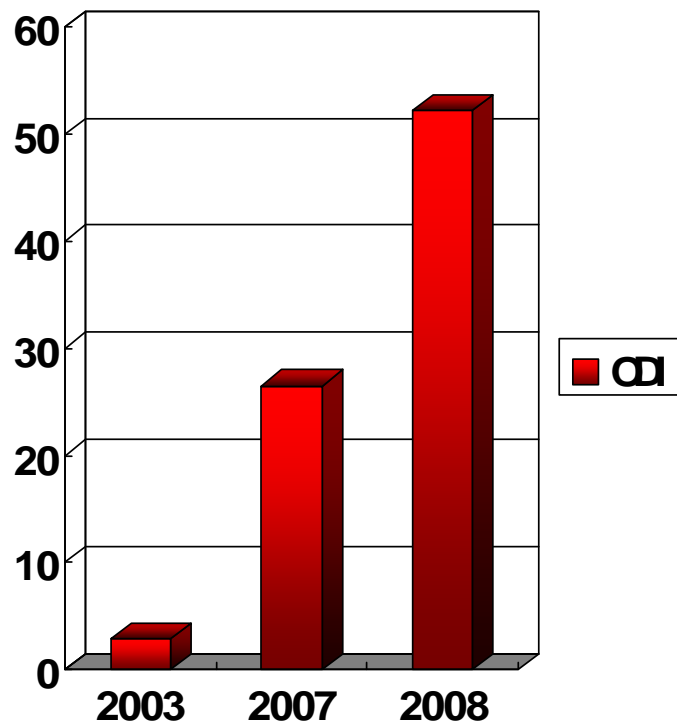


Greenfield M&A

Source: People's Daily



Chinese ODI (\$ billion)



- 2003: \$2.9 billion
- 2007: \$26.5 billion
- 2008: \$52.2 billion
- Top Destinations (2007)
 - Hong Kong: 58%
 - Cayman Islands: 14%
 - U.S.: 2%

Source: PRC Ministry of
Commerce



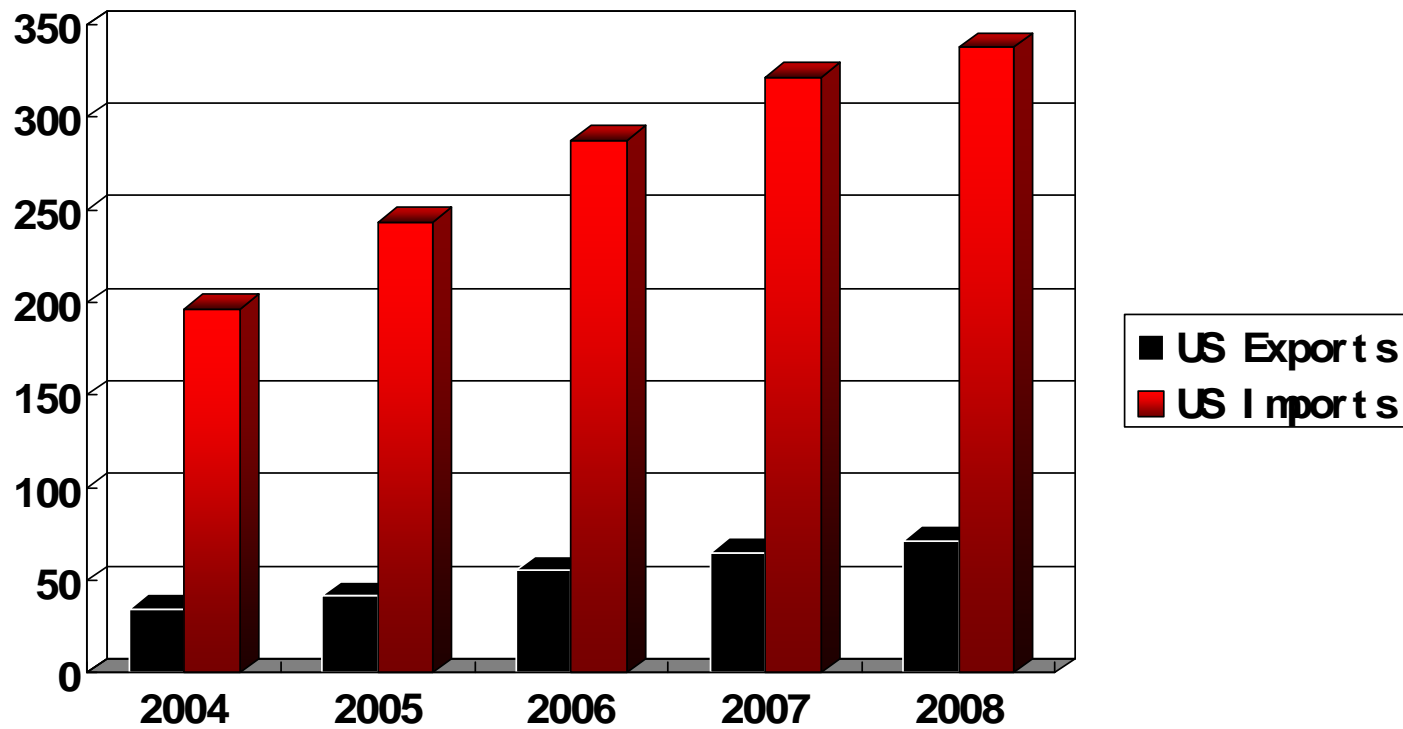
US Imports/Exports: China (\$ billion)

| | 2004 | 2005 | 2006 | 2007 | 2008 |
|------------|-------|--------|--------|--------|--------|
| US Exports | 34.7 | 41.8 | 55.2 | 65.2 | 71.5 |
| US Imports | 196.7 | 243.5 | 287.8 | 321.5 | 337.8 |
| US Balance | -162 | -201.6 | -232.5 | -256.3 | -266.3 |

Source: USITC, US DOC, and US
Census Bureau



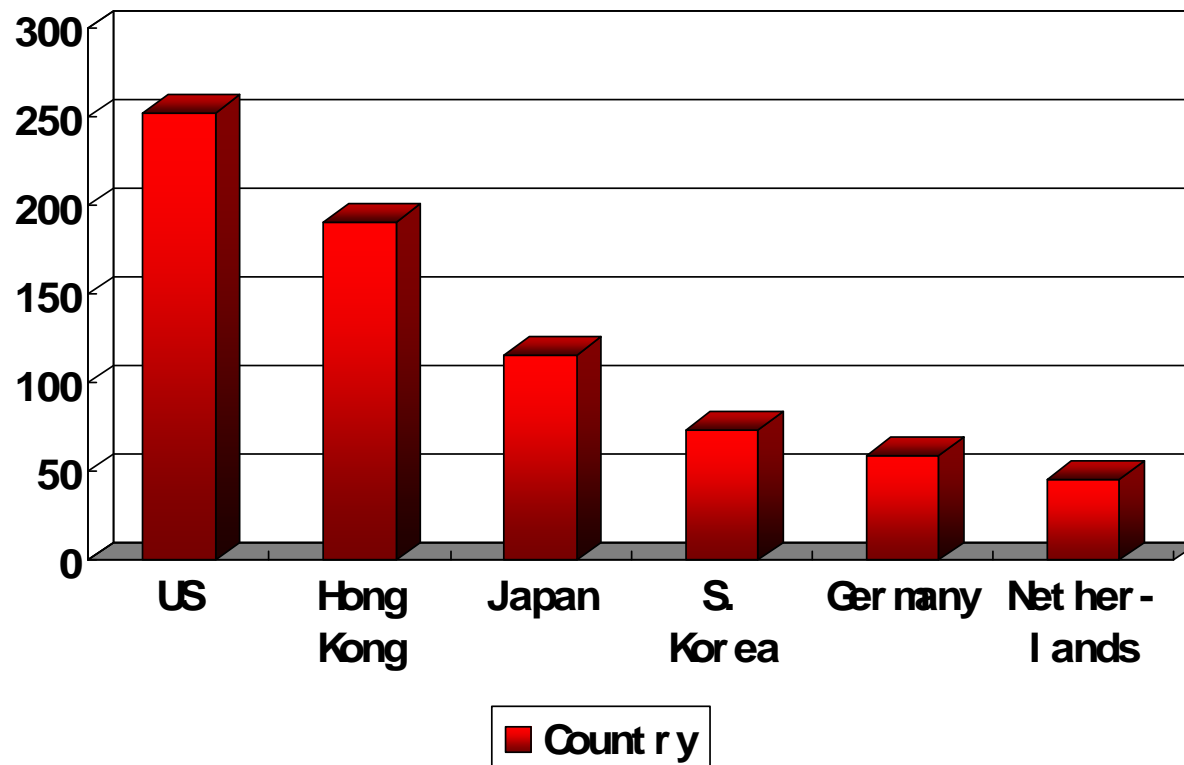
US Imports/Exports: China (\$ billion)



Source: USITC, US DOC, and US
Census Bureau



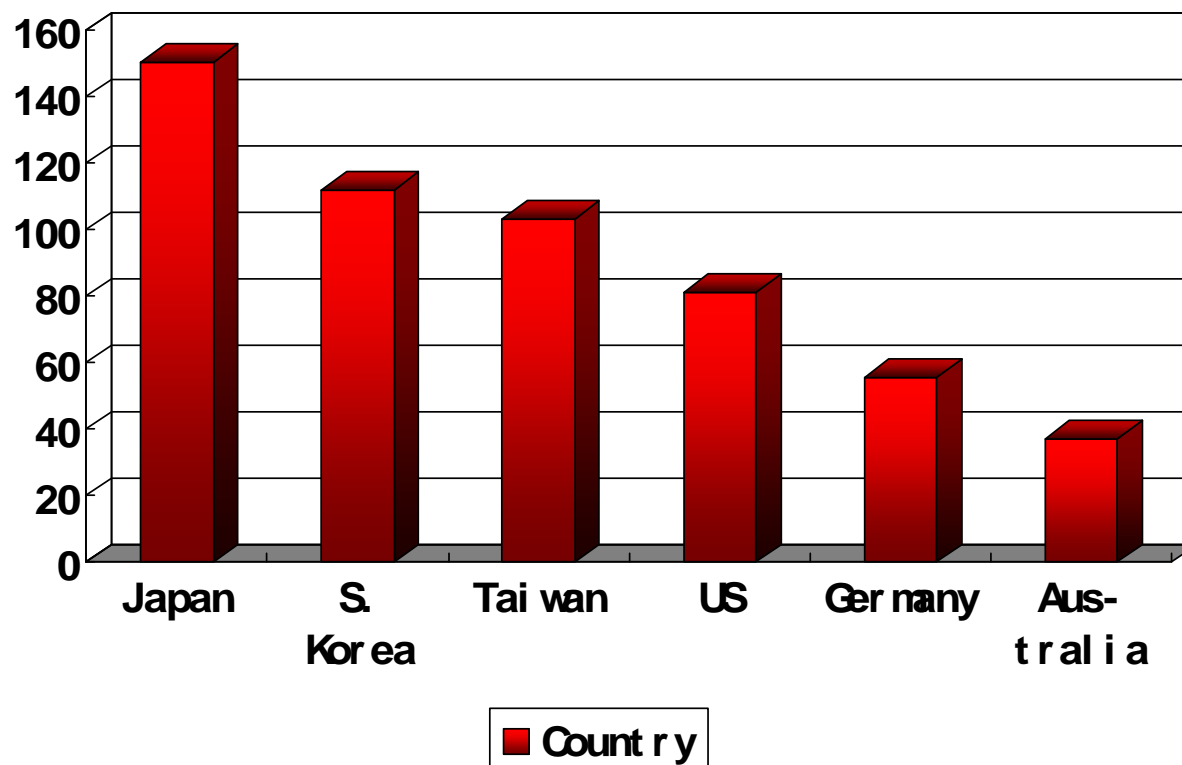
Top export destinations (2008) (\$ billion)



Source: PRC General
Administration of Customs



Top import sources (2008) (\$ billion)



Source: PRC General
Administration of Customs



Civil IP cases in China

- From 2002 to 2006, there were 54,321 civil IP cases filed, and 52,437 were resolved.
- This marks a 142.92% and 141.99% increase, respectively, in cases as compared to those from 1997 to 2001.

Source: Supreme People's Court



Civil IP Case Composition

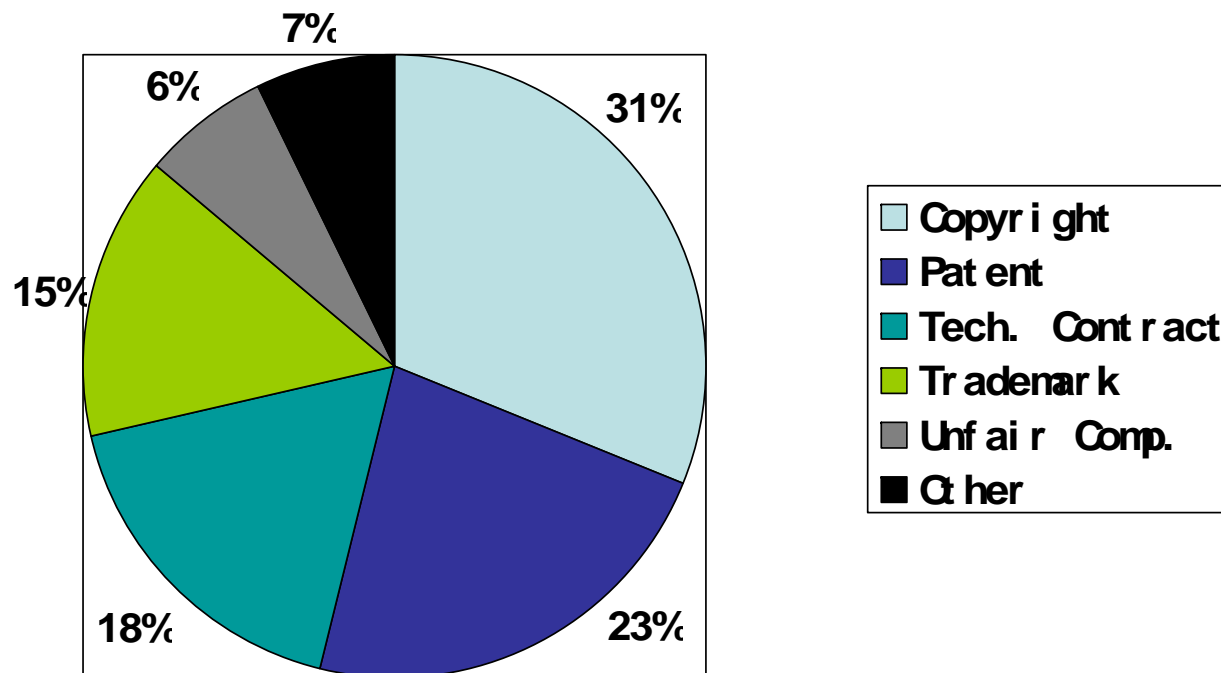
- From 1991 to 2008, there were a total of 135,475 cases, with 124,851 resolved.
 - Copyright: 42,072
 - Patent: 31,005
 - Technology Contract: 23,755
 - Trademark: 19,985
 - Unfair competition: 8,727
 - Other: 9,931

Source: Supreme People's Court



IP Case Composition

1991-2008

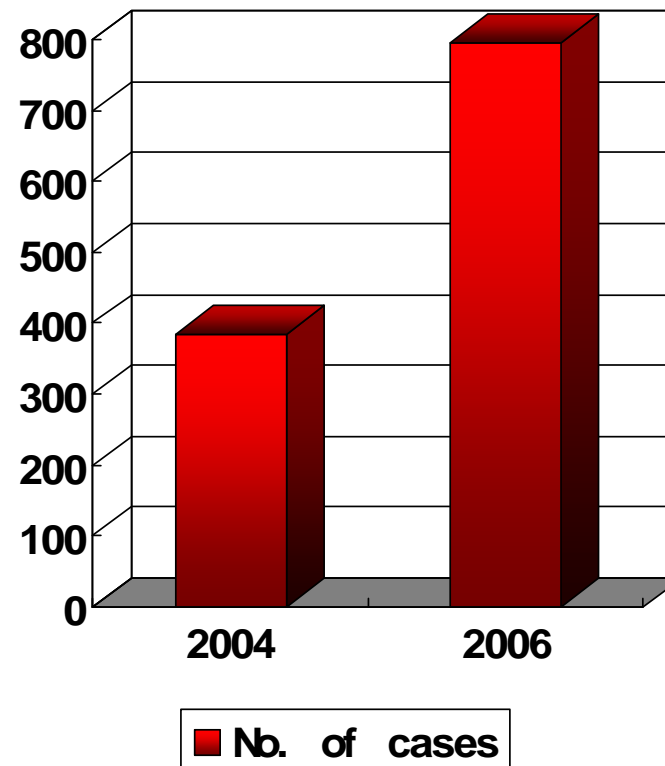


Source: Supreme People's Court



Criminal IP Prosecutions

- In 2004, there were 385 criminal IP cases
 - 653 individuals declared guilty
- In 2006, there were 796 criminal IP cases
 - number of individuals declared guilty not available
- 107% increase



Source: Xinhua News Agency and
State Intellectual Property Office



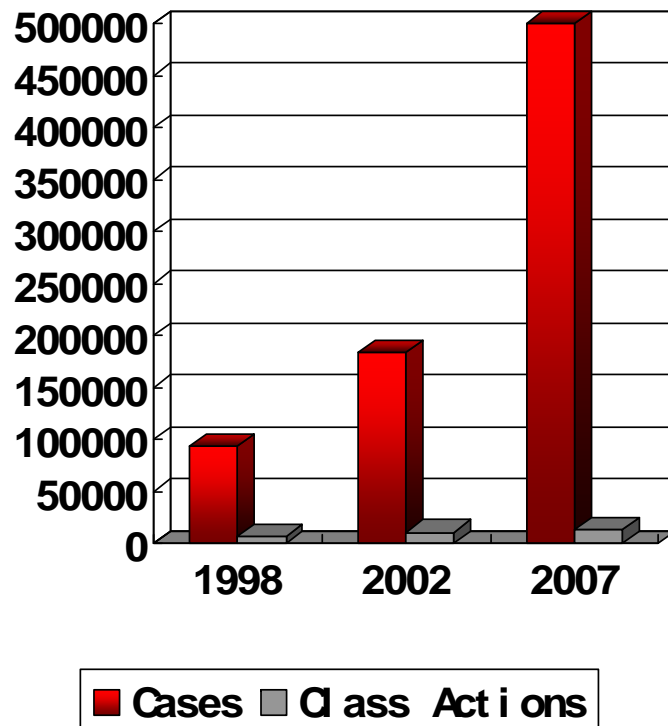
Criminal IP Prosecutions

- In 2004, crimes of **production and sale of fake or substandard products and illegal business operations** (many of which included IP violations)
 - 2,366 cases and 4,487 convicted individuals
- In 2006, crimes of **production and sale of fake or substandard products and illegal business operations** (many of which included IP violations):
 - 1,508 cases and 2,277 convicted individuals

Source: Xinhua News Agency and
State Intellectual Property Office



Domestic Labor Arbitration



- 2007: 500,000 cases
 - 150,000 mediated
 - class actions: 2.6%
- 2002: 184,000 cases
 - class actions: 6%
- 1998: 94,000 cases
 - class actions: 7%

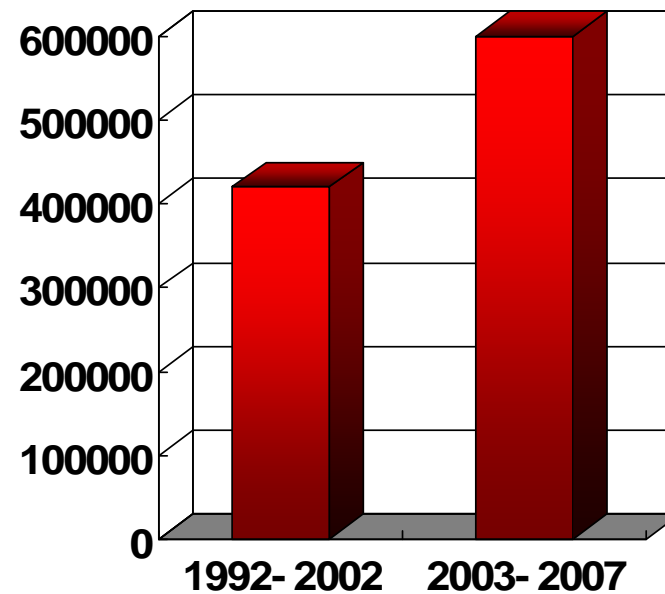
Source: PRC Ministry of Human Resources & Social Security



Labor Disputes in Courts

- 2003-2007: 600,000 cases
- 1998-2002: 420,000 cases

43% increase



■ Cases

Source: PRC Ministry of Human Resources & Social Security



Int'l Arbitration Institutions

| Institution | 2003 | 2004 | 2005 | 2006 | 2007 | Total |
|-------------|------|------|------|------|------|--------------|
| AAA/ICDR | 646 | 614 | 580 | 586 | 621 | 3,047 |
| ICC | 580 | 561 | 521 | 593 | 599 | 2,854 |
| HKIAC | 287 | 280 | 281 | 394 | 448 | 1,690 |
| CIETAC | 422 | 462 | 427 | 442 | 429 | 2,182 |

Source: School International Arbitration Research, Queen Mary, University of London





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Overview of Doing Business in Hong Kong and China

Tim Drew – Blank Rome Solicitors & Notaries
Andrew Hart – Blank Rome Solicitors & Notaries
Jeremy Sargent – JSA China



Brief overview of legal system in Hong Kong

- British Colony – Handover to China in 1997
- Basic Law – “One Country, Two Systems”
- Legal Framework – based on English Common Law and local legislation

Brief overview of legal system in China

- China's legal system based upon "civil law" – no concept of judicial precedent
- Raft of national laws supplemented by national, provincial, municipal and district-level regulations
- Rule of law improving but....
- Administrative authorities - far-reaching powers of investigation, enforcement and punishment

Establishing a Business Presence

- Hong Kong – the Gateway to China
 - Close Proximity to China
 - Rule of law
 - Independent judiciary
- Hong Kong Corporate Structures
 - Limited liability company
 - Branch of overseas company
 - Representative office

Establishing a Business Presence

- China Corporate Structures – Introduction
 - Structure should suit proposed business model (*e.g.* domestic sales, exports, manufacturing, services)
 - Chinese government approval required for all foreign investment
 - Operation limited to approved scope of business

Establishing a Business Presence

- China Corporate Structures – Representative Offices
 - A place of business registered in China
 - Not a separate legal entity but rather an “extension” of foreign parent company
 - May not engage in so-called “direct business activities” (*i.e.* may not sign contracts, receive income, etc)

Establishing a Business Presence

- China Corporate Structures – Joint Ventures
 - Chinese joint venture partner required in certain industries
 - Foreign investor must hold at least 25% of equity
 - Management – Board of Directors and General Manager
 - Certain key decisions require unanimous board approval (note possible “deadlocks”!)
 - Clear termination/exit provisions essential

Establishing a Business Presence

- China Corporate Structures – Wholly Foreign-owned Enterprise (WFOE)
 - Most popular structure - foreign investor hold 100% of equity
 - Management – Shareholders Meeting, Board of Directors and General Manager
 - Fixed term of operation (maximum generally 50 years) (extendable by approval)

Establishing a Business Presence

- China Corporate Structures – Financing your China Project
 - Foreign investor should contribute “registered capital”
 - Limits on maximum external borrowings
 - Registered capital may be contributed by installments (valuation of “in-kind” contributions may be necessary)

Establishing a Business Presence

- Acquiring an existing business in Hong Kong
 - Shares in holding company
 - Business and assets

Establishing a Business Presence

- Acquiring an existing business in China
 - Growing trend in China (30% of new projects)
 - Complex approval regime - external valuation required
 - Anti-trust review for certain acquisitions (resulting in high market concentrations, acquisitions of Chinese “well-known” brands)
 - Fears of increasing economic nationalism and protectionism

Establishing a Business Presence

- Due Diligence and Negotiations
 - “Do not believe everything you hear!”
 - Essential to conduct due diligence at every stage of a project – be prepared to commit considerable time and resources
 - Chinese entities – usually reluctant to disclose business affairs - limited public records available

Labor Issues

- Hong Kong
 - Less regulated than other countries e.g. China, UK, US
 - Employment and investment visas

Labor Issues

- China

- The most challenging business issue facing foreign investors
- No government approval required for hiring employees
- Non-discrimination in hiring
- Written employment contracts mandatory
- Remuneration
 - Minimum wages apply (levels vary depending upon location)
 - Statutory social insurance contributions
 - Housing fund contributions

Labor Issues

- China

- Termination of employment

- By employee – at any time by notice
 - By employer – only allowed for reasons set out in the law
 - In the event of a dispute, burden of proof is on employer to demonstrate termination was lawful

Systems of Taxation and Profit Repatriation

- General overview of taxation system in Hong Kong
 - Simple and low tax system – Profits tax only 16.5%
 - Territorial basis of taxation
 - No capital gains tax, withholding tax in dividends and interest

Systems of Taxation and Profit Repatriation

- China collects taxes at both the State and local levels
- Main Taxes
 - Enterprise Income Tax (“profits tax”) – 25%
 - VAT on import and/or sale of goods – 17%
 - Business Tax on provision of services – 5%
 - Consumption tax on luxury goods – 5% - 40%
 - Import duties – %age varies

Systems of Taxation and Profit Repatriation

- Individual Income Tax on wages and personal income
 - Progressive rate from 5% - 45%
- Profit repatriation
 - After-tax profits may be lawfully remitted out of China by way of dividend to overseas parent company
 - Dividends subject to withholding tax – generally 10%
- Blank Rome LLP – International tax planning capabilities
 - Joe Gulant – Partner of Blank Rome LLP (New York Office)

Dispute Resolution

- Governing law of the contract
- Forum for dispute resolution
- Arbitration



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Intellectual Property in China

Alfred W. Zaher, Partner – Blank Rome LLP

Shawn S. Li, Ph.D, Associate – Blank Rome LLP



China Made Great Effort to Conform to International Practice for IP protection

International Conventions China is a signing Party

- Paris Convention
- Madrid Agreement Concerning the International Registration of Marks (Madrid Union) with invocation of Article 3 bis
- Nice Agreement Concerning the International Classification of Goods and Services for the Purposes of the Registration of Marks
- Protocol Relation to the Madrid Agreement Concerning the International Registration of Marks (Madrid Protocol)
- WIPO (World Intellectual Property Organization)
- Berne Convention
- Geneva Convention for the Protection of Producers of Phonograms against Unauthorized Duplication of their Phonograms
- WTO Agreement

IP Laws of People's Republic of China

Trademark Law

Passed on August 23, 1982 (Effective March 1, 1983)

- Amended February 22, 1993 and October 27, 2001
- 2001 Amendments are in line with provisions of the TRIPS Agreement
- Draft Third Amendment of the Trademark Law is proposed (2008)
- Trademark Regulations
- Implementing Regulations of the Trademark Law of the People's Republic of China (effective September 15, 2002)

Patent Law

First adopted in 1984

Amended in 1992, 2000, and 2008 (Effective Oct. 1, 2009).

Copyright Law

First adopted in 2001

Judicial Interpretation in 2004 and 2007

1997 Amendment of the Criminal Code

Unfair Competition Law of China

Sources of Law

- Regulations on Development and Protection of Competition (1980)
 - The Law for Countering Unfair Competition (1993)
 - The Law for Protecting Consumer's Rights and Interest (1993)
 - Regulations on Anti-dumping and Anti-subsidization (1997)
 - Anti-trust Law (2008)
 - Employment Law (2008)
 - Contract Law
 - Criminal Law
-
- Trade Secrets are protected under the Law on Unfair Competition

Territorial Limitations

- Chinese IP protection does not extend to Hong Kong SAR or Macao SAR.
- As an example, it is not possible to designate China in an international trademark filing for Hong Kong SAR or Macao SAR via the Madrid Protocol or Madrid Agreement. Additionally, applicants wanting protection of their trademarks in Hong Kong SAR and Macao SAR must apply separately in each territory.

General Trademark Details

- Only registration of a mark confers EXCLUSIVE RIGHTS
- China is a FIRST TO FILE country
- Practitioners encourage applicants to file their trademark applications in the Chinese language in addition to the original filings. Registration of a mark does not offer protection from infringers using the Chinese translation or transliteration of the mark.
- Be mindful of the Chinese translations of a mark
 - Translation can be by closeness of meaning or sound
 - There can be more than one translation of the mark
 - Be preemptive

Choosing a Trademark to File in China

Registerable Trademarks

- “Any visual sign capable of distinguishing goods or services” from others
- “Words, designs, letters, numerals, three-dimensional symbols, combinations of colours, or a combination of any” of the aforementioned elements
- Packaging may also be protected (as long as the shape is not necessary to obtain a technical result or give a substantial value to the goods)

Also Registerable

- Service Marks
- Geographical Indications
- Collective Marks

General Trademark Proceedings

Trademark Office of the State Administration for Industry and Commerce (SAIC) is the authority for

- Trademark Examination
- Trademark Opposition
- Trademark Cancellation

Well-Known and Reputed Marks (in CHINA)

- The 2001 amendment of the Trademark Law confirmed an extension of rights to well-known marks. Registration of a mark will not be allowed if it is "a reproduction, imitation, or translation" of a well-known mark, even if the goods and/or services are different from the well-known mark.
- It is possible to have a mark declared (by the Office, or the Trademark Review and Adjudication Board) well-known during the opposition process. There are several marks already recognized as well-known by the Office.
 - Determination of a well-known mark is made with the following considerations:
 - awareness of the mark in the relevant public sector duration of use of the mark
 - duration, degree and geographical scope of publicity made for the mark
 - history of the protection of the mark as a well-known mark
 - other factors of interest for the reputation of the mar
- Owners of well-known trademarks may also apply to the trade name registry authority to cancel the registration of the offending trade name as well

Quality of Goods

- Owner is obligated to supervise the quality of goods or services represented under their trademark
- Licensee must guarantee the quality of goods or services. Licensee's name and manufacturing address must appear on the packaging. It is possible to be sued in court for inferior products and/or services
- In the event of poor manufacturing or deterioration of the goods (if the public is deceived), rectification may be ordered within a specified period by the local administrative authority for industry and commerce.
 - In severe cases, criticisms may be circulated, or a fine imposed of a maximum of 20% of the illegal sales amount or two times the amount of the illegally obtained profits. If a registered trademark is involved, it will be cancelled (there are also provisions for unregistered marks, and marks included in the registrable/not registrable list). If the party is not satisfied with the fine imposed, legal proceedings could be initiated in the competent People's Court within 15 days from the issued decision. If no proceedings are initiated, or the authority's decision is not observed, the authority may request the People's Court order compulsory execution of the decision.

Types of Patents

- Invention Patent:
 - Substantive examination
 - Patent term: 20 years from earliest priority date
 - Analogous to utility patent in U.S.
- Utility Model Patent:
 - Minor improvements in shape, structure of a product, or the combination thereof
 - No substantive examination
 - Patent term: 10 years from earliest priority date
 - Similar to German “petty patent” (*Gebrauchsmuster*)
- Industrial Design Patent:
 - No substantive examination
 - Patent term: 10 years from earliest priority date

Patent Protection in China

- “First to file” country

If two or more applicants apply separately for a patent on the same invention, the patent right shall be granted to the person who applied first.

- Any invention or utility model for which a patent right may be granted must possess the characteristics of

- novelty,

- Absolute novelty

State of art refers to any prior art (information/technology) publicly available before the application date in China or Internationally (2008 Amendments)

- Inventiveness, and

- usefulness.

Patent Protection in China

- State Intellectual Property Office (SIPO) is the patent registration and examination authority
- Invalidation of a patent is exclusively decided by the Patent Reexamination Board of SIPO

The National Copyright Administration (NCA)

- The NCA is responsible for copyright administration and enforcement. The NCA is also responsible for nationwide copyright issues, including investigating infringement cases, administering foreign-related copyright issues, developing foreign-related arbitration rules and supervising administrative authorities. Though administrative remedies are available, the NCA generally encourages complainants to use the court system due to lack of personnel.

Term of Copyright Protection

- For individuals, the term of copyright protection is generally 50 years after the life of the individual author
- For a work created in the course of employment, the term of copyright protection is generally 50 years after publication

See 2001 Copyright Law, Chapter II, Article 21

Reasons Not to Register

- Registration is not required in order to receive copyright protection if the copyright holder is from a country that is a member of the Berne Convention, but it can be difficult to enforce a copyright without registration
- Some countries counsel their citizens to not register software copyrights in China unless necessary, because of a risk that the publicly accessible part of the registered software code may be copied

Reasons to Register

- With registration, the owner establishes prima facie ownership of the copyright, and the owner can file a complaint with the Copyright Bureau anytime after discovering an act of infringement. Note that the prima facie showing of ownership can be later rebutted.
- If an owner has not registered the copyright of his works, the owner must provide evidence, e.g. the original work, to prove ownership of the copyright.
- Failure on the part of the owner to provide sufficient evidence of his copyright ownership may preclude any action by the Copyright Bureau or Customs.
- Therefore, even though an owner can enjoy copyright without registration, a copyright registration is often advisable for important works.

Enforcing IP Rights in China

Choices of Enforcement Processes

- Administrative Process
 - State Administration for Industry and Commerce (SAIC)
 - Customs
- Judicial Process
 - Usually file in the Intermediate People's Court
 - Specialized IP courts in large cities
 - Choose your forum carefully
 - Civil Enforcement
 - Criminal

SAIC

SAIC's local bureaus provide administrative enforcement of trademarks throughout China

ADVANTAGES:

- Inexpensive and fast,
- Local,
- Expert Agency (nearly every IP right has an administrative agency),
- No lawyer needed,
- May be able to obtain an injunction,
- May have other enforcement capabilities (e.g., administrative fine, seizure and destroy of infringing goods, etc.)

DISADVANTAGES:

- "Local Protectionism",
- Penalties usually non-deterrent,
- Non-transparent,
- Limited geographic jurisdiction,
- Can't reach international criminal activity,
- Damages for injured party not likely available.

Customs

- Owners of intellectual property may have specific measures available to them by the Customs Offices of China against importation and exportation of goods infringing upon an owner's exclusive rights

Civil Enforcement

• ADVANTAGES

- Specialized judiciary that may be trained in IPR
- Damages available
- Injunctive remedies
- Rights to appeal
- Nationwide jurisdiction

• DISADVANTAGE

- High cost (relatively)
- Low damage rewards
 - Draft 3rd Amendment will increase statutory damages up to ¥1,000,000 (US\$ 150,000)
- Lack of independence of judiciary in many jurisdictions
- Difficulties in collecting damages, if rewarded

Criminal Prosecution

• ADVANTAGES:

- Can be brought by police/prosecutors or injured party;
- Deterrent damages possible (fine and imprisonment),
- Possibility of civil damages in addition to criminal punishment,
- Potentially lower cost than civil litigation.
- Criminal measures for willful trademark counterfeiting and copyright piracy on a commercial scale are WTO obligations.

• DISADVANTAGES:

- Evidentiary standards have been lowered with the new Judicial Interpretation, but resource issues may still make these cases difficult to pursue.
- Not all IPR infringements are criminalized.
- Difficulties may exist in having administrative cases referred to criminal prosecution.

An Administrative Action or a Judicial Proceeding?

- Pros for Administrative Action: speed of resolution, less expensive, more likely to be reported in the news (possible “free promotion” of the copyright holder)
- Pro for Judicial Proceeding: civil damages are more widely available in court

Enforcement of Patent Rights

- Administrative process
 - New provision on administrative fine up to ¥100,000 (~\$US 15,000)
 - Prescribe equal administrative fine less than ¥100,000 for patent counterfeit as well as for passing off patented product or method to cheat the public
 - Confiscate the illegal earnings
 - May impose a fine of not more than three times illegal earnings
 - Impose a fine no more than ¥100,000 in case no illegal earnings
 - Refer to Trademark Law, provide Local Patent Administration the necessary means for investigation and interrogatories for handling and mediating the infringement and passing off cases

Enforcement Challenges

- While there has been much progress in the formal legal structure of copyright law in China, there remains a disparity between the law and the reality
- China has recognized this issue and has set goals to reform IP laws and their enforcement “improving China's capacity to create, utilize, protect and administer intellectual property” by 2020

Cultural Difference

- There is a profound difference in the attitude toward litigation
 - Noteworthy trend of Chinese businesses enforcing IP rights against Foreign competitors in China
- “Saving Face”

Local Protectionism Problems

- While IP laws are promulgated by central authorities, they are implemented by local authorities
- In some areas, infringement/piracy plays a significant role in local commerce, stimulating jobs, income, and taxes
- For example, local governments earn significant rental income from booths at state-owned markets where pirated and counterfeit products are typically sold
- International pressure on Beijing often fails to result in action at the local level
- Nationalist sentiment against enforcing IP rights owned by foreign entities

Deterrence Problems

- The low enforcement rate and relatively light penalties for copyright infringement have been insufficient as of yet to control piracy
- For many individuals making a couple hundred dollars per month, the rate of enforcement and severity of penalties is not great enough to convince the individual to choose a legitimate DVD for \$3-15 instead of a \$1 counterfeit
- There are effectively no criminal prohibitions against infringement that is not *relatively large* (the U.S. has lodged a WTO complaint against China on this issue)

Noteworthy Cases

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Viagra Trademark (2007)

- Pfizer registered Viagra 萬能
- Chinese company Weierman registered 萬能 (Mighty Brother)
- Pfizer cannot make a case of unregistered famous mark.

Viagra Patent (2006)

- 5/1994 Pfizer filed patent application covering sildenafil citrate (active ingredient of Viagra)
- 9/2001 A group of Chinese generic manufacturer filed for reexamination of the patent after it was granted
- 7/2004 Patent was found invalid by the Patent Reexamination Board of SIPO
- 9/2004 Pfizer appealed the Board's decision in court
- 5/2005 Trial started in the First Beijing Intermediate People's Court
- 6/2006 The court overturned the Board's invalidity decision

Walt Disney (1995)

- Walt Disney had obtained copyright registration for several of its famous books and cartoon characters.
- In 1992, the books and characters were published and sold without Walt Disney's permission by a Chinese company
- The court rules for Walt Disney and fined the infringer approximately \$26,000
- This case is widely regarded as the first successful IPR litigation brought by an American company in China



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Trade Barriers / Export Import Regulations / Foreign Corrupt Practices Act (FCPA)

Barbara Linney, Partner – Blank Rome LLP
Peggy Clarke, Partner – Blank Rome LLP
Shawn Wright, Partner – Blank Rome LLP



Customs Rules

- Same customs rules as any other imports
 - CBP views imports from China as “low-hanging fruit”
 - Make sure documentation is complete
- Need not be a U.S. entity to import
- Have a compliance plan
 - Reliance on broker is not a plan and is not “reasonable care”
 - Make sure documentation is complete

Customs Rules

- Focus on the three basics
 - Classification
 - Valuation
 - If exporter and importer related the transfer price requires extra care
 - Declared value includes “assists” such as materials provided to seller by buyer, engineering and design services, certain commissions and licensing fees if paid by buyer
 - Country of Origin
 - Product marking requirements as well as declaration on entry summary
 - Just because it is shipped from Hong Kong or China does not mean it is product of Hong Kong or China

Other Border Requirements

- CBP enforces other agencies' requirements or works with them at the port
- May need other documentation
 - APHIS rules
 - FDA
 - Lacey Act declarations
 - EPA
 - Chemical registry
 - Product safety requirements

Other Border Requirements

- Know your supply chain
 - CBP's 10 + 2 reporting requirements
 - New food and product safety legislation in the works requires tracing the supply chain
- Exchange rate issues
 - Lots of talk but no actions taken on China currency issues
 - No action likely in near future

Antidumping/Countervailing Duty Issues

- China is the country of choice for trade remedy claims based on allegations of unfair practices such as dumping or subsidies
 - 30% of existing antidumping orders in place are against China
 - 20% of all countervailing duty orders in place are against China
 - All but 1 countervailing duty petition filed since 2007 were against China
- Findings of dumping or countervailing duties lead to additional duties at border and increased uncertainty for importer

Antidumping/Countervailing Duty Issues

- Exporters/Importers can take steps to prevent serious disruption
 - If case filed a good defense may keep findings in range allowing trade to continue
 - Pay attention to industry scuttlebutt about potential cases
 - If case filed look at options regarding alternative sourcing, defense, monitoring to reduce or eliminate duties going forward

Export Controls

- Military export controls
 - Arms Export Control Act (AECA)
 - International Traffic in Arms Regulations (ITAR)
- Dual-use export controls
 - Export Administration Regulations (EAR)

Military Export Controls

- No exports of defense articles, technical data or defense services to China
 - Includes all 21 categories or articles, technical data and services on U.S. Munitions List
 - Obvious munitions such as weapons, ammunition, *etc.*
 - Less obvious categories such as military vehicles, navy vessels, *etc.*
 - Modern warfare support such as chemicals, electronics, communications, *etc.*
 - Also impacts hiring of Chinese nationals in positions requiring access to ITAR controlled technical data
- Import controls may also apply
- Significant criminal and civil penalties for violations of the AECA and ITAR, including debarment from participating in U.S. government contracts

Military Export Controls (cont'd)

- Before engaging in trade with China, ensure that the contemplated transactions are not subject to the embargo
 - Can be difficult to distinguish between goods and technology subject to the embargo and those that are not
- Embargo does not apply to Hong Kong, but export licenses will be required for all ITAR controlled trade and technology transfers
 - End use certificates may also be required

Dual-Use Export Controls

- Most commercial trade with China and Hong Kong is not subject to export license requirements
- Items listed on Commerce Control List (CCL) in EAR may require export licenses for China and/or Hong Kong
 - These items are primarily designed for commercial uses but have the potential for diversion to uses contrary to the national security of the United States or regional security, or for terrorism, nuclear proliferation, chemical & biological weapons, missile technology, and other such uses
- China is subject to higher levels of CBW and National Security controls than Hong Kong
- Significant criminal and civil penalties for violations of EAR and terms and conditions of export licenses

Dual-Use Export Controls (cont'd)

- EAR contain military end-use rules that subject exports of certain dual-use goods, technology and software to China to additional controls
- Examples include depleted uranium and certain bearings and machine tools, x-ray machines, computers, telecommunications equipment, lasers, cameras, navigation equipment, underwater systems and equipment, and gas turbine engines
 - Complete list contained in Supplement No. 2 to Part 744 of the EAR
- Exports of these items are subject to licensing requirements
- License applications are reviewed on a case-by-case basis to determine whether a material contribution to the military capabilities of China would result that would be contrary to the national security interests of the United States

Economic Sanctions Programs

- U.S. Department of Treasury's Office of Foreign Assets Control (OFAC) enforces numerous other trade restrictions applicable to U.S. companies and individuals
 - Country embargoes (e.g., Cuba, Iran)
 - List based embargoes
 - Target specially designated companies, individuals, vessels and representatives of governments of embargoed countries (SDNs)
- No OFAC embargoes against China and Hong Kong but SDNs may reside or do business there
- Violations are subject to significant criminal and civil penalties and affected assets may be blocked

Foreign Corrupt Practices Act (FCPA)

The anti-bribery provisions prohibit:

- Paying or offering to pay “*anything of value*,” whether directly or indirectly:
 - To a *foreign official*, political party, or candidate for political office, or to any other person while “*knowing*” that all or part of the thing of value will be paid or offered to a foreign official, political party, or candidate;
 - “*Corruptly*” for the purpose of influencing the official in some official act or decision;
- In order to obtain or retain *business* or to secure any improper advantage

FCPA Accounting Provisions

- The books and records provision in section 13(b)(2)(A) and the internal controls provisions in section 13(b)(2)(B) of the Exchange Act (collectively “accounting provisions”) compels every issuer that has publicly registered securities to:
 - Keep books, records and accounts, that accurately and fairly reflect the transactions and disposition of the assets of the issuer
 - Maintain a system of robust internal accounting controls

What Constitutes a “Foreign Government Official”?

- Government officials and employees
- Political parties or party officials
- Employers of designated international organization such as UN, WHO, etc.
- Includes full-time and part-time employees of government controlled entities
- Covers relatives of officials, including:
 - Employees of state owned enterprises
 - Professors at public universities
 - Nurses, doctors, pharmacists employed in government owned hospitals
 - Members of government formulary board
 - Custom officials
 - Immigration officials

Recent FCPA Cases

FCPA penalties continue to set records:

| | | |
|--------------------|---------------|--|
| Baker Hughes | April 2007 | \$44 million in criminal and civil penalties and disgorgement |
| York International | October 2007 | \$22 million in criminal and civil penalties and disgorgement |
| Siemens AG | December 2008 | \$1.3 billion in fines and disgorgement in connection with improper payments in 10 countries including China |
| ITT | February 2009 | \$1.4 million in disgorgement and prejudgment interest and \$250,000 civil penalty |
| KBR/Halliburton | February 2009 | \$559 million in criminal and civil fines and disgorgement |

FCPA Enforcement Trends – China

- China and Iraq are tied for second place for the countries that have generated the most FCPA cases
- China's bribery cases span seven industry sectors:

Energy

Health & Pharmaceutical

Defense & Aerospace

Manufacturing

Infrastructure

Agriculture

Telecommunications

Recent Chinese Anti-Bribery Initiatives

- Beijing initiated a campaign against corruption in the medical equipment industry
- Chinese Ministry of Health implemented new rules prohibiting pharmaceutical companies from engaging with local medical institutions
- Under Chinese laws those who offer bribes tend to be prosecuted less aggressively than those who accept them

FCPA Risk Management & Due Diligence

- Ensure foreign individuals or companies do not have a reputation for unlawful conduct
- Insist on strict performance of contractual obligations
- Contracts with foreign parties should include certification that the foreign party is not a foreign government agent, does not employ foreign government officials, will not give any portion of its compensation or profits to a foreign government official, and will ensure compliance of its employees with these terms

Risk Assessment – General Considerations

- Risk assessment depends upon specification of management objectives, with risks identified in relation to those objections
- Fraud risks must be explicitly considered in relationship to management objectives
- Risks from both internal and external sources must be evaluated

Risk Assessment – Specific Risks

Internal controls should identify specific risks or “red flags,” such as:

- Payments for goods or services that are more than market
- Irregular or greater than ordinary commissions
- Checks drawn to case, payments to third-country accounts or the use of bearer instruments
- Unusual or off-cycle bonus payments
- Evidence of over-invoicing or backdated invoices
- Payments drawn from an incorrect account
- Requests for payments to third parties rather than to an employee, agent or consultant
- Refusal to certify compliance with FCPA
- Charitable contributions to organizations associated with foreign officials
- Rumors of improper payments

FCPA Due Diligence

- Due Diligence programs for relationships with agents, consultants and business partners
 - Identify and document qualifications/reputation
 - Use of candidate questionnaires, references, interview and third party sources of information
 - Identify and resolve any red flags associated with agents, consultants and business partners
 - Prepare and maintain a written due diligence report that documents the above

FCPA Penalties

- Bribery and kickbacks and other violations of the FCPA can result in:
 - Severe financial penalties (criminal and civil) imposed on companies
 - Personal liability through criminal and civil penalties
 - Loss of personal & professional reputation
 - Prison time