

July 9, 2010

What Next in China's Indigenous Innovation Program?

Background

China's accession to the WTO was seen as an opportunity to break down the many non-tariff barriers already working against foreign investors and exporters with sights on China's burgeoning domestic consumption. Almost ten years later, it appears that market access is becoming more restricted. In addition to the continuously vexing problem of standards and their administration by China's labyrinthine bureaucracies, all eyes are now on foreign participation in government procurement and the impact of laws and regulations that implement new policies on "indigenous innovation".

As a reflection of a "Buy China" policy, the requirement of *China's Government Procurement Law (2002)* that all PRC government agencies purchase domestic goods and services is relatively uncontroversial because of its large carve out of those required items which cannot be obtained within China. However, China's "indigenous innovation" policies go well beyond favoring domestic goods and services in government procurement.

"Indigenous Innovation" is a government policy response to China's perceived over-reliance on foreign technology and intellectual property first fully articulated in various national documents dating back to 2006 that make it clear the Chinese government has intended for some time to develop a national catalog for government procurement of products that meet indigenous innovation criteria.

Through indigenous innovation, the PRC government seeks to limit reliance on foreign technology and brands by promoting the creation and commercialization of Chinese-owned technology and intellectual property and by imposing discriminatory practices to discourage foreign participation in certain industries.

To date, local governments in Beijing, Shanghai, Tianjin, Wuhan, Chengdu, Fujian, and Jiangxi have each published indigenous innovation catalogs and begun to implement procurement policies that give preference to products certified as indigenous innovation products. Very few products produced by foreign-invested businesses in China (eg: only two products in the Shanghai catalog) have received accreditation. Governments at the central and local level have also introduced financing and tax relief schemes to incentivize the development and use of indigenous innovation products by Chinese companies.

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The contents are intended for general information purposes only and are based on our understanding of the relevant Chinese law and practice and our experience representing foreign companies in China. Law and practice concerning foreign related business in China are subject to change and may require confirmation from the relevant authorities. You are urged to consult an attorney concerning your own situation and any specific legal questions you may have.

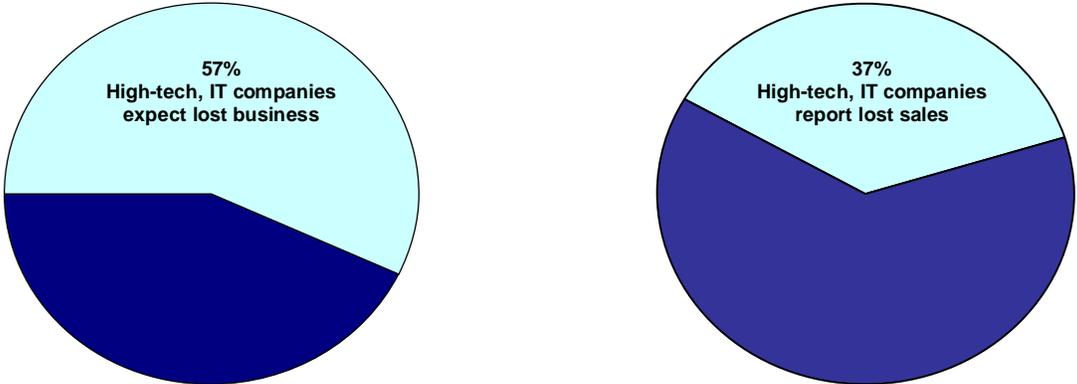
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Circular 618

The foreign reaction to these developments reached a fever pitch when, on November 15, 2009, China's Ministry of Science and Technology ("MOST"), the National Development and Reform Commission ("NDRC") and the Ministry of Finance ("MOF") jointly issued Circular on Promoting the Accreditation of New Indigenous Products in 2009 科技部 国家发展改革委 财政部关于开展 2009 年国家自主创新产品认定工作的通知 ("Circular 618") and a separate set of accreditation application procedures. Together, these documents lay out specific rules for introducing a new national-level indigenous innovation catalog of certified products and China's product accreditation procedures. The catalog covers the following six broad product areas: computers and application equipment, telecommunication equipment, modern office equipment, software, new energy equipment and high-efficiency energy-saving products.

Then on December 29, 2009, the MOST, the MOF, the Ministry of Industry and Information Technology ("MIIT") and the State Asset Supervision and Administration Commission ("SASAC") released a list of 240 types of industrial equipment which government planners hope domestic companies will begin producing in order reduce dependence on foreign manufacturers. The equipment is listed in priority for accreditation as indigenous innovation products.

These developments and concerns about controversial changes to China's patent law, which came into effect in October 2009, fed media speculation that Circular 618 was part of a wider policy of discrimination against foreign technology and IPRs. As a result, according to a survey conducted earlier this year by the American Chamber of Commerce in China, more than half of U.S. companies in China were expecting lost business due to China's indigenous innovation policy and 37% were already experiencing lost sales (see chart below).



Source: American Chamber of Commerce in China, March, 2010

Partly in response to the concerns voiced by AmCham and other foreign trade and industry groups about Circular 618, on April 10, 2010, the MOST, the NDRC and the MOF jointly released a *Draft Circular Regarding the Launch of the National Indigenous Innovation Production Accreditation Work for 2010* ("Draft Circular"). The Draft Circular affirms Circular 618 and the application rules issued in November 2009 but relaxes key restrictions on intellectual property rights ("IPR" and is intended to elicit comment on the proposed accreditation procedures.

The main features of the Draft Circular are as follows:

- Products: the list of eligible product categories is the same as for Circular 618: computers and application equipment, telecommunication equipment, modern office equipment, software, new energy equipment and high-efficiency energy-saving products.



- Eligibility criteria: products must meet general PRC legal requirements and comply with China's national industrial and technology policies, must represent advanced technology and either offer obvious benefits in conserving resources, raising energy efficiency and/or reducing pollution or must represent a substantial improvement in terms of structure, materials, quality/craftsmanship and performance. Products must possess reliable quality and bear compulsory accreditation (if subject to a compulsory product accreditation regime) and possess all special licenses (if subject to a special licensing administration requirement). Furthermore, the product must have already been released in the market and be manufactured in China by a lawfully registered business that: a) owns the product's IPRs (ie: patents) in China or has a license to use the IPRs in China [emphasis added]; b) has exclusive rights to the product's registered trademark or has the right to use the trademark in China [emphasis added];
- Accreditation process: online declaration via a MOST website (<http://program.most.gov.cn>), followed by submission of documents to any regional MOST office prior to September 10, 2010. Preliminary examination of all submissions is to be carried out by experts organized by MOST, the MOF and the NDRC. Provincial MOST offices will file their accreditation recommendations with MOST (at Central government level) before October 20, 2010. A preliminary list of products to be included in the national catalog will be compiled by MOST officials from accreditation recommendations with the list becoming available before the end of 2010.

The principle amendment adopted by the drafters of the Draft Circular relative to Circular 618 is that whereas Circular 618 required the entity to own the relevant patent(s) and trademark(s), the Draft Circular only requires the entity to have a lawful right to use such IPRs.

What Now?

Although the initial response to the Draft Circular has been less shrill than with Circular 618, it has been predominantly negative. This ignores the many foreign-based manufacturers who regard the development of China's indigenous innovation accreditation system as a potentially lucrative opportunity to bid for PRC government procurement contracts.

Government procurement in China currently accounts for roughly between US\$70-130 billion a year across a wide range of industry sectors. There are, no doubt, manufacturers who are keen to comply with the accreditation requirements in order to supply software or telecommunications equipment to whole government departments or to a network of provincial hospitals.

Nevertheless, for most foreign technology providers (as well for domestic industry and ultimately for the PRC government), indigenous innovation presents numerous difficulties.

China's indigenous innovation policy constitutes a market entry barrier for any foreign businesses seeking government procurement contracts. Many foreign companies will simply be unable to compete for PRC government procurement contracts because they will not be able to obtain accreditation for their products. The eligibility criteria set forth in the Draft Circular are an improvement over those outlined in Circular 618 – they do not require that patents for accredited products be owned by an entity in China, and trademarks on the products no longer need to be registered in China. However, meeting the other criteria may not be so straightforward for foreign-invested manufacturers.

Manufacturers that decide to bid for government procurement contracts will need to ensure that their products are submitted before the September 10 deadline for accreditation examination. They also need to ensure that those products actually meet the criteria. Products manufactured outside of China or without proper licenses to use patents or trademarks in China will not be eligible. For any products which are still in development spread over a variety of jurisdictions, manufacturers need to take steps to ensure that they too will meet accreditation criteria. Although the Draft Circular does not require local ownership of the relevant patent or trademark, in practice, preference may be given to accredited products backed up by China patents and trademarks. Where a new technology or design feature is the outcome of collaboration



between a foreign-invested entity and overseas affiliates, it may be necessary to take steps that most of the critical work was carried out in China to ensure that the new feature can be patented.

Seek Accreditation or Not?

For those products which do meet the criteria, should you decide to seek accreditation?

There are two main reasons why many manufacturers will decide not to seek accreditation. First, the accreditation process outlined in the Draft Circular does not inspire confidence that technology and IP will be protected. The widespread perception reported by the media is that product examinations will be carried out by experts at government facilities, not at third-party testing agencies, and the scope of examination will go well beyond innovation features and will review underlying technology secrets.

Secondly, multinational corporations ("MNCs") and developers of sensitive and cutting edge technologies may decide to forego government procurement opportunities in China out of fears that exposing technology secrets to the Chinese government may hurt their exports outside of China.

To date, there are no authoritative empirical studies on the effect of the indigenous innovation policy on Chinese technology but as with protectionist policy makers the world over, China has not understood that such policies are fundamentally anti-competitive and will ultimately lower standards and harm the interests of Chinese manufacturers and consumers because barring foreign products from government procurement will in the long run render local manufacturers less competitive.

China's indigenous innovation policy will become a policy thorn in the side of the PRC government as well. Although other countries impose restrictions such as local content on government procurement, none make nationality of IP ownership a market access criterion and nearly all, including the U.S. Buy American Act, feature a variety of carve-outs for foreign suppliers to avail themselves of. China has, for the moment, stepped back from demanding Chinese ownership of IP but restricting government agencies from buying products which are not listed in the national catalog is blatantly protectionist and contrary to China's WTO obligations.

When China joined WTO in 2001, it committed to becoming a signatory to the WTO Agreement on Government Procurement ("GPA") which aims to guard against protectionism. China also committed to treating products manufactured in China by foreign-invested entities the same as products manufactured by Chinese entities. The indigenous innovation policy is inconsistent with that commitment and the terms of the GPA and China will be taken to task later in July 2010, when the WTO Government Procurement Committee meets, for not creating a level playing field for government procurement.