



China Insights

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2006 Report on China's WTO Compliance

Introduction

Inasmuch as the 2006 Report to Congress on China's World Trade Organization ("WTO") Compliance (the "Report") is the fifth since China's accession to the WTO, and the fourth commented upon in *China Insights*, we thought it appropriate to look back at our articles about China's WTO compliance in 2003, 2004 and 2005. There is certainly a recurring theme which can be paraphrased as, "although much progress has been made, much remains to be done and areas of concern remain."

It is fair to say that although the pace of real progress in certain areas of compliance (e.g., actual implementation of intellectual property rights protection) has been much too slow, the broader, cumulative scope and level of compliance has significantly progressed. It is to be expected that as a great deal of what once needed to be done by China in order to satisfy WTO requirements has been done, there is a sharper focus by the U.S. on, and a greater concern (and often frustration) with, what remains to be done.

The underlying cause of slow progress in certain areas ranges from—at one end of the spectrum—a shortfall in the

infrastructure, personnel, and training needed to implement compliance, to—at the other end of the spectrum—a conscious effort (often at the local level) on the part of individuals, businesses and sometimes governmental units to cling to economic and other advantages by simply ignoring national or provincial compliance directives (combined with acquiescence by the higher levels of government). Whatever the cause, real harm will continue to be suffered by U.S. interests as long as such "compliance gaps" continue.

As in prior years, whenever the Report's own language concisely and clearly describes a particular point, we borrow from that language directly. In other instances, we paraphrase or interpret. Also, as in prior years, space limitations preclude us from covering all sections of the Report, so we have focused on areas in which we feel our readers will have the greatest interest. We hope that you find the following three articles to be informative and interesting.

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As demonstrated by the 2006 Report, despite the fact that the five year period for China to achieve full WTO compliance has now concluded, there are many areas where improvements are needed and changes are expected....

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Trading Rights and Distribution Services

Trading Rights. Trading rights refer to the right to freely import goods into China and the right to export goods from China without having to use an intermediary. The United States Trade Representative (the “USTR”) notes that by mid-2004, China had implemented its commitment to substantially liberalize trading rights, and current law allows domestic and foreign entities and individuals to register for automatic trading rights. U.S. companies have reported few

problems with the new trading rights registration process. However, China has not yet implemented its trading rights

commitments insofar as they relate to the importation of books, newspapers, periodicals, electronic publications, and audio and video products. Beginning in May 2006, the U.S. used a series of high-level and technical-level bilateral meetings in Beijing to raise the profile of its concerns, however, China has maintained that it can continue to preclude foreign enterprises from importing those products and continues to impose various restrictions on their distribution by foreign enterprises within China. According to the Report, the U.S. continues to press China on these areas of noncompliance and will take further actions seeking to eliminate China’s restrictions in 2007.

Distribution Services. China previously made a commitment to eliminate national treatment (i.e., affording less favorable treatment to foreign companies than is afforded to domestic companies) and market access restriction on foreign enterprises providing distribution services through a local presence by

December 11, 2004. Overall, China has made substantial progress in implementing its distribution services commitment. However, some technical challenges remain. For example, pursuant to the implementing regulations, cities without approved commercial development plans cannot apply to central government authorities for approval of foreign-invested projects in the distribution services sector, thus making it easier for cities to reject applications. In addition, the area of direct selling, or sales away from a fixed

location, remains problematic, with limited progress made since the issuance of implementing rules in August 2005. In 2007, the U.S. will

continue to closely monitor how MOFCOM and relevant provincial and municipal authorities exercise their licensing authority, particularly in the area of direct selling. For further background on the history of distribution rights, please refer to the March-April 2004 issue and July-August 2005 issue of *China Insights*.

On a practical note, U.S. and other foreign companies will face challenges with regard to the creation of nationwide distribution networks in China. This is mainly due to the fact that the country’s distribution networks remain highly fragmented. China’s commitment to develop nationwide distribution networks should ultimately help foreign companies compete more effectively.

Import Regulation

Tariffs. China’s 2006 tariff schedule reductions principally involved motor vehicles and motor vehicle parts.

Overall, China’s tariff changes have increased market access for U.S. exporters in a range of industries. Indeed, tariff changes contributed to a significant increase in overall U.S. exports, which rose approximately 35 percent compared to the same period in 2005. In addition, China continues to eliminate tariffs on computers, semiconductors, and other information technology products. U.S. exports of such goods were projected to exceed \$6.8 billion by the end of 2006, increasing by 68% for the first nine months of 2006, when compared to the same period in 2005.

Customs Valuation. U.S. exporters continue to encounter valuation problems at many ports. For example, the current regulations provide that imported goods should be valued on the basis of their transaction price, i.e., the price the importer actually paid. However, customs officials are still improperly using “reference pricing,” which usually results in a higher dutiable value. More generally, U.S. exporters continue to be concerned about inefficient and inconsistent customs clearance procedures in China. These procedures vary from port to port, massive delays are not uncommon, and the fees charged appear to be excessive and are rapidly rising. In 2006, as in prior years, the U.S. voiced its concerns about customs valuation problems.

Rules of Origin. China issued regulations intended to bring its rules of origin into conformity with WTO rules for import and export purposes in September 2004. The Customs Administration subsequently issued implementing rules addressing the issue of substantial transformation in December 2004. U.S. exporters have not raised concerns with China’s implementation of these regulations and rules.

Overall, China has made substantial progress in implementing its distribution services commitment.

Import Licensing. China made a commitment that the issuance of import licenses will not be based on performance requirements of any kind, such as local content, export performance, offsets, technology transfer, or research and development, or on whether competing domestic suppliers exist. Despite its commitment, in May 2005, the Chinese government began imposing new import licensing procedures for iron ore without prior WTO notification. China has restricted licenses to 48 traders and 70 steel producers and has not disclosed the qualifying criteria used. The U.S. raised its concerns with China in October 2006 during a meeting of the U.S.-China Steel Dialogue. According to the Report, the U.S. will continue to closely monitor this matter in 2007 and will raise objections as appropriate.

Non-Tariff Measures (“NTMs”). China previously committed to eliminate numerous NTMs, including import quotas, licenses, and tendering requirements covering hundreds of products. Prior to its accession to the WTO, China’s import quota system was beset with problems, the biggest of which related to the auto import quota system, resulting at times in significant disruption of wholesale and retail operations for imported automobiles. China has adhered to the agreed schedule for the elimination of all of its import quotas as well as all of its other NTMs and, in some cases, China has eliminated its NTMs ahead of schedule.

Tariff-Rate Quotas (“TRQs”) on Industrial Products. China agreed to implement a system of TRQs designed to provide significant market access for three industrial products, including fertilizer, a major U.S. export. Under the TRQ system, a set quantity of imports is allowed at a low tariff rate, while imports

above that level are subject to a higher tariff rate. In 2005 and 2006, MOFCOM’s administration of the fertilizer TRQ system had not noticeably improved and U.S. fertilizer exports to China declined sharply in 2006. However, U.S. and other foreign fertilizer producers were anticipating increased exports after December 11, 2006, when China was scheduled to begin allowing foreign enterprises to engage in the wholesale and retail distribution of fertilizer within China. The U.S. will monitor developments in this area closely in 2007.

Antidumping (“AD”) and Countervailing Duties. Since its accession to the WTO, China has become a leading user of AD measures, with a total of 86 AD measures covering 18 countries currently in place and 25 investigations in progress. According to U.S. antidumping experts, the greatest shortcomings to date in China’s antidumping practices relate to transparency and fair procedures. Moreover, China does not provide adequate opportunities for interested parties to provide input for their deliberations. The U.S. continues to voice its concerns regarding China’s AD practices.

Export Regulation

WTO members are generally prohibited from maintaining export restrictions unless (1) such restrictions are imposed for the purpose of conservation of exhaustible natural resources; (2) such restrictions are made effective in conjunction with those on domestic production or consumption; or (3) such restrictions are not applied in a manner that would constitute a means of

arbitrary or unjustifiable discrimination between countries where the same conditions prevail or as a disguised restriction on international trade. Little progress has been made since the last Report on China’s WTO compliance status with regard to its export

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regulations. China continues to impose export restrictions on a few highly demanded raw materials, citing the above exceptions to justify its non-

compliance with WTO obligations. The most significant adverse effect of China’s export restrictions on the U.S. is its longstanding export restrictions on blast furnace coke, a key steel input, which is an indispensable material for U.S. integrated steel producers and their customers. China restricts the export of coke by using a limited export quota system, which has caused the export price for coke to rise to the vicinity of \$500 per metric ton while domestic prices range between \$150 and \$200 per metric ton. The United States, as well as other WTO members, has been pressing China for complete elimination of its annual quota and other export restrictions on coke, as well as other products, but no progress has been made.

Internal Policies Affecting Trade

Non-Discrimination. Non-discrimination, also referred to in the United States as “normal trade relations,” or the rule of “national treatment,” is based on one of two fundamental GATT principals, namely, “Most-Favored-Nation” (“MFN”) treatment. Compliance with MFN means that all of the goods of an importing member’s trading partners are on equal terms with one another. China has committed to observe this rule with

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regard to all WTO members, including separate customs territories, such as Hong Kong, Macau, and Taiwan. China has also committed to making progress on compliance with the national treatment rule, which requires an importing WTO member to put its trading partners on equal terms with the importing member's own goods. To that end, China has reviewed pre-WTO accession laws and regulations and revised many of those which conflict with WTO standards on national treatment and MFN.

National treatment has been secured, for example, with regard to boilers and pressure vessels, after-sales service, and the pricing of pharmaceutical products, among other areas. However, China does not observe MFN and national treatment requirements in all areas. For example, China continues to apply value-added tax ("VAT") in a manner that unfairly discriminates between imported and domestic goods; and its industrial policies on automobiles and steel appear to discriminate against foreign producers as well as imported goods.

Taxation. China resolved its discriminatory tax rates applied to imported versus domestically produced semiconductors for the integrated circuit industry in 2004; however, similar issues still remain in other areas. For example, China also uses VAT policies to benefit domestic fertilizer production, exempting all but one type of phosphate fertilizer from a 13 percent VAT. The United States has raised this issue both

bilaterally with China and at WTO meetings. So far, China has refused to make any significant changes in its policies. Concerns also remain with respect to the unfair enforcement of China's VAT system. Often, Chinese producers are able to avoid payment of the VAT while the full VAT must still be paid on competing imports.

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Consumption taxes are another area of non-compliance with national treatment rules. The United States has raised its concerns with China on various occasions

over China's tax regulations, which use different tax bases to compute consumption taxes for domestic and imported products such as alcoholic beverages, tobacco, cosmetics, rubber, motorcycles, and automobiles. The effective consumption tax rate for certain imported products is substantially higher than domestic products.

Subsidies. China has made a commitment to eliminate all subsidies contingent on export performance (export subsidies) and subsidies contingent on the use of domestic over imported goods (import substitution subsidies). China submitted its long-overdue subsidies notification to the WTO's Subsidies Committee in April 2006, but it failed to notify of any subsidies provided by China's state-owned banks or by provincial and local government authorities. Moreover, China did not make any commitment to withdraw the subsidies. A number of U.S. industries, including the steel, paper and textiles industries, expressed

increasing concern in 2006 about the injurious effect of China's subsidies on the U.S. market as well as in China and other markets. The United States began seeking changes to China's subsidies policies immediately after China submitted its subsidies notification but, to date, China has been unwilling to commit to the immediate withdrawal of the subsidies in question.

Price Controls. China agreed that it would not use price controls to restrict the level of imports of goods or services. However, it continues to maintain price controls on several products and services, including pharmaceuticals, tobacco, natural gas, and certain telecommunication services. In addition, China has implemented price controls on products such as gasoline, kerosene, diesel fuel, fertilizer, cotton, various grains, various forms of transportation services, and professional services such as engineering and architectural services. The United States will continue to monitor China's progress in this area in 2007.

Standards, Technical Regulations, and Conformity Assessment Procedures. In its WTO accession agreement, China made a commitment to develop standards, technical regulations, and conformity assessment procedures and to apply those standards and regulations transparently and on a non-discriminatory basis. While the country has made significant progress in the areas of standards and technical regulations and addressed problems that foreign companies had previously encountered in locating relevant regulations and predicting how they would be implemented, certain U.S. industries still have significant concerns about

conformity assessment and testing-related issues in China. For example, it is reported that China's regulatory requirements are not enforced as strictly or uniformly against domestic producers as they are with foreign producers. The USTR notes that China has been making progress in this area, but the progress has been inconsistent. China has also embarked on the task of reviewing all of its existing 21,000 standards and technical regulations to determine their continuing relevance and consistency with international standards. In October 2005, China reported that it has nullified 1,416 national standards; however, China did not provide an update on its progress in 2006. The U.S. Trade and Development Agency launched the U.S.-China Standards and Conformity Assessment Cooperation Project in Beijing in 2006 to provide education and training for Chinese policy makers and regulators with regard to U.S. standards and conformity assessment procedures. Nevertheless, concerns have grown over the past few years as China continues to actively pursue the development of unique requirements that constitute a means for protecting domestic companies from competing foreign standards and technologies, despite the existence of well-established international standards. For example, China issued two mandatory standards for encryption over Wireless Local Area Networks (WLAN) applicable to domestic and imported equipment containing WLAN technologies. More recently, China declared TD-SCDMA to be the national standard for 3G telecommunication, raising concerns among U.S. and other foreign communication companies.

One positive development occurred in August 2006 when China announced a proposed revision of its distilled spirits standards and indicated that it was accepting public comment.

Other Internal Policies

State-Owned and State-Invested

Enterprises. China has recently agreed to some policies with regard to disciplinary activities of state-owned and state-invested enterprises. For example, China agreed that its laws, regulations, and other measures relating to the purchase of goods or services for

commercial sale by state-owned enterprises would be subject to WTO rules. It also agreed that state-owned enterprises would have to make purchases and sales based solely on commercial considerations such as price, quality, marketability and availability, and that the government would not influence the commercial decisions of state-owned enterprises. Few compliance problems in this area have been raised since China joined the WTO; however, China raised certain concerns among WTO members in 2006 when it issued a number of measures restricting the ability of state-owned enterprises to accept foreign investment.

State Trading Enterprises. China has agreed to instill discipline on the importing and exporting activities of state trading enterprises and to provide full information on the pricing mechanisms of state trading enterprises

to ensure transparency and full compliance with WTO rules. However, China has only provided general information so far, which does not allow a meaningful assessment of its compliance efforts.

Government Procurement. China is not a party to the WTO Agreement on Government Procurement ("GPA") at

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present. However, China attempts to follow the spirit of the GPA and adopted its "Government Procurement Law" in June 2002. Meanwhile, U.S. businesses have expressed concerns about certain rules

on government software procurement which contain guidelines encouraging the purchase of software developed in China. China has taken note of these concerns and indicated that it will indefinitely suspend the drafting of the implementing rules on government software procurement.

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Intellectual Property Enforcement in China

As in years past, the USTR reports that China is in need of significant improvement with respect to intellectual property rights (“IPR”) enforcement. There continues to be inadequate deterrence, market restrictions that encourage counterfeiters, and a legal framework with many gaps that need to be filled.

However, China is taking some important steps in the right direction, such as continuing to revise its intellectual property laws and fostering a growing awareness of the importance of IPR.

The Report notes that there are many factors that contribute to inadequate IPR enforcement in China. Of these, the most significant factor is the lack of significant criminal deterrence mechanisms due to the high monetary thresholds for criminal investigation, prosecution, and conviction. As a result, most IPR enforcement comes through administrative remedies, which amount to little more than an inconvenience or just a cost of doing business to IPR violators. Other important factors that contribute to inadequate IPR enforcement are China’s restrictions on imports and wholesale and retail distribution. These restrictions prevent legitimate movies, video games, and books from reaching the Chinese market. Since consumers cannot purchase legitimate goods, infringers have flooded the market with counterfeits.

Even though China still has a long way to go with respect to enforcement and

market restrictions, the government has committed to strengthening its IPR regime. The USTR reports that China has “allocated substantial resources to the effort and attempted to improve

not only public awareness but also training and coordination among the numerous Chinese government entities involved in IPR enforcement

while simultaneously fighting local protectionism and corruption.”

Additionally, in 2006 China announced a new Action Plan to revise its laws to better protect intellectual property. Subsequently, China released new versions of its patent and trademark laws for public comment. The U.S. government and U.S. industry groups have taken advantage of this welcome opportunity to submit comments.

However, one major shortcoming of the Action Plan is China’s failure to address needed changes in its criminal laws. For example, the requirement of identical trademarks in counterfeiting cases and the absence of minimum, proportional sentences continue to hinder effective enforcement. Changes to the criminal law are not likely to take place in the near future. In fact, the USTR reports that “in a series of bilateral meetings that took place in Beijing in 2006, Chinese government officials indicated that any further lowering of the monetary thresholds below the levels set in the December 2004 judicial interpretation would require legislative action by the National People’s Congress, which is not contemplated.”

In 2006, the United States used the U.S.-China Joint Commission on Commerce and Trade (“JCCT”) to obtain new commitments from China on IPR and implementation of prior promises. At the April 2006 JCCT meeting, China pledged to: (1) ensure the legalization of software used in Chinese enterprises, (2) cooperate to combat infringing goods displayed at trade fairs and sold at major consumer markets, (3) increase cooperation with U.S. law enforcement and customs authorities, and (4) accept U.S. technical assistance to aid in fully implementing the World Intellectual Property Organization’s internet treaties. The Report notes that, with the exception of requiring computers to be pre-installed with licensed operating system software, China has been slow to follow through on its April 2006 JCCT commitments.

According to the USTR, there continue to be many weaknesses in China’s IPR regime that have led to many problems, such as: (1) “squatting” of foreign company names, designs, and trademarks; (2) theft of trade secrets; (3) registration of foreign companies’ trademarks as design patents and vice versa; (4) use of falsified or misleading license documents or company documentation in counterfeiting operations; (5) false indications of geographic origin of products; (6) unfair commercial use of undisclosed test results submitted by foreign pharmaceutical companies; and (7) inadequate oversight of the production of active pharmaceutical ingredients by chemical manufacturers.

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Even though China's overall legal framework for the protection of IPR is in need of improvement, by far the most serious problem cited by the USTR is inadequate IPR enforcement.

"[E]nforcement is hampered by lack of coordination among Chinese government ministries and agencies, lack of training, resource constraints, lack of transparency in the enforcement process and its outcomes, and local protectionism and corruption." This lack of enforcement affects products, brands, and technologies from many of the major U.S. industries. Among the hardest hit are the businesses that rely on copyright protection; the copyright industry has reported piracy levels that range between 85 and 93 percent. In addition to costing U.S. industries money, China's counterfeiters pose a threat to the health and safety of consumers. Indeed, examples of counterfeit goods that are being produced in China include: industrial equipment, toys, auto parts, and even pharmaceuticals!

In 2004, the United States launched the Strategy Targeting Organized Piracy ("STOP!"), which is a "U.S. government-wide effort to stop fakes at the U.S. border, to empower U.S. businesses to secure and enforce their intellectual property rights in overseas markets, to expose international counterfeiters and pirates, to keep global supply chains free of infringing goods, to dismantle criminal enterprises that steal U.S. intellectual property and to reach out to like-minded U.S. trading partners in order to build an international coalition to stop counterfeiting and piracy worldwide." As a result of its

increased efforts to prevent counterfeit products from entering the country, U.S. customs has seized an enormous amount of infringing goods shipped from China. In fact, goods shipped from China accounted for 69 percent of the \$87.2 million worth of infringing goods seized by customs in 2005. This is more than ten times the amount of infringing goods seized from any other U.S. trading partner.

According to the USTR, China is not going to successfully meet its WTO obligations for protection and enforcement of IPR until the State stops profiting from infringing activities and Chinese enterprises begin to realize the importance of IPR. The Report points out that many of the Chinese markets offering counterfeit goods are the biggest local taxpayers. In addition, many legitimate businesses have grown up around these counterfeit markets. This means that, in some locations, if the Chinese government shuts down the counterfeit market, then it effectively shuts down the local economy. Accordingly, there is often a significant tension between IPR enforcement and social stability associated with job creation.

With respect to Chinese enterprises realizing the importance of IPR, the USTR offers some encouraging signs. "Chinese right holders own the vast majority of design patents, utility models, trademarks, and plant varieties in China and have become the principal filers of invention patents." Moreover,

most IPR enforcement actions in China are initiated by Chinese rights holders. As Chinese enterprises seek to protect their own IPR, they will be more likely to respect the IPR of other companies.

Despite the shortcomings highlighted in the Report, China remains an important

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market for many businesses. Accordingly, U.S. and other foreign businesses must take the necessary steps to protect their IPR.

There are many resources available to help navigate IPR protection in China. For example, the U.S. Embassy in Beijing offers a China IPR toolkit on its website, (<http://beijing.usembassy-china.org.cn/ipr.html>), which provides information on China's current IPR environment, protection through prevention, China's IPR enforcement system, how the US government can help in IPR infringement cases, and other information resources. By taking advantage of the assistance offered by the U.S. government and by seeking the advice of competent and experienced legal counsel, U.S. businesses can more safely meet the challenges of China's IPR climate.

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China's Legal Framework

China continues to make uneven progress with respect to three primary considerations of its legal framework as a WTO member: transparency, the uniform application of laws, and judicial review. In order to provide greater transparency as to China's laws and regulations, the United States and other WTO members have continuously called upon China to fulfill its commitment to establish a journal dedicated to the publication of all laws and regulations affecting trade. In March 2006, the State Council directed that all central, provincial, and local trade-related laws be published in the *MOFCOM Gazette*. Adherence to the State Council's directive has been far from complete, and the United States continues to monitor the effectiveness of this measure.

Another critical aspect of transparency is the ability for interested parties to provide public comment. Despite ongoing pressure by the U.S. and other WTO members for greater opportunities to provide comment (and, ultimately, for China to adopt a mandatory notice-and-comment procedure), improvements in this area have been limited, with uneven compliance.

The latter two aspects of China's legal framework received somewhat less attention in the Report, an indication that improvements are being made in these areas. Nonetheless, uniform application of laws in China continues to be an area of concern for the USTR, despite China's WTO commitments to end historic practices of national favoritism. In particular, problems in the areas of customs and trade administration, taxation, and intellectual property rights persist. With regard to judicial review, the USTR notes that China has continued to improve the quality of its judiciary, however, significant concerns remain about the overall independence of judges in China. Observers continue to see political, government, and business pressures on judges, particularly outside of major metropolitan areas.

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Conclusion

The "leveling" of the playing field in China will continue to be a topic of great interest to political leaders, business operators and service providers, among others, for the foreseeable future. As demonstrated by the 2006 Report, despite the fact that the five year period for China to achieve full WTO compliance has now concluded, there are many areas where improvements are needed and changes are expected (and will be demanded) by the United States and China's other WTO trading partners. Since this is an area of significant interest for our clients and friends, we will continue to monitor and report on WTO compliance in future issues of *China Insights*.

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