
China Tightens Scrutiny Over the Transfer of Intellectual Property Rights to Foreign Parties

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The *Measures on the Transfer of Intellectual Property Rights to Foreign Parties (Pilot)* (“Measures,” click [here](#) for the Chinese-language text) (dated March 18 and published March 29, 2018, with immediate effect) tighten scrutiny over the transfer of intellectual property rights (IPR) to foreign parties on national security or public interest grounds. Public interest here is apparently defined as the development of core innovation capacity in major technology areas. Technologies related to national defense as opposed to national security are separately governed and therefore are not subject to the Measures. Issued by the General Office of the State Council, the Measures are intended to enhance national security institutional systems, safeguard national security and major public interests, and regulate the transfer of IPR to foreign parties. The features of security assessments under the Measures are set forth below.

I. Certain IPR Transfers Subject to Security Assessments

A security assessment is required before the proposed transfer of IPR to foreign parties if the transfer involves patents, exclusive rights to integrated circuit layout designs, computer software copyrights or new plant varieties (including the right to apply for IPR registration) through the export of technology and/or acquisition of an onshore enterprise by a foreign party. As the Measures refer to onshore enterprises (*jingnei qiye*), their scope includes acquisition of Chinese-foreign joint ventures or their IPR by foreign parties.

The IPR transfer is defined as the transfer of domestic IPR from Chinese entities or individuals to foreign companies, individuals or organizations, including by change of IPR holder or actual control person or by exclusive license of IPR.

The IPR transfer will be assessed based on its impact on national security and the country's core technology innovation capacity in major areas.

Technology which is restricted from export under the *Catalogue of Technologies Prohibited and Restricted from Export* (2008 Catalogue, amended September 16, 2008)¹ must undergo the following assessment mechanism:

- With respect to the transfer of patents and exclusive rights to integrated circuit layout designs, an application has to be submitted to the local commerce commission, which will solicit written opinions from the local IP administrative agency, i.e., the local counterparts of the State Intellectual Property Office, and make its decision in accordance with the *Administrative Regulations on the Import and Export of Technology* (effective January 8, 2011).
- With respect to the transfer of computer software copyrights, the local commerce commission, together with the science and technology administrative agency, i.e., the science and technology bureau, will assess the transfer and make its decision in accordance with the *Administrative Regulations on the Import and Export of Technology* (effective January 8, 2011) and the *Regulations on Protection of Computer Software* (amended March 1, 2013).
- With respect to the transfer of new plant varieties, the agriculture or forestry administrative agency will assess the transfer in accordance with the *Regulations on Protection of New Plant Varieties* (amended July 29, 2014) with a focus on its impact on national agricultural security, particularly grain and seed security.
- With respect to IPR transfers embodied in foreign acquisition of an onshore enterprise, if the acquisition triggers a security assessment under Chinese law, the foreign investment security assessment authority will make its decision after soliciting and considering written opinions from the relevant administrative departments under the State Council. In particular, the IPR administrative department is responsible for the assessment of the transfer of patents and exclusive rights to integrated circuit layout designs; the copyright administrative department is responsible for the assessment of copyright transfers; and the agriculture or forestry administrative department is responsible for the assessment of new plant variety transfers.

Transfers of trademarks will not be subject to a security assessment.

II. Analysis

China introduced a system for security assessments with respect to mergers and acquisitions in 2011.² Transfers or assignments, as opposed to licenses, of IPR are separately subject to a very daunting review process in accordance with the 2008 Catalogue. The Measures thus tighten security assessments over IPR transfers with respect to patents, exclusive rights to integrated circuit layout designs and plant varieties.

Considering the broad definition of national security under the National Security Law (effective July 1, 2015)³ and the open-ended conception of public and societal interests, large numbers of such transfers and transactions involving such transfers may be subject to a security assessment. China's broad concept of national security and the treatment of the development of indigenous innovation capacity in major areas as a core national interest may ultimately bring many areas of technology generally considered elsewhere in the world to have no direct relationship to national security, including medical devices and pharmaceuticals, within the scope of the Measures. Moreover, the assessment criteria—impact on national security and core technology innovation

capacity—are overly broad and ambiguous, as with the Cybersecurity Law (effective June 1, 2017),⁴ which compels foreign parties to store data in China and subjects cross-border data transfers to security assessments, particularly with respect to important data and personal consent or anonymization, on the grounds of protecting data privacy and cybersecurity.

The Measures are linked to China's drive to upgrade its economy on the basis of innovation instead of continuing to rely on low labor costs. Zhang Zhicheng, director of the Protection and Coordination Department in the State Intellectual Property Office, stated that “in 2017, China's intellectual property royalties from abroad exceeded USD4 billion ... if China fails to strictly scrutinize core IPR transfers related to national security, China may lose control of indigenous innovation capacity on core technologies in major areas, and therefore incur huge economic losses and cause adverse impact on China's indigenous innovation capacity and international competitiveness”⁵ Nevertheless, the Measures may be construed as a move to promote China's aggressive policy of indigenous innovation by husbanding technology developed within China while increasing access to foreign technology through such means as coerced technology transfer as a precondition for market access which was the subject of the USTR's recent Section 301 Report into China's Acts, Policies, and Practices Related to Technology Transfer, Intellectual Property, and Innovation.⁶

Director Zhang Zhicheng stressed that the Measures comply with international treaties and customary practices, citing the *Agreement on Technical Barriers to Trade* (TBT Agreement),⁷ which provides in Article 2.2 that no country should be prevented from taking measures necessary to fulfil a legitimate objective. There is, however, reason to question whether the Measures unreasonably stretch the national security exception to the prohibition under Article 2.2 to preparing, adopting or applying technical regulations “with a view to or with the effect of creating unnecessary obstacles to international trade.” Treatment of the control of indigenous innovation capacity as a justification for the Measures would not appear to fall under the national security or any of the other exceptions under Article 2.2. The exclusion of national defense technologies from regulation under the Measures may also provide grounds for challenging the national security justification for the Measures in the WTO. While Mr. Zhang noted that the US, EU and Japan have set up similar assessment systems, he did not note that such systems currently have a much narrower scope than the Measures.

III. Conclusion

Until detailed guidance is provided on how restrictively the Measures will be enforced, the extent to which the Measures will affect transfers of Chinese IPR is unclear. Foreign parties pursuing M&A transactions or technology acquisitions in China will now, however, need to give more careful consideration to the following:

- Conduct due diligence and, ideally, early consultation with relevant administrative agencies as to whether the technology at issue is likely to be subject to restriction on transfer to foreign parties;
- Calculate the value of the IPR when contemplating an M&A transaction, incorporate the risk of disapproval of the IPR transfer in a breakup fee as well as the conditions precedent and decide whether the risk of disapproval of the IPR transfer is a deal killer.

China for its part should consider whether restrictive implementation of the Measures will lead other countries to further tighten their scrutiny of proposed acquisitions by Chinese parties.

¹ See <http://www.mofcom.gov.cn/article/b/c/200809/20080905801122.shtml> for the 2008 Catalogue. The Ministry of Commerce, together with the Ministry of Science and Technology, circulated the draft second amendment to the 2008 Catalogue on November 3, 2017, for solicitation of public comments.

² See <https://www.wilmerhale.com/pages/publicationsandnewsdetail.aspx?NewsPubId=92913> and <https://www.wilmerhale.com/pages/publicationsandnewsdetail.aspx?NewsPubId=94240>.

³ See <https://chinacopyrightandmedia.wordpress.com/2015/07/01/national-security-law-of-the-peoples-republic-of-china/>.

⁴ See http://www.npc.gov.cn/npc/xinwen/2016-11/07/content_2001605.htm for the Cybersecurity Law; see <https://www.wilmerhale.com/pages/publicationsandnewsdetail.aspx?NewsPubId=17179884681> for our client alert on *Cross-Border Data Flows Security Assessments in China*.

⁵ See <http://www.sipo.gov.cn/mtsd/1121214.htm> for Zhang Zhicheng's response to media inquiry.

⁶ See [https://ustr.gov/sites/default/files/Section 301 FINAL.PDF](https://ustr.gov/sites/default/files/Section%20301%20FINAL.PDF).

⁷ See https://www.wto.org/english/docs_e/legal_e/17-tbt.pdf for the TBT Agreement.

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