

**SUMMARY:**

**Decision:** A WTO Panel has ruled against a number of restrictions imposed by China on the importation and distribution of publications, audiovisual products, sound recordings and films. In response to a complaint by the United States, the Panel ruled that such measures violated China's commitments under its Protocol of Accession, as well as under the General Agreement on Trade in Services (GATS) and the General Agreement on Tariffs and Trade (GATT).

**Significance of Decision / Commentary:**

This is one of two simultaneous challenges launched by the Bush Administration with respect to China's treatment of U.S. copyrighted cultural products, such as books and films. In the first case, the United States argued that China's intellectual property rights laws were inconsistent with China's obligations under the WTO Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS). The Panel in that case rendered its decision earlier this year, and the outcome fell far short of U.S. expectations [see our report of February 18, 2009; available on request].

The current case dealt with market access, particularly "trading rights", i.e., the right to import and export. The United States argued that China "denies U.S. companies the right to import books, journals, movies, music, and videos, and instead requires all imports to be channeled through specially authorized state-approved or state-run companies." The United States also complained about similar restrictions on the distribution of these products. From the U.S. perspective, the outcome of the present case was significantly more successful than its TRIPS challenge, as it established violations relating to both trading rights as well as national treatment for goods and services.

This is **the first WTO Panel to rule on trading rights**. These disciplines on the right to import and export are not included in the Uruguay Round Agreements, and apply only to countries that acceded to the WTO after it was founded in 1995. Trading rights are now routinely included in the "Working Party Reports" (WPRs) of acceding countries, principally to seek to ensure that tariff concessions are not undermined by restrictions on the right to import. These are "WTO Plus" obligations that do not apply to the original Members of the WTO. (The Panel described this more delicately, noting that it was "mindful of the possibility that the Accession Protocol may impose obligations on China that are not imposed on other Members under the WTO Agreement, or are stricter than those that are applicable to other Members.") The Panel read the trading rights provisions of the Protocol broadly, stressing that "China was under an obligation to ensure that 'all enterprises in China', including foreign-invested enterprises registered in China (wholly foreign-owned enterprises, Chinese-foreign equity joint ventures and Chinese-foreign contractual joint ventures), have the right to import all goods into China."

At the same time, the Protocol of Accession states that China's trading rights obligations are "[w]ithout prejudice to China's right to regulate trade in a manner consistent with the WTO Agreement." This qualifier is a potentially significant carve-out. The Panel ruled that "China's right to regulate trade in a WTO-consistent manner takes precedence over China's obligation to ensure that all enterprises in

China have the right to trade.” However, it is unclear when the “right to regulate trade” can or should “take precedence” over trading rights. The Panel considered – and rejected – one potential instance of precedence, as China argued that its right to regulate trade included its right to invoke the “public morals” provision of the GATT, as discussed below.

This is the **first WTO Panel to rule on the GATT “public morals” defence**. This provision – one of the exceptions set out in the GATT – states that “nothing in this Agreement shall be construed to prevent the adoption or enforcement by any contracting party of measures...necessary to protect public morals[.]” The exception for “public morals” has been part of the multilateral trading system since its inclusion in the original GATT in 1947. However, the fact that it had not previously been invoked likely reflects the reluctance of many countries to override objective trade rules with something as subjective as public morals.

The United States was the first country to invoke the public morals defence, as it cited the parallel provision in the GATS in the 2005 US – Gambling dispute. The Panel US – Gambling found that “the term ‘public morals’ denotes standards of right and wrong conduct maintained by or on behalf of a community or nation” and that “the content of these concepts for Members can vary in time and space, depending upon a range of factors, including prevailing social, cultural, ethical and religious values.” The US – Gambling Panel also stressed that WTO Members “should be given some scope to define and apply for themselves the concepts of ‘public morals’... in their respective territories, according to their own systems and scales of values.” The Panel in the present case saw “no reason to depart” from this interpretation.

However, the current Panel held China to a **strict standard to justify the invocation of the public morals defence as “necessary.”** It ruled that China failed to satisfy the “necessity” standard, in part because the United States identified other, less trade-restrictive means for China to achieve its objectives.

This Panel ruling confirms that “public morals” will be defined on a national basis, which will vary from country to country – there is no international or WTO standard of “public morals.” Thus, WTO Members can expect a certain degree of deference by WTO Panels when they “define and apply for themselves” the concept of public morals, based on the “social, cultural, ethical and religious values” of the invoking country. However, no such deference will be accorded on the issue of whether the policy is “necessary” to protect the defined public morals. In determining the viability of the public morals defence in future cases, the necessity test will continue to be determinative.

Finally, the Panel chose not to rule on the **threshold issue of whether the public morals defence is available for non-GATT violations**. The exceptions set out in GATT Article XX can be used to defend breaches of “this Agreement”, i.e., the GATT. It could be argued that such a defence cannot be invoked to defend violations of non-GATT commitments, such as those set out in China’s Protocol of Accession. On the other hand, China’s Protocol of Accession, by its own terms, is “an integral part of the WTO Agreement”, and the WTO Agreement includes the GATT. The Panel chose not to address these interpretive issues, and instead assumed – without deciding - that GATT Article XX could be invoked for non-GATT Agreements, pending a ruling on whether China met the terms of Article XX(a). This question is important not just for the public morals defence, but for all of the GATT Article XX provisions that could be invoked for non-GATT violations. The resolution of this interpretive issue will need to await a future dispute.

China has announced to the press that it is likely to appeal this Panel’s decision.

## **ANALYSIS:**

### **Trading Rights: “all enterprises in China” have the right to import**

China made a range of commitments in its accession WPR, which were incorporated by reference into its Protocol of Accession. China’s WPR provided in part that following a transition period, “all enterprises in China would be granted the right to trade.” The WPR similarly provided that “China would permit all enterprises in China and foreign enterprises and individuals...to export and import all goods...throughout the customs territory of China.” In addition, the Protocol of Accession stated that “[w]ithout prejudice to China's right to regulate trade in a manner consistent with the WTO Agreement, China shall progressively liberalize the availability and scope of the right to trade, so that, within three years after accession, all enterprises in China shall have the right to trade in all goods throughout the customs territory of China....”

The Panel interpreted the clause “all enterprises in China” to encompass “both Chinese enterprises registered in China and foreign enterprises invested and registered in China.” As noted above, the Panel found that “China was under an obligation to ensure that ‘all enterprises in China’, including foreign-invested enterprises registered in China...have the right to import all goods into China.”

The Panel then turned to the “without prejudice” language in the Protocol of Accession. The Panel stated that “we consider that the phrase ‘without prejudice to’ is intended to indicate that China's obligation to ensure that all enterprises in China have the right to trade must not, and does not, detrimentally affect China's right to regulate trade in a WTO-consistent manner.” Therefore, in the Panel’s view, “if China regulates trade in a WTO-consistent manner, and this results, contrary to the obligation[,],...in ‘enterprises in China’ not ‘hav[ing] the right to trade in all goods’, China's right to regulate trade in a WTO-consistent manner takes precedence over China's obligation to ensure that all enterprises in China have the right to trade.”

The Panel interpreted the phrase “right to regulate trade” to mean the “right to regulate imports and exports.” It added that “we consider that China's ‘right to regulate trade’ in a WTO-consistent manner includes, by implication, a consequent right to regulate importers or exporters of the relevant good(s) in a WTO-consistent manner.”

The Panel stated that it was “mindful of the possibility that the Accession Protocol may impose obligations on China that are not imposed on other Members under the WTO Agreement, or are stricter than those that are applicable to other Members.” However, in the Panel’s view, “this element does not logically lead to the conclusion that the obligation to grant trading...was intended to prejudice China's ability to regulate imports and exports and, incidentally, importers or exporters of the regulated goods. As explained above, other elements and considerations lead us to a different conclusion.”

The Panel noted that the Protocol of Accession also provided that “all foreign individuals and enterprises, including those not invested or registered in China” must be accorded treatment no less favourable than that accorded to enterprises in China with respect to the right to trade. The Panel found that the phrase “all foreign ...enterprises, including those not invested or registered in China” applied “both to foreign-registered enterprises which wish to engage in importing or exporting, but have no commercial presence in China, and foreign-registered enterprises maintaining a commercial presence in China and wishing to engage in importing or exporting through the entity present in China.”

Having enunciated these principles, the Panel then examined the numerous “trading rights” measures challenged by the United States. One of the successful claims advanced by the United States related to foreign-invested enterprises. The Panel found that as foreign-invested enterprises in China did not have the right to import the relevant products, this was inconsistent with China’s obligations under the WPR and the Protocol of Accession.

Although the Panel found for the United States on some of its trading rights claims, the Panel also rejected a number of such claims and the ground that the United States had not established violations.

### **China’s “public morals” defence fails the “necessity” test**

China pointed to the language in the Protocol of Accession that its trading rights commitments were “[w]ithout prejudice to China's right to regulate trade in a manner consistent with the WTO Agreement”, which China argued included the “public morals” defence in GATT Article XX(a). China asserted that “imported cultural goods, because they are vectors of different cultural values, may collide with standards of right and wrong conduct which are specific to China.”

The Panel raised - but did not rule on – the issue of whether GATT Article XX was available as a defence for violations of non-GATT provisions, such as a Protocol of Accession. Following the approach taken by the Appellate Body in the 2008 case of US – Customs Bond Directive, the Panel proceeded on the provisional assumption that Article XX was potentially available to China as a defence to violations under the Protocol. Turning to the scope of the “public morals” defence, the Panel followed the interpretive approach adopted by the GATS Panel in US – Gambling, as noted above.

However, the Panel in the present case found that the Chinese measures at issue failed the “necessity” test, in part because “it is not apparent to us that the requirements in question make a contribution to protecting public morals.” Moreover, the Panel found that the measures could not be considered as “necessary” in light of a less trade-restrictive alternative proposed by the United States, i.e., that the Chinese Government could make final content review decisions before the products were cleared through customs. The Panel considered that “the US proposal would allow China to achieve its desired high level of protection of public morals” and would “have no restrictive impact on those wishing to engage in importing the relevant products.”

Given the conclusion that “China has in any event not established that the measures at issue satisfy the requirements of Article XX(a)” the Panel decided that “we need not, and hence do not, revert to the issue whether Article XX(a) is in fact applicable as a direct defence to breaches of China's trading rights commitments. We thus take no position on this issue.”

### **National treatment obligations: “adversely modifying the conditions of competition”**

GATS Article XVII imposes a national treatment obligation with respect to services trade. It provides in part that “each Member shall accord to services and service suppliers of any other Member, in respect of all measures affecting the supply of services, treatment no less favourable than that it accords to its own like services and service suppliers.” The Panel found a number of Chinese measures to be inconsistent with this obligation, including a law that had the “effect of prohibiting foreign service suppliers from wholesaling imported reading materials, while like Chinese suppliers are permitted to do so.” In the view of the Panel, such a measure “clearly modifies the conditions of

competition to the detriment of the foreign service supplier and thus constitutes ‘less favourable treatment’ in terms of Article XVII.” (In addition to the multiple violations of GATS Article XVII, the Panel also found that a limitation on the participation of foreign capital in contractual joint ventures engaged in the distribution of audiovisual products was inconsistent with China's market access commitments under GATS Article XVI.)

The United States made a number of claims under GATT Article III:4, a national treatment obligation applicable to goods. GATT Article III:4 requires importing WTO Members to accord to imported products “treatment no less favourable than that accorded to like products of national origin in respect of all laws, regulations and requirements affecting their internal sale, offering for sale, purchase, transportation, distribution or use.” The Panel accepted two U.S. claims under this provision.

Under one measure, imported reading material – but not domestically-produced reading material – must be distributed through a subscription-based regime. The Panel stated that “a distributor of domestic newspapers and periodicals can distribute individual issues to consumers via newsstands, bookstores, and other shops, as well as via subscription, while a distributor of imported newspapers and periodicals may only distribute its products through a subscription to every issue of that publication.” This meant that “the restrictions on the distribution channels...may reasonably be expected to adversely modify the conditions of competition in the marketplace between imported and domestic like products”, inconsistently with GATT Article III:4.

Another measure limited the “type of sub-distributors available to imported books, newspapers, and periodicals by excluding foreign-invested enterprises from the potential pool of sub-distributors.” The Panel stated that “domestic publications have a wider range of possible sub-distributors than their imported counterparts.” It concluded that this measure “may reasonably be expected to adversely modify the conditions of competition in the marketplace between imported and like domestic products”, in violation of GATT Article III:4. The other U.S. claims under this provision were rejected.

The United States brought a large number of claims and sub-claims against China in this case, which in the interests of brevity have not been summarized in their entirety here. The description above should thus be considered as illustrative rather than exhaustive. The Panel also ruled that a number of the U.S. claims were outside its terms of reference on procedural grounds.

The decision of the Panel in *China - Measures Affecting Trading Rights and Distribution Services for Certain Publications and Audiovisual Entertainment Products* (DS363) was released on August 12, 2009.

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