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GREETINGS...

Greetings to all of our U.S. and Chinese contacts, friends, clients and associates. Please enjoy our latest newsletter. We look forward to visiting China in the Fall.

Sincerely,

Aaron Schechter and Frances Chou

HOT TOPICS...

Recent Developments in the China Stock Market

For the past year, the China Securities Regulatory Commission (CSRC) has been working on the restructuring of the China stock market. Prior to restructuring, the China stock exchanges, located in Shanghai and Shenzhen, were in a long slump, having lost half of their market value between 2001 and last summer, while other "emerging-market" stock exchanges were achieving spectacular gains. The China stock market consists of the 15 year old Shanghai exchange and the Shenzhen exchange with combined listings of approximately 1,400 companies and a total market capitalization of \$650+ Billion. The companies listed on the exchanges are state-owned enterprises (SOE's) with the majority of shares (approximately two-thirds) held by the Chinese government-related entities. The heavy concentration of shares by the Chinese government had acted as an overhang on the stock market and had a dampening effect on the market, due to investors' concerns that the Chinese government would eventually decide to unload their shares, and that stock prices would head downward.



Since last summer, the CSRC has attempted to introduce "investor friendly" reforms in the hopes of re-invigorating their stock markets. To date, approximately 80% of the 1,400 listed companies on the China stock exchanges have at least begun the process of having their Chinese government owned shares restructured from non-tradable shares into tradable shares, with the Chinese government assurance that the shares currently held by Chinese government-related entities cannot be sold for at least 3 years and limits the amount of stock that can be sold. Additionally, at the end of this month, the Chinese government will issue new guidelines related to listed companies adopting international accounting standards in 2007, in order to add transparency to the market. The CSRC recently lifted a one year moratorium on IPO's. In May, in order to make the markets more dynamic, regulators adopted a new policy to allow domestic Chinese investors to buy and sell a stock in the same day and also signaled more comfort in allowing investors to trade with borrowed funds. They are also working to allow stock shares prices to fluctuate according to market forces and not be limited to 10% swings in any given day.

Since last summer, when the reforms began, Chinese domestic investors have responded, and the Shanghai and Shenzhen exchanges have been among the best performing stock markets in the world with the larger Shanghai composite index gaining 60%. During the first half of this year, domestic Chinese investors opened 600,000 new brokerage accounts to trade on the Shanghai and Shenzhen exchanges, pumping \$12 Billion in new funds into the two exchanges. Another possible reason for the strong showing is that Chinese domestic investors may feel that continued liberation of capital standards and letting the yuan float may lead to more liberal policy and future gains. It should be noted that the China stock market is unusual in that it is only open primarily to domestic Chinese investors, and ownership by foreign investors is extremely limited to 1% of the markets total capitalization. In June, J.P. Morgan Chase and Co. announced the first authorized fund in Hong Kong to invest directly in mainland China's Class A shares.

Despite the recent gains, some on Wall Street have their doubts that the recent gains on the China stock exchanges are lasting due to several factors. They point out the China stock market's lack of transparency, poor corporate governance, lack of available financial data, and heavy regulation by the Chinese government, while it may be well meaning, is still prevalent. They point out that Chinese corporate profit forecasts, when they are available, are often linked to expectations of how the government will regulate a sector or company, and not just expectations of a company's future earnings.

Foreign investors tend to focus on Chinese companies, whose stocks are traded in Hong Kong. The better Chinese companies tend to list their shares overseas on the U.S., London or Hong Kong stock exchanges. The Hong Kong exchange has decades more experience than the Chinese stock market, operates to international standards, and more closely correlates to the ebb and flow of world markets. Approximately 40% of the value of the Hong Kong exchange is made of companies from the China and in 2005 Chinese companies raised \$19 Billion on the Hong Kong exchange.

LEARN THE ROPES...

On July 20, 2006, Frances Chou was the lecturer on Legal Do's and Don'ts for California Center for International Trade and Los Angeles Area Chamber of Commerce.

RECENT DEVELOPMENTS...

New Regulations by MII on Foreign Internet Companies Operating in China

On July 26, 2006, China's internet regulator, the Ministry of Information and Industry (MI), issued new regulations that could create complications for foreign Internet companies operating in China as well as for Chinese internet companies listed overseas.

Internet use has exploded in China to over 120 million internet users, making it second largest in the world, only behind the U.S. Major U.S. internet companies like Yahoo, Google, Ebay and Microsoft's MSN have entered into the Chinese market. At the same time, Chinese internet companies, such as internet portals Baidu.com and Netease.com have attracted foreign investment through listing on the Nasdaq stock exchange. The increased foreign role in China's internet sector has come at a time when the Chinese government is trying to tighten its control of the web and has unnerved regulators.

Since China's laws limit direct foreign ownership of domestic companies that provide internet content and related services, Chinese web operators that want to sell shares overseas usually establish a legal entity offshore, such as in the Cayman Islands or the British Virgin Islands, which own the



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trademarks, domain names and other key intellectual property. The offshore entity works with the local Chinese company through contracts by, in a nutshell, having the offshore entity license such intellectual property to the local Chinese company, in exchange for the local Chinese company's giving the offshore entity any revenues collected on the website. The new rules say that local providers of "value added telecom services", including search engines and other websites, are to own the domain name and trademarks that they use in China, which are key pieces of intellectual property often controlled by foreign entities, affiliates or investors. The new measures also indicate that local operators should own the servers and other infrastructure used to operate sites, and that such companies operating in China have until November 1st to comply. Some analysts believe that this is a "starting step" for the MMI, and that the significance will depend on the level of enforcement of this new regulation.

Recent Changes on Rules Related to the Structure of the NASDAQ

For those companies, who are interested in going public in the US, please be aware that a few rules related to the structure of the Nasdaq have recently been approved by the Securities and Exchange Commission (the "SEC").

First, as you might be aware, the NASDAQ SmallCap Market was changed to the NASDAQ Capital Market on September 27, 2005. More recently, in July, the "NASDAQ National Market" was divided into two tiers, the "NASDAQ Global Market" and the "NASDAQ Global Select Market". Initially, the NASDAQ transferred approximately 1,200 companies listed on the NASDAQ National Market to the NASDAQ Global Select Market. It should be noted that the initial financial listing standards for the NASDAQ Global Select Market are extremely difficult. At this point, the new market classifications for NASDAQ have been completed.

Second, the NASDAQ Stock Market has been approved by SEC to be registered as a "national securities exchange", because it was considered an automated inter-dealer quotation system of a national security association. The exact date of transition has not been set yet, however, NASDAQ expects to complete such a transition in August of 2006. After NASDAQ operates as a "national securities market", all the companies listed on NASDAQ will have to file manually with NASDAQ Section 16 and Form 144 filings. However, NASDAQ expects to receive approval from the SEC to allow such filings to be done electronically through the SEC's EDGAR system. Also, all the companies listed on NASDAQ also have to file a short-form registration statement on Form 8-A to change registration from Section 12(g) of the Securities Exchange Act of 1934 (the "Act") to Section 12(b) of the Act. In addition, any deregistration process for a NASDAQ listed company will be changed in order to conform such deregistration process for a company listed on a national securities market. With regard to the issue of "covered securities", securities listed on the NASDAQ Capital Market will not be considered "covered securities" and, therefore, are subject to state blue sky regulation, however, NASDAQ has filed a petition with the SEC seeking to designate such securities as "covered securities." Some of the states, including California, exempt companies listed on national securities exchanges from certain corporate filing requirements, however, such exemption is granted only after such national securities exchange is designated by the commissioner of corporation or secretary of state.

LEGALLY SPEAKING...

The following is provided by Y.F. Chou, Prof. Corp. For questions, please contact info@yfchou.com.

IPR Enforcement in China is Getting More Complicated – Watch Out For Forum Shopping by the Infringers

In the US, it is common to send a cease and desist letter to a company, after you discover that such company has infringed on your intellectual property rights ("IPR"). In China, many foreign and Chinese companies are now following this same procedure. However, be aware that in China, by sending such a cease and desist letter, you might give the infringer a chance to file a declaratory action of "non-infringement" in its own hometown. Such action may result in forcing you to answer such a lawsuit in a less friendly forum and losing your rights to have your case heard in a forum with more experience in IPR cases, such as the courts in Beijing or Shanghai, or where your China operation is located.

The rights to bring an action for declaration of non-infringement are not provided in any statutes or laws in China. Instead, such rights were established by the Supreme People's Court in China. The Supreme People's Court, in a case in 2002, held that a "declaration of non-infringement" is a proper cause of action, on the ground that an IPR holder, by sending a warning letter to distributors with infringement accusations concerning a product made by a specific manufacturer, would have the effect of stopping the distributors from selling that product, which would result in injuries to the manufacturer of that product, and that, therefore, the manufacturer had a direct interest in the case and should be allowed to bring an action for declaration of non-infringement.

After this ruling had been issued, some of the more sophisticated Chinese companies engaged in manufacturing counterfeit products found a way to use the rulings in this case to gain a home court advantage. For example, such a company would make and sell counterfeit products in the more remote areas in China. After the IPR true owner found out about this infringement practice and sent a cease and desist letter to this Chinese company, this Chinese company would immediately file a declaratory action of "non-infringement" in its own hometown. Some of the IPR owners then would file an action of infringement in another court. However, the Supreme People's Court has held that in order to avoid inconsistent rulings, the second lawsuit, which is the action of infringement, had to be transferred to the court hearing the declaratory action of "non-infringement."

So far, the Supreme People's Court has not provided any guidelines for such cases. However, in a draft Rules on Several Issues Relating to Trial of Patent Infringement Cases, Article 62, seems to reaffirm an interested party's right to bring an action for declaration of non-infringement. This Article provides that if such an interested party receives any act of warning, which "impinges upon the legal rights of the warned party," such a warned party could bring an action, seeking to cease impingement, compensate for damages, eliminate ill influence and/or make an apology."

So, what should you do if you find out somebody is manufacturing and selling your products in China without your authorization? Of course, each case is different, however, if you decide to send a cease and desist letter to such an infringer, you should be extremely careful in drafting the letter. The most you might be able to offer in such a letter probably would be to ask the other side to start a negotiation with you concerning this issue or to ask the other side if they are willing to obtain a license from you to continue manufacturing and selling your products. You need to be careful not to include any language which might trigger a declaratory action. You probably should consult an attorney in drafting this letter. Also, if you do not receive the results that you desire, you should consider filing an infringement action in your choice of venue immediately, instead of waiting for the infringer to act first.

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