the SEC study, there were nine ECNs operating within the U.S. securities markets, Instinet arguably being the industry leader.\textsuperscript{10} ECNs provide many market services to their subscribers, which include retail investors, institutional investors, market makers, and other broker-dealers.\textsuperscript{11} For example, ECN subscribers can enter limit orders into the ECN, usually through a custom computer terminal or a direct dial-up.\textsuperscript{12} The ECN will post those orders on the system for other subscribers to view.\textsuperscript{13} The ECN will then match contra-side orders for execution.\textsuperscript{14} Usually, the buyer and seller remain anonymous to each other and the trade execution reports will list the ECN as the contra-side party.\textsuperscript{15} "In addition, subscribers may use features such as negotiation or reserve size, and may have access to the entire ECN book (as opposed to the "top of the book") that contains important real-time market data regarding depth of trading interest."\textsuperscript{16} Because ECNs provide significant savings in execution costs, they present international competitive challenges to established markets.

In the European Union ("EU"), securities regulations have not yet categorized these new trading systems in any of the Member States.\textsuperscript{17} Because of the driving forces in technological advances, the increasingly international character of markets, and the emergence and international use of ECNs, the SEC implemented Regulation ATS in 1998.\textsuperscript{18} The U.S. is currently the only nation to implement securities regulations addressing ECNs.\textsuperscript{19} The SEC allows ECNs to be categorized under Regulation ATS as either broker-dealers or as a national securities exchange for regulatory purposes, depending on the desire of the ECN and the satisfaction of minimum requirements.\textsuperscript{20}

This note examines how ECNs are currently regulated within the European Union and how the recent move toward integration of the European securities markets requires regulatory action by the EU for efficient integration of ECN systems into their markets. In part II, this note begins by describing the background of ECNs and how these systems are revolutionizing the securities market. Part III examines the impact that ECNs have made in securities markets on a global scale. This section also assesses how new innovations have acted in concert with ECNs to achieve a Pan-European securities market integration. Next, part IV describes the recent regulatory initiatives effecting the integration of ECN technology into the international securities industry. Part V scrutinizes the concerns that have come to light as ECNs increasingly gain market share and proliferate on an international scale. Finally, part VI suggests how the EU may achieve efficient market integration. This note concludes that as the EU leads in global regulatory efforts to stimulate efficient market integration via ECNs, there are several weaknesses and unaddressed issues within these efforts.

\section{II. Background}

Markets seek to achieve the most efficient execution for securities transactions.\textsuperscript{21} Efficiency in execution is conventionally achieved by promoting competition within the securities industry.\textsuperscript{22} Competition in this industry fosters positive impacts on order flow, liquidity, execution costs, and spreads.\textsuperscript{23} The recent innovation of ECNs has stimulated increased

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\textsuperscript{10} Special Study, supra note 1.
\textsuperscript{11} Id.
\textsuperscript{12} Id. A limit order is defined as the following: [A]n order that sets a specific price (Limit Price) that is the highest a buyer will pay or the lowest a seller wants to receive. Buyer will accept price lower than limit and seller higher than limit. It may be a Day or GTC (Good Until Canceled) order. If no price is indicated, the order is a market order by default.
\textsuperscript{13} Special Study, supra note 1.
\textsuperscript{14} Id.
\textsuperscript{15} Id.
\textsuperscript{16} Id.
\textsuperscript{17} As of the time of this Note, Tradepoint is the only ECN based out of the EU and operating within its markets. Tradepoint is a recognized Investment Exchange under section 37(3) of the U.K. Financial Services Act 1986. The Exchange does not have a physical trading floor, but is a screen based electronic market for the trading of securities. Tradepoint Financial Networks, Plc; Notice of Application for Limited Volume Exemption From Registration as an Exchange Under Section 5 of the Securities Exchange Act, SEC Release No. 34-40161, International Series Release No. 1144, 64 Fed. Reg. 37146 (July 9, 1998).
\textsuperscript{18} Regulation ATS categorizes ECNs as "alternative trading systems," which is defined as "any organization, association, person, group of persons, or system ... that constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange ...." 17 C.F.R. § 242.300(a)(1)(2001).
\textsuperscript{19} 17 C.F.R. § 242.300(a)(1)(2001).
\textsuperscript{20} 17 C.F.R. § 242.300(a)(2)(2000). In rare cases, an ECN may petition the SEC to seek exemption from Regulation ATS in section 5 of the regulation if the Commission determines that "such an order is consistent with the public interest, the protection of investors, and the removal of impediments to, and perfection of the mechanisms of, a national market system." 17 C.F.R. § 242.300. Tradepoint has successfully received a section 5 exemption to operate in the U.S. on a limited basis.
\textsuperscript{22} Id. at 18.
concern over the issues of lower transaction costs to retail investors, reduced market impact costs, anonymity, passive pricing, specialized services, ease of access to institutional investors as well as retail investors, and expanded product ranges. However, regulators must ensure that competitive forces in the markets do not sacrifice quality in their efforts. Thus, regulators must find a balance between beneficial regulation and market forces to achieve the most efficient market system.

However, technology has outpaced regulatory efforts on an international scale. ECNs now account for 30% of all trade volume on the NASDAQ. In London, ECNs account for a smaller but growing percentage of trading on the London Stock Exchange. Tradepoint, established in 1996 as a for-profit exchange, currently has over eighty members, including institutions and broker-dealers. Instinet, founded in 1969, is the largest global agency broker and arguably the leader in electronic trading technology. Currently, Instinet is a member of twenty exchanges in North America, Europe and Asia. Instinet offers equity trading, research, and direct electronic access to all operators in the global markets. Recently, Instinet and Tradepoint reached an agreement to facilitate access to each other’s markets (i.e., U.S. investors may trade European securities on Instinet which then routes the orders through Tradepoint’s system).

Existing regulations merely try to pigeonhole ECNs into conventional scopes of industry regulations. These actions have been inconsistent at best. In the EU, ECNs can practically circumvent regulatory efforts in the most regulatory EU Members by registering as an exchange in only one Member State. In the U.S., the regulations are even more peculiar. If the ECN is a domestic entity, it may register as an exchange or as a broker-dealer under Regulation ATS. If it is a foreign entity, it may possibly circumvent the entire registration procedure by seeking a Section 5 Exemption if it meets certain low volume requirements as interpreted by the SEC.

Regardless of how ECNs are classified, the reality is that they operate as exchanges. The inconsistency in regulations for an industry of international character raises significant concerns that will be addressed later in this note. Where regulatory barriers existed before, technology has facilitated access to foreign exchanges. In effect, the current situation provides for the proliferation of ECNs across borders on an international scale without adequate regulation. As ECNs continue to proliferate and gain market share, advantages and incentives will naturally arise in certain nations. For example, in the EU, ECNs may be able to provide their automated trading services within several nations by virtue of operating out of the Member State with the lowest level of regulation.

III. MARKET IMPACT

A. CURRENT MARKET STATUS

In the summer of 2000, Instinet and Tradepoint Financial Networks, plc ("Tradepoint") reached an agreement that facilitates electronic access to the securities markets across the Atlantic. Sixteen European nations and the U.S. have obtained access to each other's equities markets by way of the agreement. Furthermore, the recent adoption of the Euro in the EU and the permanent establishment of foreign exchange rates between Euro-adopting Member States have fueled Pan-European trading in the markets. U.S. investors have access to 230 Continental European equities and all of the constituents of the major European indices. It is only a matter of time before an automated currency converter is implemented into ECN systems to further facilitate international securities transactions.

Currently, the financial markets in Europe are taking further steps towards full integration with Tradepoint which is arguably at the forefront of...
Tradepoint Financial Networks PLC, ISD/93/22/EEC.

The following advantages: direct trading in the constituents of all major blue chip exchange that will be called "virt-x." Among the terms of the agreement, all trading will be conducted within a single regulatory environment supervised by the FSA. Tradepoint has already been designated as a Regulated Market throughout Europe under the Investment Services Directive. This designation allows it, as virt-x, to offer trading in the shares of companies listed by a competent authority or other approved organization. The virt-x market was launched on June 25, 2001 and was completed on July 9, 2001. Instinet announced that it would provide access through its systems on June 25, 2001. "Virt-x will combine Tradepoint's Pan-European blue chip market ... with SWX's highly functional EBS trading system to create a fully integrated Pan-European exchange." Since the announcement of the deal, Tradepoint's average daily volumes have risen from 41 million pounds to 73 million pounds since it was launched in July.

It is anticipated that virt-x will offer its European and U.S. members the following advantages: direct trading in the constituents of all major European indices on one exchange with one rule book, an electronic anonymous order book, a fully integrated trading system, a clearing and settlement model with a central counter-party for cross border trading provided by London Clearing House, significant scope for cost savings, and multi-currency capability, among other advantages.

B. CURRENT MARKET TRENDS

Frits Bolkestein, the commissioner of the European Union, addressed many trends regarding the integration of the European markets and ECNs. While addressing the trends, Bolkenstein pointed out a major impediment towards integration: "the length of time that it takes to legislate for a European Directive means that any legislation that we draft can take three, four, sometimes five years before it is in effect in all Member States, and that is assuming that negotiations and implementation go smoothly." The internet is also facilitating the process. Even in those Member States not part of the "eurozone" (i.e., UK, Sweden, and Denmark), many exchanges and investment service providers have moved to pricing in Euro, thereby reducing market fragmentation.

1. Market Defragmentation

Market defragmentation in the EU is one trend that has facilitated market integration. Most EU member states have adopted the Euro, which is the major catalyst for change by enhancing the price transparency of all European markets. The internet is also facilitating the process. Even in those Member States not part of the "eurozone" (i.e., UK, Sweden, and Denmark), many exchanges and investment service providers have moved to pricing in Euro, thereby reducing market fragmentation.

2. Market Cooperation

Moreover, five other key trends are taking an effect. First, there has been increased cooperation between existing exchanges, leading to mergers. Such mergers have the possibility of delivering additional cost-savings and enhanced performance in terms of liquidity and price-discovery. As the process of merging accelerates, and provided competition concerns results...
are overcome, the EU will be on the way to constructing markets of considerable global size and scope.  

3. Technology Advancements

The next trend is the development of e-commerce and other technology. The number of on-line brokerage accounts in Europe is increasing rapidly. These occurrences will ease the distance related impediments to investment services, without regard to national or legal boundaries. 

Surveys are already showing that half of on-line brokerage companies trade on a cross-border basis and most of these are active on a number of national exchanges. Thus, there is already a blurring of boundaries between trading systems and service providers. Alternative Trading Systems ("ATS") are emerging in competition with the traditional exchanges. They have made less dramatic inroads in the EU than in the U.S., but they are developing in certain niche activities. Bolkestein contends that the EU's concern is to ensure that the integration of ECNs does not result in an undesirable fragmentation of European liquidity, and that all trading functions providing similar services are placed on level regulatory footing.

4. Specialized Markets

Another trend to note is that in recent years, there has been a growing interest in more specialized markets concentrating on smaller high-risk companies. However, the number of companies served by these markets still remains low in the EU, with around 650 companies listed on Easdaq, AIM and Euro.NM combined in July 1999 compared to nearly 5000 companies listed on Nasdaq in the U.S. The fact remains that in terms of raising capital, and especially early-stage venture capital, the EU is still far behind the U.S.

5. Increased Use of Financial Markets

A fourth trend to note is the way in which European households are beginning to use financial markets. Reports suggest that over 500,000 more Germans invested in securities last year than the year before. Bolkestein expects the assets managed by unit trusts and other forms of collective investment to quadruple over the coming decade.

6. Consolidation of Clearing and Settlement

The fifth trend is that the EU is seeing the beginnings of consolidation of clearing and settlement: the high costs of clearing in Europe - currently estimated to be eight times higher than in the U.S. - are coming under the spotlight. Therefore, market users are pressing for consolidation of these systems at a European level. Merging firms have become among the major players in advocating for consolidation.

The EU has not addressed the financial market situation or the trends that Commissioner Bolkestein has enumerated. For a U.S domiciled ECN to operate in the EU, the ECN must become registered as an exchange in a EU Member State. Under current EU regulations, described infra in section IV, the ECN will automatically be allowed to offer its trading services throughout the EU by virtue of registering as an exchange in one Member State. However, many barriers exist regarding consistent regulation of ECNs, thus impeding their efficient integration into EU markets.

IV. RECENT REGULATORY INITIATIVES

Why do we need regulation? The SEC raised some concerns while implementing Regulation ATS. The SEC stated that the inconsistencies at that time of Regulation ATS's adoption created disparities that affect investor protection and the operation of the markets as a whole. Without consistency, inadequate surveillance of ECNs for market fraud and
manipulation might result. Just as this was an issue of national scale within the U.S. markets, it is a major issue within the EU markets. In order to better integrate ECNs into the international market system, the current regulatory structure needs to be modernized.

In a 1994 Discussion Paper, the Securities and Investments Board ("SIB") indicated that the current diversity of regulatory provisions applicable to trading services "is not conducive to the cost-effective achievement of regulatory coherence." In response, the EU passed the Investment Services Directive ("ISD"). This directive is arguably the most important regulation in the EU affecting international securities markets.

### A. THE INVESTMENT SERVICES DIRECTIVE

The ISD's major provisions are intended to provide: (1) common minimum authorization; (2) mutual recognition of the license granted in the home state by all other Member States or "host states"; (3) prudential rules establishing common minimal financial soundness standards among the Member States; (4) certain guiding principles for adoption of conduct-of-business rules by the host states; (5) direct access to each Member State's domestic stock exchange for both outside investment firms and banks; (6) requirements for concentration of securities trading in regulated markets which preserve investor choice to trade in less-regulated off-exchange markets; (7) minimum transparency rules for regulated markets; and (8) reciprocity for non-EU firms to participate in the newly integrated marketplace.

Although raised during the legislation of the ISD, the EU decided not to address fundamental questions regarding market structure and transactional disclosure, including: (1) whether securities markets should be divided into wholesale and retail segments; (2) whether the markets should be quote-driven and screen based or order-driven and floor-based; and (3) whether securities markets should be fully transparent, with real-time reporting of price and volume information, or relatively opaque, with minimal or delayed reports to protect investment firms’ market positions.

### B. UNSETTLED ISSUES OF THE ISD

#### 1. Regulated Markets

A regulated market is a regularly functioning securities market. Being a regulated market represents a potential competitive advantage. If that market wishes to operate on a community-wide basis, being "regulated" enables it to provide remote access terminals to traders in other Member States. Pursuant to the "single passport" principle, article 15(4) of the ISD provides that regulated markets are entitled to provide trading screens to investment firms based in other Member States without having to seek approval from the relevant foreign authority.

#### 2. Transparency

Transparency of trading implies the scope and updatedness of available information with regard to executed trades. The ISD's transparency provisions were also subject to intense controversy and are consequently quite vague. Some parties argue that stringent transparency rules were critical to ensuring an adequate level of investor protection and to reducing risks of distortion between competing markets. In a way, the decision of the EU to sidestep these issues may have parochial effects. In essence, the ISD covers two major issues: regulation of investment firms and regulation of securities markets. In general, it prescribes a system of "a single passport", under which a business regulated in one Member State may conduct business in the entire EU without further regulatory requirements on behalf of host countries. Two controversial issues are encompassed within this regulation. The first is the question of what is a regulated market? And second, the level of transparency is vehemently debated among Member States because of their protectionist agendas in preserving competitive advantages for domestic firms.

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72 Id.
73 The SIB is a private limited company, formerly reporting to the Chancellor of the Exchequer with responsibility for the regulation of the UK investment market, in accordance with the Financial Services Act 1986. It was replaced by the Financial Services Authority (FSA) in October 1997.
74 ISD/93/22/EEC.
76 Id. at 183.
transparency was presented as a proxy for quality. Others argue that limited secrecy regarding trading transactions was essential to the protection of market makers, and thus, of market liquidity. These two positions arise because of different driving forces in European markets.

For example, in a typical order-driven market, a high level of transparency may improve the market's functioning as a price discovery mechanism. On the other hand, in a typical quote-driven market, dealers commit capital to provide liquidity. Full transparency would undermine their ability to unwind positions they are obliged to take as market makers. By publicizing their exact position they would make themselves vulnerable to trading in adverse conditions. Transparency in this context includes the timely display of orders, market depth, and last sale reporting. If minimum transparency standards are not required, an ECN might lack transparency and inhibit the pricing discovery process or create unfair informational advantages. ECN operations should be subject to transparency standards appropriate to their operations. However, it must be recognized that complete transparency in relation to, for example, institutional-size orders may be counter-productive.

From an international perspective, transparency will come to play a vital role in the integration of ECNs. There is currently no international standard on regulation of ECNs. Tradepoint, an exploding electronic exchange in the UK, is the first ECN type of company to cross international waters into the U.S. by way of a Section 5 exemption in which it registered as a low-volume exchange. Securities regulators attempt to classify ECNs through current regulations instead of addressing them head-on. The U.S. has incorporated Regulation ATS and the U.K. has registered Tradepoint as an exchange, in which it thus obtains all the benefits of an exchange via the ISD.


The ISD provides for reciprocity among Member States. Foreign ECNs may possibly infiltrate EU markets by complying with the "national treatment" approach imposed by the ISD. To satisfy the national treatment condition, the non-EU country must provide EU investment firms the same competitive opportunities available to domestic investment firms. The ISD also provides for continuing review to determine whether non-EU states are providing national treatment and "effective market access" to EU firms. These provisions raise the question as to whether an ECN is a bona fide investment firm as interpreted by the EU. Additionally, questions arise regarding the level of discretion provided by the terms "national treatment" and "effective market access."

(A) Investment Firm Classification

As interpreted by the EU, the term "investment firm" is defined to include "any legal person the regular occupation or business of which is the provision of investment services for third parties on a professional basis." Investment services includes: (1) the reception and transmission of orders on behalf of investors as well as the execution of those orders; (2) dealing for one's own account; (3) managing portfolios for a discretionary client-by-client basis; (4) underwriting or placing issues. These services must relate to certain investment instruments according to the annex of the ISD. These instruments include: (1) transferable securities and mutual fund units; (2) money market instruments; (3) financial futures contracts; (4) forward

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86 Id. 87 Id. 88 Id. 89 Id. 90 Id. 91 Id. 92 Id. 93 Id. 94 Regulation of Alternative Trading Systems in Europe, Fesco/00-064c (Sept. 2000), available at http://www.europe.fesco.org/documents/recomp/h0-064c.pdf. 95 Amir N. Licht, Discussion Paper, Regional Stock Market Integration in Europe (Mar. 1997), available at http://www.cid.harvard.edu/caer2/htin/stranis/str_auth.htm. 96 Order Granting Limited Volume Exemption from Registration as an Exchange Under section 5 of the Securities Exchange Act, SEC Release No. 34-41199, International Series Release No. 1189, 64 Fed. Reg. 14953, 14956 (Mar. 29, 1999). A Section 5 Exemption allows for an exemption under Section 5 from registration as a national securities exchange under Section 6 of the Securities Exchange Act of 1934 ("Exchange Act") on the basis of expected low volume. Under the proposed Exemption, the Exchange would be exempt so long as (i) the average daily dollar value of trades (measured on a quarterly basis) involving a U.S. Member did not exceed $40 million, and (ii) its worldwide average daily volume (measured on a quarterly basis) did not exceed ten percent of the average daily volume of the LSE [London Stock Exchange]. The limitation on the Exchange's worldwide trading volume would ensure that the Commission could reevaluate the appropriateness of the low volume exemption should the Exchange achieve significant volume relative to the LSE. SEC Release 34-40161; see also supra note 75. 97 ISD/93/22/EEC. 98 Warren, supra note 75, at 216. 99 Id. 100 Id. 101 Id. 102 Id. 103 Id. at 194. 104 Id. at 195. 105 Id.
interest rate agreements; (5) interest-rate, currency and equity swaps; and (6)
options to dispose or acquire any of the covered instruments. 106

(B) Exchange Classification

Under the EU’s definition of investment firm, ECNs assuredly qualify as such. However, Tradepoint is classified as an exchange in London. 107 In the U.S., Tradepoint has received a Section 5 exemption enabling it to operate as a low-volume exchange. 108 Due to the inherent operations of Tradepoint as an ECN, it is also an investment firm. Thus, within the EU, a discrepancy arises as to whether an ECN is an investment firm or an exchange. 109 Seemingly, Tradepoint is the only ECN licensed as an exchange that is taking advantage of the ISD to offer Pan-European services.

4. EU Regulatory Framework Creates a Barrier to Market Entry for Foreign ECNs

ECNs foreign to the EU have yet to penetrate the EU markets. Potential barriers to the entry of foreign ECNs include the EU’s discretionary use of the terms “national treatment” and “effective market access.” 110 These two terms, encompassed within the ISD, are quite ambiguous. For example, does the SEC’s granting of a Section 5 exemption qualify as giving EU based ECN’s “national treatment” or “effective market access” under these definitions?

This possibility seems unlikely. The SEC’s Section 5 Exemption allows Tradepoint to operate as a low-volume exchange. 111 The restrictions applied to Tradepoint do not exist for domestic ECN’s. Domestic exchanges may operate under Regulation ATS as either exchanges or broker dealers. 112 The Section 5 exemption was based on a calculated ratio of transactions through Tradepoint with the transactions executed through the LSE. 113 The basis of low volume was not in respect to transactions on an U.S. exchange. 114 As stated in section I, ECNs in the U.S. combined provide for over 30% of all volume on the Nasdaq. 115 This share of the volume is a considerable amount more than the counterpart in the EU.

However, the EU does not provide for any exemptions within its Member States. Thus, a question arises as to whether the granting of a section 5 exemption to Tradepoint, actually allowing it to operate as an exchange within the U.S., qualifies as “national treatment” to allow non-EU ECNs to operate within the EU. Within the current regulatory framework, Tradepoint is the only ECN operating within the EU and it is classified as exchange in London as explained supra. Since EU officials have not directly addressed how they will regulate ECNs within the EU, the regulation of Tradepoint provides the only guide to non-EU ECN’s contemplating operations within the EU.

Currently, the regulatory framework is arguably inefficient. The barriers to entry described within the regulatory framework considerably hinder open and efficient competition. Tradepoint is unable to efficiently compete with U.S. domiciled ECNs due to the low-volume restrictions. Non-EU ECNs seem to have to register as an investment firm by way of first becoming an exchange within a Member State. Non-EU ECNs currently gain access to foreign markets either by incorporating and capitalizing an EU subsidiary in one of the EU nations or by creating an affiliation with EU investment firms so that they can indirectly operate within the EU. 116 These methods are undoubtedly inefficient. The cost for registering as an exchange, and compliance costs associated with these operations in every Member State individually, is a high barrier to entry for foreign competitors.

If the EU implemented a regulation such as Regulation ATS, foreign ECNs may still not qualify under its “national treatment” standard. The EU would have an incentive to impose limitations on the volume of the ECNs since the SEC has restricted volume on Tradepoint’s operations. Thus, non-EU ECN’s seeking operations within the EU need to assess this potential low-volume barrier to participating in EU markets.

104 Id. at 196.
107 In most EU jurisdictions, ECN’s have the choice of being licensed either as an exchange or as an investment firm. Where an ATS operator seeks investment firm status, it is subject to a regime that focuses predominantly on investor protection. ATS operators that apply for exchange licensing are subject to regulation more focused on market integrity. See Regulation of Alternative Trading Systems in Europe, supra note 94, at 24.
108 Warren, supra note 75, at 217.
111 SEC Release No. 34-41199, supra note 96, at 14957. The SEC found that the transactions executed through Tradepoint accounted for less than 1% of the transactions executed on the LSE.
112 Id.
113 Special Study, supra note 1.
The international discrepancies in regulatory efforts raise several concerns regarding competition and efficiency within the securities industry. Regulatory efforts in the EU are the most stifling since they have yet to provide an alternative to ECNs.

V. OTHER CONCERNS

With different regulations among Member States, the ECNs may suffer from "race to the bottom phenomena" within the EU. ECNs will have incentive to migrate to countries with lower standards through "regulatory arbitrage." Many concerns are included in this possibility. Among them are concerns of market fragmentation/reduced liquidity, increased systemic risk, absence of self-regulatory program/unfairness, and lack of coordination with exchange markets.

A. MARKET FRAGMENTATION/REDUCED LIQUIDITY

The fragmentation concern is that trading interest might be split widely among multiple exchanges and ECN operations, "resulting in a loss of the liquidity that would otherwise be provided by a central market." Similar concerns have arisen with multiple exchanges in a single jurisdiction (e.g., Hong Kong prior to 1986, Australia, and a number of European markets) where a consolidation was later made or is being considered.

B. INCREASED SYSTEMIC RISK

The systemic risk concern arises where an ECN becomes of sufficient size and importance that its operational or financial failure could materially disrupt the market. Similar concerns exist with exchange markets, clearinghouses, brokers, and banks. In all of these areas, the applicable regulatory regimes should impose minimum standards of operational and financial capabilities appropriate to the functions performed.

C. ABSENCE OF SELF-REGULATION/UNFAIRNESS

Many exchanges act as self-regulatory organizations, meaning they are responsible in the first instance for regulating their market and members. An ECN that is not an adequate self-regulator or is not otherwise subject to adequate regulatory oversight may thus lack integrity. This concern also raises an issue of fairness. The operation of a self-regulatory program entails considerable expense. On the other hand, exchanges generate significant revenue from listing fees, sale of transaction data, and membership fees. In the view of some, these revenues may offset an exchange's self-regulatory obligations. Thus, the regulatory authority should be vigilant to ensure that ECN operations do not enjoy unfair or inappropriate advantages in relation to the functions they perform versus those of exchange markets.

D. LACK OF COORDINATION

"The coordination concern, for example, relates to situations where an exchange temporarily suspends trading in a stock pending a company announcement, but an ECN continues trading." Similarly, 24-hour trading in an ECN environment may not be subject to the same information disclosure requirements as exchange trading. In this regard, and depending on the circumstances, it may be desirable for ECN operators to disclose that the home market may be suspended or subject to a corporate announcement. Depending on the sophistication of users of the ECN, it also may be desirable for the ECN to suspend trading in line with the exchange market. This would likely be required by the exchange if the ECN operator were an exchange member. However, this would be difficult where the ECN provides trading services in foreign shares where the home...
market for the shares is not mature and the ECN operator is not a member of the exchange in that market.  

VI. CONCLUSION: POSSIBLE SOLUTIONS TO EFFICIENT INTEGRATION

The EU must approach integration with the protection of investors as the primary objective. A possible means of achieving efficient integration is adopting a comprehensive approach to transparency, whereby all trading systems should be subject to transparency requirements to a standard acceptable to all Member States of the EU. Implementing such a standard would require a comprehensive approach to trade reporting and surveillance whereby the regulatory system must have overall arrangements which fosters confidence that trading activities will be tracked and monitored in a way which will enable detection of market abuse and misconduct. The regime for non-exchange trading systems must ensure similar standards of conduct for users of these systems as for users of exchanges. However, establishing similar standards could be the responsibility of self-regulatory organizations or an organization with power delegated by the EU, rather than the responsibility of the system operator. Finally, regulators will have to keep in mind the different driving forces among the markets, some are quote driven and others are order-driven.

Open competition will only get integration so far in the EU. Currently, ECNs only have a door open through the UK. By way of the Investment Services Directive, ECNs may operate as a Pan-European ECN as long as they become a registered exchange in a Member State (e.g., as Tradepoint has done in the UK). Thus, open competition in the EU markets is severely limited in contrast to the more efficient open competition system in the U.S. If the EU is to achieve true market integration, regulatory efforts will need to be implemented even if only temporary in nature.

TRADEMARK LAW & ENFORCEMENT IN CHINA: A TRANSNATIONAL PERSPECTIVE

JESSICA JIONG ZHOU*

I. INTRODUCTION

Deng Xiaoping's effort to encourage the economic development of the People's Republic of China has made China, with a population of more than one billion consumers, a magnet for international companies as well as counterfeits of their products. International companies have been eager to enter and service this vast market, but some have found much to their surprise, that their goods are already available in China—or at least counterfeits of their goods.

Issues surrounding the transfer of intellectual property across national borders have provoked intense discussions during the last three decades. At the core is the desire to obtain protected intellectual property quickly and inexpensively irrespective of its current holders' proprietary rights and profit motives. Particularly with regard to developing countries, some commentators have pointed out that the necessity of intellectual property represents a fundamental paradox because those countries cannot afford it. However, a country hungry for technology learns quickly that the engine that drives technological advancement is the effective protection of intellectual property rights. The People's Republic of China is such a country.

China has reached a stage in its development where it increasingly recognizes the value of a strong intellectual property protection regime. The country aspires, as part of its drive for even faster economic development, to join the league of industrialized countries with such regimes. In recent years, China has made bold strides to reform its domestic intellectual property legislation, and thus making its shores safer for foreign trademarks, patents, and copyrights. The country has also, within a remarkably short

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† Deng Xiaoping, now deceased, was the former Secretary General of the Communist Party of the People's Republic of China.


‖ Id.

period of time, strengthened the judicial and administrative mechanisms necessary to protect intellectual property.

However, critics often charge that the extensive promulgation of new intellectual property laws, especially those with respect to trademark protection, is nothing but a mere carbon copying of concepts and rules from other countries, given the lackluster enforcement of the laws. Intellectual property protected by trademarks is a vital asset for enterprises to distinguish products and services from one another in the marketplace, both nationally and globally. But in China, perhaps not too surprisingly, there news reports such as “Chinese villagers protest government investigation of counterfeit jeans manufacturers.” Due to rampant trademark counterfeiting, U.S. trademark holders doing business in the largest developing market in the world used to claim billions of dollars of profit loss annually. Moreover, China's long-time inability to join the World Trade Organization (WTO) had been largely attributable to political oppositions from the U.S. and Europe claiming, among other things, that China could not provide adequate protection for intellectual property rights.

Have the genuine legislative efforts of the Chinese government become futile? What are the underlying ambiguities and loopholes within such a legal regime? What are the cultural, economic, and social impediments to effective and adequate trademark protection? What are the public and private mechanisms that western, especially U.S. businesses selling on the Chinese market can use to safeguard their trademarks? Can China really achieve the international standard in trademark protection? This article attempts to answer these and many other questions and to explore the real landscape of trademark law and its enforcement in China, from both a national and a transnational perspective. Part II of this article provides a historical overview of the recognition and protection accorded to trademark rights in China. Part III outlines the current legislative framework. Part IV discusses the current enforcement conditions and problems. Part V suggests some of the practical considerations for foreign trademark owners doing business in the Chinese market. Finally, Part VI attempts to shed some light on China’s prospects to achieve the international standard in trademark protection.

II. LOOKING BACK IN THE MIDST OF MISCONCEPTIONS: THE GLORIOUS PAST YET ONLY PAST GLORY?

At the outset, is it fair to say that China has historically disregarded the importance of intellectual property rights? Many western commentators have generally assumed so. In fact, however, this is a misconception.

A. ANCIENT HISTORY

During its five thousand years of civilization, China has been one of the world’s leaders in scientific discovery and technological inventions. For example, the Chinese were the first to invent papermaking, printing with movable types, gunpowder, and the compass. These and other famous ancient inventions and discoveries had at times “changed the whole face and state of things throughout the world.” As a result, social awareness for the importance of scientific advancement has always been remarkable in China.

The first Chinese law on intellectual property is the copyright law in the Tang Dynasty (618-906 A.D.), a dynasty witnessing the widespread use of printing and an unprecedented boom in liberal arts. The first Chinese patent law, the “Provisional Rules on the Encouragement of Art and Crafts,” was enacted in December 1911, and it granted five-year patents for innovations.

The use of trademarks can be traced back as early as the Northern Zhou Dynasty (556-580 A.D.), when the Chinese used marks to identify the source of their products. These marks were the embryonic form of trademarks in China. In the Tang Dynasty, when more merchants began to use different marks to distinguish their goods from others, the marks increasingly served a source-identifying function. Merchants who valued...
their business own reputation and craftsmen who took pride in their own craftsmanship carefully designed their own logos to protect and enhance their reputation. For example, fine china bearing the "Jingdezhen" mark, designating the geographic origin, still enjoys worldwide fame today.

In 1904, the Qing Dynasty government enacted the first formal trademark law, which was largely administered by foreigners who took substantial control of China’s trade at that time. The development of trademark law continued during the reign of the warlords in the early 1900s, when the Northern Warlord government issued a trademark law which was administered by a newly created "trademark office" under the Ministry of Agriculture and Commerce. Later, the Nationalist government also promulgated its own trademark law in 1931. Hence, China’s trademark intellectual property law has evolved much earlier in history than its Anglo-American counterparts.

B. MODERN HISTORY

The existence of a law on trademarks in a socialist country is bound to strike the reader as somewhat anomalous, if not as a downright abandonment of basic principles of the socialist system. After all, trademarks are used to identify and distinguish the products of individual manufacturers ... to the general public to foster fair and effective competition. In a socialist economy ... why should there be a need for trademarks?

1. Early Trademark Regulation

(A) The 1950 Regulations

As the history of China entered a new phase, the Provisional Regulations on Trademark Registration were enacted in 1950 (the "1950 Regulations"), and provided for a centralized trademark registration system. The legislative intent was to "assure the right of [the] exclusive use" of trademarks in "industry and commerce." The Regulations required mandatory re-registration of old marks formerly registered with the Nationalist Government. However, registration of new marks was largely voluntary and few firms saw the reason to register. Those who did register, however, were able to see the advantage much later when in the 1980s trademark regulators relied upon such registration to resolve disputes among competing firms.

(B) The 1963 Regulations

The 1950 Regulations were replaced in 1963 by the Regulations for Administration of Trademarks (the "1963 Regulations"). The principal underlying policy tilted from protecting the "exclusive right to use" to strengthening "trademark control" and improving product quality. Under the 1963 Regulations, regulatory agencies had the authority to supervise the quality of goods bearing trademarks and the Central Administration of Industry and Commerce could revoke the trademarks of poor quality goods. For goods that did not bear trademarks, the Regulations required that the name and address of the producer appear on the packages. This reflected a stronger emphasis on economic centralization in the 1960s, a time of economic difficulties in China.

A major improvement in the 1963 Regulations and its Implementing Rules is that they established the reciprocity principle with respect to foreign trademarks. Under this principle, a foreign entity that has already registered in its home country can seek trademark registration in China, as long as the home country has reciprocal trademark protection with China through the China Council for the
Promotion of International Trade (the “CCPIT”). For example, in March 1978, the CCPIT approved the registration of several U.S. trademarks under the reciprocity principle after finding that the U.S. Lanham Act recognized the same principle.

However, the mere existence of law did not guarantee its enforcement. The Chinese legal system was still at an early development stage, and the concept of the Rule of Law remained vague in people’s minds. Moreover, productivity was low and goods were in such limited supply that people did not have much latitude choosing among the products that were available. In fact, there was often only one brand-named product for certain goods. Therefore, for example, “LIGHTHOUSE” was almost synonymous for washing soap, “GOLDEN FISH” for powder detergent, and “PHOENIX” or “FOREVER” for bicycles. In addition, under the “iron rice bowl” distribution regime, a manufacturer had little incentive to seek protection of its trademarks, since economic rewards were not linked with a product’s success or failure in the market. Consequently, the government made little efforts to implement and enforce the trademark laws.

2. The Cultural Revolution

A “Cultural Revolution” swept China between 1966 and 1976. During this “Revolution,” the “Gang of Four” and their followers controlled the central government and executed a policy of extreme economic egalitarianism. They painted the illusion that pure Marxist ideological aspirations, not economic incentives, would promote social productivity. “Eating from the big rice pot” and “distribution according to one’s need, not one’s contribution” were popular propaganda at the time. Not surprisingly, individual ownership of intellectual property therefore did not fare well with these extremist ideas.

However, people were soon disillusioned as national production plummeted, natural disasters erupted, and political chaos ensued. Knowledge was looked down upon. Children were put out of school to “participate in the revolution.” Sketches of scientific and technological advancements were thrown into trashcans. Young intellectuals were sent to the countryside to receive “re-education” by peasants who were having trouble feeding themselves, and old intellectuals were prosecuted because their thinking was considered “worthless and harmful to the people.”

During this darkest period of modern Chinese history, the whole legal system came to a complete halt. Trademark registration nearly stopped, as did regulatory supervision of product quality. Trademarks such as “Red Flag,” “East Wind” and “Worker-Peasant-Soldier,” all highly symbolic of the “Revolution,” became uniform for all kinds of goods.

C. The New Era

With the downfall of the Gang of Four in 1975, Deng Xiaoping reappeared in public life and launched an ideological attack on the policy of excessive egalitarianism that completely ignored the importance of economic development. A landmark document entitled “Some Problems in the Acceleration of Industrial Development,” for the first time pronounced that:

...[t]he restriction of bourgeois right can never be performed in isolation from the material conditions and spiritual conditions at the current stage ... [W]e cannot deny distribution according to one’s work, reject necessary differences ... (A)bsolute egalitarianism is not only impossible at present but also impracticable in the future.

The new leadership saw the need to incorporate the concept of property rights into the socialist lexicon of “distribution according to work” rather than “according to need.” The government established the Center for the Research of Economic Laws, which later became the aide of the State Council, to implement a new set of economic and commercial laws and
ensure that they keep pace with the operation of the new "socialist market economy." The 1983 trademark law was a product of this research center.

1. Impetus For Implementing A New Intellectual Property Regime

(A) From Big Iron Rice Pot to Self-Sufficiency: Adjustment to Market Mechanisms and Enterprise Economy

The "big iron rice pot" that everyone used to feed from soon became rusted when the government installed a new economic structure. Enterprises began to have more autonomy in their operations and retain a larger portion of their profits than before.\(^{34}\) State-run enterprises that used to operate under "central plans"\(^{35}\) and rely on state subsidies now have to account for their own livelihood. Economic decentralization has prompted price liberalization, as the government announced that virtually all price ceilings would soon disappear.\(^{36}\) Market mechanisms, rather than government plans, began to play an increasingly important role in shaping the economy.

Since China's economy began to take great leaps,\(^{37}\) its people have enjoyed a higher standard of living\(^{38}\) and a greater supply of goods. Personal consumption in this fast developing economy soon began to outstrip brisk GDP growth rates.\(^{39}\) As the market became more competitive, firms have increasingly realized the importance of their trademarks as the primary means of retaining consumer goodwill and promoting sales.

(B) From Collective Ownership to Private Ownership: An Ideological Change

Confucianism,\(^{40}\) a philosophy that dominated ancient China for over two thousand years, promotes self-abstinence and forbearance. This coupled with the notion of the "big iron rice pot," which supports collective ownership and equal allocation of social resources, ran afoul to the fundamentals of private ownership of property, including intellectual property.

Nevertheless, by the late 1970s, the idea of science and technology being the number one driving force for productivity had replaced the Cultural Revolution slogan of "knowledge is useless."\(^{41}\) Intellectual property quickly became the engine for China's modernization.

At the same time, China's state-owned enterprises experienced a major transition. These enterprises used to be monuments to bureaucratic ineptitude. While they accounted for half of the country's industrial output, 60 percent of its industrial employment\(^{42}\) and two-thirds of its GNP,\(^{43}\) they absorbed almost three-quarters of domestic credit.\(^{44}\) Even in a boom year, around two-thirds of the enterprises were losing money, and among the approximately 45 million urban industrial workers they employed, one-third was superfluous.\(^{45}\) Believing that only privatization can bring salvation,\(^{46}\) many of these enterprises have embarked on a journey of privatizing from government hands.


\(^{35}\) For a period of time, central authorities, such as the State Planning Commission, administered the sales of most products under a quota system. See, e.g., Wu-Olsson, supra note 30, at 95.


\(^{37}\) China's estimated Real GNP increased from ¥121 billion Yuan in 1975 to ¥427 billion Yuan in 1989. In 1992, the Real GNP was ¥2398.8 billion Yuan, and in 1993 it was targeted to be ¥2638.7 billion Yuan. Shwu-Eng H. Webb, U.S. Dep't of Agriculture, CHINA'S ECONOMY CONTINUED TO EXPAND, INT'L AGRIC. & TRADE REP.; CHINA DAILY, Aug. 30, 1997, available at 1997 WL 11282070.

\(^{38}\) China is an agricultural nation. 75% of its population (about 800 million in 1992) live on the land. Approximately 200 - 270 million Chinese were thought to have been living in "absolute poverty" (not even having enough food) in 1978. During the three-year natural disaster, even urban people had to live on stringent monthly quotas of food supply. Later, the number of the absolutely poor shrank to 100 million due to farming reforms. There has been a startling rise in living standards for both the rural and urban population. See The Titan Stirs, ECONOMIST, Nov. 28, 1992, available at 1992 WL 11282205.

\(^{39}\) According to the WEFA Group, an economic consulting firm, the most dramatic economic changes between 1983 and 1993 took place in East Asia, where per capita incomes rose at an estimated annual rate of 6.5%. In China alone, incomes over that period grew 8.5% annually. The World Bank predicts that developing countries (excluding Eastern Europe and the former Soviet Union) could have an annual average GDP growth of 4.8% over the next ten years, against 3.5% in the 1980s. See Rahul Jacob, The Big Rise: Middle Classes Explode Around the Globe, Bringing New Markets and New Prosperity, FORTUNE, May 30, 1994, available at 1994 WL 2801603.

\(^{40}\) See, e.g., Folsom & Minan, supra note 29, at 1-2. Confucianism is the philosophy of the ancient Chinese philosopher and educator Confucius. The essence of Confucianism is the virtues of being modest, good-hearted, humble, spendthrift, and willing to forbear. In particular, it stresses the virtues of yielding and compromise so as to avoid friction and achieve societal harmony.

\(^{41}\) This is a popular saying among the Red Guards during the Cultural Revolution. See Ladany, supra note 16, at 74.


\(^{43}\) Worthy, supra note 36.


\(^{45}\) Id.

\(^{46}\) Cleaning Up the Chinese State, supra note 42.
The massive economic changes inevitably spilled into society. People began to embrace the idea of private property ownership, a right that they increasingly choose to defend rather than forbear like their ancient ancestors. Moreover, the public awareness of private ownership increasingly expanded to intangible properties, especially intellectual property.

(C) From Closed Door to Open Door: Incentives for Foreign Investment

Like nervous hosts, countries in need of economic development sometimes promise party favors to the first guests who show up.47

Global economic integration has demonstrated the futility of isolation on the world stage. In 1978, China, a country that has historically played an important role in international politics, decided to also become an active participant in international economy. The Chinese government initiated an "open-door" policy, seeking to bring an end to its economic isolation since the birth of the country in 1949. In the next two decades, the country's economic performance brought about one of the "biggest improvements in human welfare anywhere at any time."48 Real GNP grew at an average of nine percent annually, and by 1994, China's economy was already several times bigger than that in 1978.49 Foreign trade and investment were so strongly encouraged that foreign investors swarmed in to "chase the dragon."50 In 1995, China received more direct foreign investment than any other country except the United States.51

The Beijing government, like a generous hostess throwing her first party, issued both economic incentives52 and legal incentives to attract foreign investment. In the less than two decades following the adoption of the reform and open-door policy, the country's top-level legislation, the

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47 Ford S. Worthy, Getting In On the Ground Floor, FORTUNE, Fall 1990, at 61 (Special Issue).
48 The Titan Stirs, supra note 38.
49 Id.
50 Id. The dragon is a traditional symbol of China.
52 Economic incentives include, for example, tax breaks, operational autonomy, liberalization of the domestic market, and the opening-up of domestic industries, such as transportation, retail and banking. For detailed discussions, see Pierre Maugue, Tax Incentives in the People's Republic of China: who Benefits?, 5 TOL. J. INT'L & COMP. L. 155 (1997); Henry J. Graham, Foreign Investment Laws of China and the United States, 5 J. TRANSNAT'L L. & POL'Y 253 (1996); Daniel J. Brink & Xiao Lin Li, A Legal and Practical Overview of direct Investment and Joint Venture in the "New" China, 28 J. MARSHALL L. REV. 567 (1995).

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35 National People's Congress (the "NPC") and its Standing Committee have passed and amended over three hundred laws, seeking to change the stagnant state of economic legislation and bring China's market economy within the rule of law.54

As China accelerated its industrialization and hosted more foreign investment, new intellectual property issues emerged, creating the need to implement a complete legal regime for the protection of intellectual property rights ("IPR"). In addition, Western countries also began to lobby for more effective intellectual property protection in China.

Among these western countries, the U.S. is the most ardent advocate. The U.S. employs a powerful weapon, the "Special 301," for fast solution of international IPR problems. Under Special 301, the U.S. Trade Representative (the "USTR") can lodge a complaint against any country that it believes to be conducting unfair trade practices.56 Special 301 views IPR violations as a market barrier to U.S. exports, and accordingly, the U.S. can deny the infringing country access to the U.S. market. China used to be a "priority country" on the U.S. Special 301 list. In order to avoid trade sanctions and to invite U.S. support in China's bid to accede to the World Trade Organization, Beijing signed a bilateral Memorandum of Understanding with Washington in January 1992.57 In February 1995, when the final bell rang for the end of the second round of bilateral discussions over the issue of the piracy of U.S. IPR, China further agreed to draw out Action Plans to improve border enforcement, to share enforcement effort data with the U.S., and to establish a licensing-and-permitting system against piracy.58

Therefore, China's decision to enter the world marketplace became the catalyst for its development of an IPR protection system. The country considered IPR protection as one of the legal cornerstones for its economic reform and integration into the global market, and quickly strengthened

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57 Id.
58 Id.
Trademark Law and Enforcement

that cornerstone by instituting domestic legislation as well as signing international agreements.60

2. Legislation in the New Era

(A) The 1983 Laws

In 1982, the 24th Session of the Standing Committee of the 5th NPC adopted a new trademark law based on the revision of the 1963 trademark law.61 The new laws became effective in 1983 (the "1983 Law"), followed by the enactment of a set of implementing regulations, which served to fill in gaps and address specific application of the laws.62

The 1983 Law made it possible for individuals and institutions, in addition to enterprises, to apply for trademark registration.63 This reflected the change in the structure of ownership of production.64 Moreover, as a major improvement upon prior trademark laws, the 1983 Law protected the exclusive right of a trademark owner to use a registered mark and authorized a private right of action against acts of infringement.65 However, damages for infringement remained compensatory, and service marks remained unregistrable.

The subsequent surge in applications for registration manifested in a revived public awareness of trademark rights.66 Nonetheless, the new laws did not require mandatory registration except for certain goods. Thus, some producers put on the market products with unregistered marks or no marks at all.67 These products often had poor quality, leading to consumer complaints. In response, the State Administration of Industry and Commerce ("AIC") issued a decree requiring that producers state their name and address on the packaging of products with no registered trademarks.68

(B) The 1993 Laws

The most recent amendments to China's trademark laws occurred in 1993, partly in response to the criticism that China was not providing adequate enforcement against trademark infringement.69 The 30th Session of the Standing Committee of the 7th NPC revised the old laws to comply with the requirements of the Paris Convention of Industrial Property (the "Paris Convention") and the Madrid Union to which China was a signatory. In the same year, the Standing Committee promulgated the Supplementary Regulations Against Counterfeiting Registered Trademarks, intensifying the battle against counterfeiting.

The 1993 Law incorporated the legislative purpose of previous legislation. The law was designed to improve "the administration of trademarks" and encourage "producers to guarantee the quality of their goods and maintain the reputation of their trademarks, with a view to protecting consumer interests and to promoting the development of [the] socialist commodity economy."70

Moreover, the 1993 Law for the first time made registration available for service marks.71 It defined "infringement" to include the sale of goods that one is "fully aware" are counterfeits of a registered mark, the forgery or unauthorized manufacturing of representations of another's registered trademark, and the sale of trademark representations that were forged or manufactured without authorization.72 In addition, it improved trademark registration procedures, increased administrative fines, and permitted administrative authorities to order payment of damages.73


See 2 China Laws for Foreign Businesses: Business Regulation (CCH) ¶ 1-1-500, at 14,001.


Wu-Chison, supra note 30.

The economic reform encouraged more diverse ownership of production, including the state ownership, the collective ownership, and also the previously much abhorred private ownership. For a detailed analysis of ownership transition in China, see, e.g., Lan Cao, The Cat That Catches Mice: China's Challenge to the Dominant Privatisation Model, 21 BROOKLYN J. INT'L L. 97 (1995).

Trademark Law of the People's Republic of China, art. 4, supra note 61.

For example, from August 1982 to June 1985, the Trademark Office received 92,600 applications, out of which 23,700 were filed in the first half of 1985 alone. By mid-1985, the Office registered more than 116,000 trademarks, of which foreign applicants owned 17,900. China Advances in Building Industrial Property System, XINHUA [NEW CHINA] GENERAL OVERSEAS NEWS SERVICE, Item No. 092497, Sept. 24, 1985, available at LEXIS, News Library, Xinhua file.

According to a survey at that time, only 29 percent of the products coming from the city of Harbin bore registered trademarks, and among those enterprises using trademarks, a large proportion failed to obtain registration. See Shen, A Talk in the Formation and Development of China's Trademark Laws, FAXUE YANJU (LEGAL RESEARCH) 37, 40 (1980).


William P. Alford, Don't Stop Thinking About ... Yesterday: Why There Was No Indigenous Counterpart to Intellectual Property Law In Imperial China, 7 J. CHINESE L. 3, 5-6 (1993).


Remjardi & D'Amato, supra note 7, at 178-79.
III. CURRENT TRADEMARK LEGISLATION

A. CONSTITUTIONAL BASIS AND LEGISLATIVE OBJECTIVES

The Constitution of the People's Republic of China lays out the foundation for China's intellectual property laws. It provides that "[t]he state promote the development of the natural and social sciences, disseminate scientific and technical knowledge, and command and reward achievements in scientific research as well as technological discoveries and inventions." Therefore, the Constitution explicitly recognizes the importance of intellectual property in social development. However, the Constitution leaves open two questions: (1) whether such intellectual property should belong to the people at large or to the individual who generates it, and (2) how such individual will be "rewarded" and "commended." Perhaps because of such constitutional ambiguity, China's intellectual property laws traditionally focused very heavily on encouraging the creation and dissemination of intellectual property, but not on protecting its private ownership. However, this ambiguity has gradually clarified itself as society began to embrace the idea of private ownership and recent laws have become increasingly cognizant of the rights and interests of intellectual property owners. For example, the General Principles of the Civil Law of 1986 provides:

If a citizen's or legal person's right of authorship (copyright), patent right, right to the exclusive use of a trademark, right of discovery, right of invention or other right pertaining to scientific or technical achievements is infringed upon in the form of plagiairy, falsification or imitation, the citizen or legal person shall have the right to demand that the infringement be stopped, the effects of the infringements eliminated and damage compensated for.

III. TRADEMARK LAW AND ENFORCEMENT

Such explicit acknowledgement of the rights of intellectual property holders refutes the critique that China's intellectual property laws remain merely instrumental to the ideological agenda of a socialist society.

However, the trademark laws, like other intellectual property laws in China, do carry policy objectives that are different from those of their western counterparts. Specifically, they mandate the protection of the consuming public. For example, early legislation such as the Measures for the Control of Trademarks provided that registration of a trademark could be cancelled if the quality of the products was not up to a prescribed level or where cancellation was demanded "by most of the people." Similarly, the Trademark Law of 1993 aims not only to protect the "exclusive right to use a trademark," but more importantly, to guarantee product quality and protect "consumer interests."

Moreover, the Trademark Law's role in assuring consumers of good quality products is also supplemented by other laws regarding product quality and consumer protection. For example, the Product Quality Law, Protection of the Rights and Interests of Consumers Law, and Unfair Competition Law all have relevant trademark provisions geared toward protecting consumers.

B. LEGISLATIVE FRAMEWORK

1. At the Domestic Level

Currently, major trademark legislation includes the Trademark Law and its Implementing Rules, the Well-known Trademark Law and the Trademark Law and Enforcement.
Regulations,\textsuperscript{85} and the Trademarks for Foreign Trade Regulations.\textsuperscript{86} However, the bulk of China's trademark law is contained in the 1993 Trademark Law and its Implementing Rules.

2. \textit{At the International Level}

In addition to legislative efforts at the domestic level, during the past two decades, China has attempted to keep in line with internationally recognized intellectual property protection standards by becoming signatory to international and multilateral trademark treaties.\textsuperscript{87}

The July 1979 U.S.-China Agreement on Trade Relations marked the first of China's IPR legislative steps at the international level. The agreement provided for reciprocal protection of patents and copyrights between the two countries.\textsuperscript{88} In the same year, Beijing sent out its observer team to sit in on the International Trademark Registration Treaty Conference convened by the United Nations World Intellectual Property Organization ("WIPO").\textsuperscript{89} A year later, China submitted a membership application to the Organization, and in June 1980, it became a member of the WIPO.\textsuperscript{90} Three years after joining the Paris Convention, China adopted the International Classification of Goods and Services system for trademark registration in 1988.\textsuperscript{91} The following year, China acceded to the Madrid Agreement for the International Registration of Marks. By the 1990s, China has entered into most major international IPR treaties.

\textsuperscript{85} Detailed Rules for the Implementation of the Trademark Law of the People's Republic of China. Id. \S 1-505.

\textsuperscript{86} Provisional Regulations on the Recognition and Administration of Well-known Trademarks. Id. \S 1-523.

\textsuperscript{87} Regulations of the Ministry of Foreign Trade and Economic Cooperation and the State Administration for Industry and Commerce Concerning the Administration of Trademarks for Foreign Trade. Id. \S 11-535.


\textsuperscript{90} The team was headed by Ren Jianxin, the director of the Law Department of the China Council for the Promotion of International Trade, later Justice of the Supreme People's Court. In 1979, the Chinese government also sent a delegation for an intellectual property protection observation tour to more than ten countries. The delegation was headed by Wu Heng, Vice Minister of the State Science Commission, who turned in a report to the State Council. See id.

\textsuperscript{91} Id.


\textsuperscript{93} In October 1992, the Guizhou Higher People’s Court sentenced one man to death where he counterfeited MAOTAI wine, resulting in illegal profit of approximately US$260,000. The Kunming Intermediate People’s Court issued the death penalty to one of the defendants and life imprisonment to six others in April 1993 where they sold counterfeit "RED PAGODA MOUNTAIN" cigarettes for an illicit profit of about US$150,000. In August 1993, China prosecuted three men found guilty of producing fake medicine and poor quality fertilizer, false advertising, and trademark piracy; but this time, under the Criminal Law provision dealing with crimes against property, rather than the Criminal Law’s trademark provision. By September 1993, the courts have handled 68,989 cases involving fake or shoddy goods, sentenced 500 people to prison, one additional person to death, and five additional to life imprisonment. See Paul B. Birden, Jr. Trademark Protection in China: Trends and Directions, 18 Loy. L.A. Int’l & Comp. L. Rev. 431, 431 (1996).

\textsuperscript{94} Among these cases, 1,676 were tried, and 1,375 people received imprisonment or other criminal penalty. Li, supra note 92, at 58.

\textsuperscript{95} Trademark Infringers Shut Down, CHINA DAILY. June 3, 1994, at 3 (N. AM. Ed.).

\textsuperscript{96} Li, supra note 92, at 57.

\textsuperscript{97} Id. at 6.
is inquisitorial rather than adversarial, a judge's lack of competence can be particularly devastating.\textsuperscript{98} Therefore, China is in the process of appointing more legal professionals with technical expertise, high ethical standards, and foreign language proficiency to be judges for the intellectual property courts. Courts at different levels have also organized training workshops and sent judicial personnel abroad for study and on-the-job-training.\textsuperscript{99}

Non-judicial efforts are also notable. Supporting organizations such as the Product Liability Department under the China Management Association and various consumer associations have been established.\textsuperscript{100} Additionally, in an effort to train more intellectual property professionals, Beijing University set up the first graduate program in intellectual property law,\textsuperscript{101} soon followed by similar programs at other major universities.\textsuperscript{102}

C. PROBLEMS

Despite significant improvements over the past two decades, the trademark protection regime in China still has many problems.

1. Judicial Independence

China's Constitution provides that the people's courts exercise judicial power independent from any interference by political parties, administrative agencies, and individuals.\textsuperscript{103} It also mandates that the people's courts execute their responsibilities on the basis of facts and in strict accordance with the substantive and procedural laws.\textsuperscript{104} Nonetheless, the question remains whether every court in the country is truly independent of non-judicial interference. Due to the long absence of the

Rule of Law, China's judiciary had for a long time remained inextricably linked with the Party.\textsuperscript{105} Although the trademark laws seek to blend the best of foreign and Chinese expertise,\textsuperscript{106} the establishment of true judicial independence necessary to breathe life into the laws will still take time.

2. Bureaucracy

Today, China has a complete set of sophisticated trademark laws. However, a successful trademark protection regime depends on how people work with these laws. Although China is quickly marching toward modernization, some of its governmental bodies still hold on to their old bureaucratic habits. Files are often passed around, lying beneath teacups on different desks without being read, and then joining previous backlogs and thrown into oblivion.

As the old organizational structure became increasingly burdensome and inefficient, the country's new generation of leadership initiated bold organizational restructuring to end bureaucracy. Even during the economic slow-down in the late 1990s,\textsuperscript{107} the government reduced the number of State Council ministries from forty to twenty-nine, and downsized the number of civil servants from eight million to four million.\textsuperscript{108} In light of such large-scale structural reform, legal professionals who should still be prepared to deal with bureaucracy can expect to see less and less of it in the future.

3. Inadequate Remedies

Critics have argued that the damage awards in most trademark infringement cases in China are not enough to curb current infringement and deter future ones. This is because courts and administrative authorities usually only grant injunctions against future infringement, but do not grant compensation for damages caused by past infringement. Absent more powerful remedies, free-riders of others' trademark rights are
likely to continue free riding. For example, they can circumvent court decrees by transferring the illegal activity from one factory to another, and by the time their illegal activities are exposed again, they would have already made another windfall. To these people, the business is enormously lucrative and the risk is minimal.

Even in cases where monetary damages are awarded, the amounts are often so nominal that they barely justify the litigation costs. Walt Disney Company, for example, incurred more than $15,000 in legal costs battling for its Mickey Mouse in 1993, only to win a single fine of $91 as compensation from one of the factories raided as compensation.109 Failing in an effort to appeal, the frustrated company returned from the battlefield only to find its film, The Lion King, appearing in China before its own video release in the U.S.110

4. Regional Discrepancy

Economic growth and accompanying disparities among China’s regions — along with diversification of Chinese political, cultural, and social life — have driven the country’s political decentralization, and will likely continue to do so. ... This model seeks to accommodate just enough regional power to maintain Party and national State hegemony at the apex of a widened political pyramid.111

Decades of economic decentralization has made China different from the highly unitary state fifty years ago.112 At the national level, the power of law-making ultimately resides in the NPC and its standing committee. At the lower levels, the people’s congresses of provinces, provincial capitals, autonomous regions, and directly-administered municipalities113 promulgate local laws and regulations to implement laws made by the national legislature.114 Additionally, the Special Economic Zones115 can also issue their own legislation subject to approval from provincial legislature.

However, because the legislative powers at the different levels are not very well defined, some local governments, with their own economic objectives in mind, often fail to observe the regulations of the central government. This has made it difficult for law enforcers to find the applicable law, and thus leading to confusion and lax enforcement at the local level.

Furthermore, the publication of new laws often lags behind their promulgation. Often times, a brief newspaper account is the only source for people to learn about important new laws. While the NPC and the Supreme People’s Court publish laws and judicial opinions in official gazettes, their provincial counterparts usually do not.116 Therefore, legal guidelines at the local level are very vague.

In addition, because the ultimate authority to carry out anti-counterfeiting raids lies in local hands, protectionism, driven by local economic incentives, often tends to undo the central government’s enforcement efforts. Especially after the 1994 implementation of a nationwide “tax assignment” system117 which permitted local governments to retain a portion of the tax money for local use, local governments had more incentives to enhance tax revenue by encouraging short-term projects with quick return. Ironically, the local-based trademark counterfeiters are often big contributors to local tax revenue, because they operate on low cost (they do not incur the cost of developing and protecting the trademarks) and sell for high profit. Thus, as long as these counterfeiters pay taxes, some local governments have been reluctant to put them out of business. As some local officials have put it, “just open one eye and close the other.”

Finally, apart from policy discrepancies between the central and the local governments, the various local governments can also have very different administrative approaches. Decentralization and market reform have replaced the “cellular economy,” an economic legacy reflecting Mao’s idea of every city being self-efficient within a unified national market. However, regional economic gaps have expanded.118 As such,
uneven application of laws among different localities can also add to the difficulty for trademark protection.

5. Criminal Enforcement: Some Real Color?

The criminal prosecution of trademark cases has always lacked real teeth. In the last few years, even where prosecutors have undertaken seizures at the behest of IPR owners or administrative authorities, they have usually been reluctant to ask the court for criminal sanctions.\(^{119}\) Behind such reluctance is a combination of factors: lack of clear local guidelines, limited financial and human resources, vested local interests, and in some cases, corruption.\(^{120}\) Consequently, although criminal enforcement against trademark infringement in major cities has significantly increased over recent years, places with no criminal enforcement mechanisms have attracted manufacturers and wholesalers specializing in counterfeiting and trafficking counterfeits.

A bright sign may lie in the new Criminal Procedure Code which authorizes a private right of action in criminal prosecution of trademark infringement.\(^{121}\) The Supreme People's Court's interpretation of the Code further lifted barriers to private prosecution by allowing trademark owners to bring complaints directly to the court for criminal prosecution without prior approval from local prosecutors or other authorities.\(^{122}\) However, while this may alleviate the difficulty in criminal enforcement, whether the local judges are willing to convict the politically powerful can still pose a problem.

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\(^{120}\) Nevertheless, the Chinese government has demonstrated a true resolve in combating corruption of government officials in the past ten years: between April 1988 and March 1992, prosecutors handled over 40,000 bribery cases; between January and August 1992, governmental supervisory bodies disciplined approximately 22,900 corrupted officials. Major corruption cases doubled in the year of 1993 when China strengthened a national effort against economic crimes. See also Chang Hong, *Corruption Purge has Officials on the Rack*, CHINA DAILY, Nov. 7, 1992, at 11, available at 1992 WL 8729446; *Party Wages War on Corruption as Incidents Soar*, CHINA DAILY, Mar. 3, 1994, available at 1994 WL 11428358 (N. Am. Ed.).

\(^{121}\) See Catherine Gelb, *Foreign and Chinese Software Firms are Competing, and Cooperating, to Build A Dynamic Sector*, CHINA BUS. REV. (Sept. 1, 1997), available at 1997 WL 9618789.

\(^{122}\) See id.