

Welcome to the Dec 2007 edition of Pragma's China Newsletter, prepared by Jesa Consulting

➔ FOCUS ON: Intellectual Property in China



A lot of products in the same genre have brand-worthy attributes that are applicable across different countries. However, since all the products in a certain category share similar characteristics (for example, all coffees are bitter), it is very difficult for a company to differentiate its product

basing solely on these primary attributes. On the contrary, companies must attempt to create a defining identity that is unique to their product through promotion of a product's secondary attributes. The difficulty lies in finding secondary brand attributes that can, without a doubt, be claimed as your own.

Ultimately, how a brand establishes its image is one of the deciding factors in whether it succeeds. As a result, companies make big efforts to protect their brands from imitators, counterfeiters and other abusers of intellectual property. For companies operating in China, this protection is of particular concern. A European commission report in 2006 identified China as the most problematic country of counterfeiting and abuse of intellectual property for European companies.

Theoretically, Chinese laws are as strong as those of any other WTO member. It has a strong legal system and clearly defined procedure for identifying and prosecuting companies and individuals that infringe intellectual property. However, in practice, the system suffers from some weaknesses.

First, at the time of registration of a patent or trademark, China operates on a "first to file" basis. Unlike the USA, which follows a "first to invent" rule, in China the first person to file a patent owns it, regardless of whether he/she invented it or has any intention of actually producing it. In an extreme scenario, it could possibly lead to a situation whereby a company or individual could sabotage or blackmail a competitor by pre-emptively registering a patent.

A further problem with patent registration in China is that although in theory it should take no more than a few months, in practice it is a long process. Moreover, when filing a patent in China, the company is required to disclose all information about that patent and manufacturing involved. While all companies wishing to register a patent must do so at China's State Intellectual Property Office (SIPO) in Beijing, provincial and municipal SIPO offices are responsible for administrative enforcement. Unfortunately, this system is open to abuse as regional offices are much more susceptible to corruption.

It is important to know that what holds true elsewhere in the world does not necessarily apply in China, both legally and in terms of basic business practices. For example, while China in theory recognizes trademarks registered in most of its main trading partners, the American Embassy in Beijing advises all foreign companies seeking to distribute their products in China to register their marks and/or logos with the China Trademark Office as an added precaution.

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What is Jesa?



Jesa's reception desk in Shanghai

Jesa is a service company headquartered in Shanghai specialising in facilitating start-up of new industrial productions while providing reliable

management and control solutions. We operate 4 main branches in China and a foreign office in Ulaan Baatar (Mongolia).

Since 1998, Jesa has built a team of 70 specialized employees in addition to 25 technicians following "in loco" projects. Commercial relationships are exclusive and strictly confidential, ensuring the highest expertise on every single commercial and technical issue.

Jesa is a leader in managing manufacturing processes and eliminating any industrial and regulatory problems while helping our clients save financial resources.

Jesa is currently expanding its services to provide support to those companies seeking to develop distribution network and retail system in China as well as in Mongolia.

We also perform HR audit and investment analysis (trouble-shot analysis) to check performances in support to companies already established in China.



Trésor Doré as Fake Ferrero

A lengthy legal battle between the Italian chocolate maker Ferrero and the Chinese look-alike rival Montresor illustrates why brand owners in Asia must think carefully about their trademark registration from the outset. Ferrero filed a lawsuit against Montresor (Zhangjiagang) Food, a Chinese competitor, accusing it of copying the *Ferrero Rocher* gold-wrapped packaging and heart-shaped transparent box for its *Trésor Doré* chocolates. The Tianjin 2nd Intermediate Court initially ruled, in November 2004, that Montresor was innocent because its *Trésor Doré* product had been well known in China for longer than the *Ferrero*

Rocher product. However, Ferrero successfully appealed this decision to the Tianjin High Court, which said that *Trésor Doré* products were counterfeits and ordered Montresor to pay RMB 700,000 (US\$ 87,000) in compensation and to cease selling these products. Privately owned Ferrero has spent US\$ 800,000 over the past several years defending its intellectual property rights in China.

There is a considerable difference in Chinese law between what is written and how it is applied. The application of law in China is highly fragmented and localized. The major urban areas have, in the main, a well developed and impartial policing and judicial system, although some southern Chinese cities like Guangdong and Shenzhen are otherwise. Yet, while the law is often effectively enforced in first-tier cities, in second-tier cities and rural areas the law becomes much more arbitrary as local governments, judiciary and business interests become increasingly intertwined.

Criminality is another, very visible, problem that companies in China have to face and in particular the damage that is done to their products and brands' image by imitations, counterfeiting and "*third shift*" goods. Foreign companies regularly outsource their production to China using local factories manned by local staff. The "*third-shift*" refers to when a factory manager would run two official shifts to produce his or her quota and a third "unofficial shift" producing exactly the same product but which would be sold via alternative routes. In late 2001, for instance, Too Inc., which runs the Limited Too chain of clothing stores for girls, discovered that discounter TJ Maxx was selling 31 styles of Limited Too apparel at markdowns - 653,000 garments. TJ Maxx was stocking many more units than Too had ever ordered from its Asian suppliers, and what Too had ordered was still being sold in its own stores.

When Too sued TJ Maxx to stop sales, though, its lawyers candidly admitted that they weren't sure whether the clothes were counterfeits or third-shift goods. Though discounters can always be enjoined from selling counterfeits, some judges will let them sell third-shift goods unimpeded, viewing the latter as legally "genuine." In Too's case, the judge enjoined the sales, ruling that even third-shift goods were a form of trademark infringement, albeit less serious than counterfeiting. That seems to be the emerging view.

Even in the case of litigation through legal means, companies will often continue manufacturing and selling disputed goods despite legal proceedings against them, which is often a long, drawn-out process. Moreover, although the number of foreign companies that win intellectual property rights and image violation cases is quite high, the penalties imposed by Chinese courts are often nothing more than a token gesture and focus solely on the estimated impact on profits lost, rather than taking into account damage done to the brand's image and potential loss of consumer confidence.



Beijing 2008 Olympics' mascots

Many challenges still remain. Beijing has successfully clamped down on the counterfeiting of its Olympic mascots and logos through the dual strategy of increased police vigilance and harsh sentences for those found guilty of such offences. While this achievement is to be lauded, it bears more than a whiff of self-interest and raises the question of why the same level of protection is not extended to companies operating in China. The Beijing authorities

certainly have the means to enforce a much bigger crackdown on the distribution and sale of counterfeit goods than they are presently doing.

Currently, the most important thing in Chinese government's mind is the need to maintain social stability through economic growth and employment. Factories in the underdeveloped interior provinces may be making counterfeited goods but they are employing people and paying taxes. For local governments, this point is more important than ephemeral intellectual property rights.

In such a situation, Jesa suggests the companies looking for suppliers to outsource part of their production pay attention to their qualification and control. At the same time, the selection of the suppliers' location plays a major role: the commitment of local authorities to the enforcement of the law and to the companies' economic interests is fundamental when choosing to approach the Chinese market. Jesa suggests finding a reliable partner who could control suppliers and the respect of the law.

Brand ripoffs: A user's guide

Counterfeit:

A product that bears a trademark that its maker had no authority to use.

Knockoff:

A broad term encompassing both counterfeits and items that look like branded products though they don't actually bear forged trademarks.

Third shift:

An unauthorized product made by an authorized contractor.

New steps to control foreign investments

At the beginning of November, China's National Development and Reform Commission announced the issuance of a new and substantially revised Catalogue for the Guidance of Foreign Invested Firms. The Catalogue provides basic guidance for foreign investment in China. It divides investments into "encouraged," "restricted" and "prohibited" categories. In the 2007 catalogue, the encouraged section is more than twice the length of the 2004 Catalogue. The restricted and prohibited categories have not substantially changed but do contain some surprises. The major changes to note in the 2007 Catalogue are the following:

1. There has been a substantial restriction on foreign investment in real estate and real estate brokerage firms. Construction and operation of luxury hotels, villas, office buildings and conference centres have been placed in the restricted category. In this context, this means an absolute prohibition.
2. Continued restriction and prohibition of participation in publishing, media, market research and social research. In recognition of the influence of the Internet as an alternative publishing source, various Internet based businesses have been added to the prohibited category.
3. Opening of the service area to logistics and service outsourcing by placing these in the encouraged category. The service area continues to be opened to foreign investment. The addition of outsourcing to the encouraged category is important. China is trying to catch up with India as an outsourcing centre. Dalian in particular is being pushed as a location for such businesses.
4. The new policy discourages or prohibits foreign investment in businesses solely devoted to export (a 180 degree reversal of prior policy). The new policy restricts or prohibits investment in industries China has already mastered (like toys, furniture, shoes, clothing) or in industries with high usage of resources or energy (like steel, aluminium, paper, cement, other basic industries). This is another 180 reversal of prior policy. The message is that there will be no more dumping of outmoded or wasteful production in China. Whether China can successfully implement this policy at the local level remains an open question.

The main purpose is to move from emphasizing the quantity of foreign direct investment (FDI) to emphasizing the quality of that investment. This new approach will involve the following:

- Shifting from using foreign capital to make up for a shortage of investment funding and foreign exchange to using foreign capital to introduce advanced technology, management experience and high quality talent to China.
- Focusing on ecology, environmental protection, conservation and the comprehensively utilizing its resources.
- Combining the use of foreign capital with the upgrading of domestic industry and technology.

The 2007 catalogue is another step in Beijing's plan to reform the environment for foreign investment in China. It is consistent with other measures which eliminated the tax break for foreign invested enterprises, limited foreign M&A activity, and eliminated many supports for export oriented enterprises. It appears China is serious about making this change and foreign investors need to become familiar with this new system.

Zhejiang, China's secret growth engine



Zhejiang is a province of 44 million people and ranks 11th in population among China's 33 provinces, municipalities and autonomous regions, but 4th in total trade.

At the beginning of the reforms in the 1980s, Zhejiang was already investing overseas and trading equity stakes in private companies – albeit underground – without interference of the central government. This province is now considered by economists a bottom-up model of development with fearless regard for the global economy and as an example for the entire Chinese economy.

While much of rest of China is still run by state bureaucracies, nearly three quarters of the economic output and more than a half of the tax revenue in Zhejiang comes from private enterprise. Small and medium sized enterprises dominate, funded by an elaborate underground banking network, with a default rate near zero.

Zhejiang is still well known as a manufacture centre for buttons, socks and textile, but now it is also going high-tech. R&D investment in private industry last year grew by 47% over 2005, and the value of high-tech companies as a percentage of total industry increased by 26%. Alibaba, for example, was founded in 1999 in Zhejiang.

Zhejiang is a province of 44 million people and ranks 11th in population among China's 33 provinces, municipalities and autonomous regions, but 4th in total trade. Since 1978, year in which the economic reforms started, its economy has grown at an annual rate of more than 13%, three points higher than the nation as a whole, and it is expected to expand by 14.7% this year.

The Zhejiang presence in foreign countries is impressive too. FDI from this province has doubled since 2005 to USD1 billion, making it the most aggressive investor of any Chinese province. At the same time, while Asia accounts for about 40% of Zhejiang outbound M&A investment, Europe and North America follow closely behind with 37% and 27%, respectively.

In brief

Investing in Shanghai real estate

In newspapers from Shanghai as well as on the Internet, all the articles about real estate market in Shanghai seem to agree on the same two points, that are both correct and wrong:

- Property prices are increasing;
- A property bubble is threatening.

Here are some information about the situation that foreign businessmen may encounter concerning real estate market.

On one side the market is developing fast: Since the beginning of the year up to June, \$ 130.1 billion have been invested into real estate. This value represents an increase of 28.5% compared to the same period of the last year; investments in commercial buildings registered a 30.9% increase. On average, prices of properties around the country (70 cities as sample) increased by 7.1% in June alone, 0.7 point more than the previous month. This phenomenon represents a 23 months record.

On the other side, the government is trying to cool down this phenomenon in order to prevent the increasing threat of property bubble. The corrective action made by public administrators consist in several rules whose aim is to increase prices of the houses for investors who buy a second house. For instance, people who hold more than one mortgage must pay an advance note of 40% of the property's value (it was 30% in September). This kind of buyers must also pay a 10% premium on their interest rate. For people who get the third or fourth house using mortgage, the down payment and the premium on interests will be even higher. In September 28th, the People's Bank of China stopped releasing mortgages, waiting for new procedures. Moreover, the refinancing of mortgage was prohibited because, as authorities said, this instrument could be used to purchase more properties.

In China everything is possible, good deals or bad deals. Our readers would be advised to be very wise, well informed and to have a complete clear idea about the regulations before signing any kind of agreement. The deal can be easy if you are well equipped.

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