

# Decrypting China's Encryption Regulations



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Wednesday, March 25, 2009  
8:30 am - 11:00 am  
Trader Vic's Conference Center  
Palo Alto, California

# Agenda

BAKER & MCKENZIE

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- |                     |   |
|---------------------|---|
| 8:30 am – 9:00 am   | <b>Registration and Continental Breakfast</b>   |
| 9:00 am – 9:10 am   | <b>Welcome and Introductory Remarks</b><br><i>John McKenzie, San Francisco/Palo Alto</i>  |
| 9:10 am – 9:45 am   | <b>Overview of China's Commercial Encryption Regulations</b><br><i>Allan Marson, San Francisco/Palo Alto</i>  |
| 9:45 am – 10:00 am  | <b>Break</b>  |
| 10:00 am – 10:50 am | <b>Introduction to Recent Developments and What to Expect in the Future</b><br><i>Eugene Lim, Beijing/Hong Kong/Shanghai</i><br><b>Significance and Implications for Businesses Operating in China</b><br><i>John McKenzie, San Francisco/Palo Alto</i> |
| 10:50 am – 11:00 am | <b>Q&amp;A</b>  |
| 11:00 am            | <b>Program Concludes</b>  |

# Decrypting China's Encryption Regulations

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# Featuring

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## Agenda

- Overview of China's Commercial Encryption Regulations
- Introduction to recent developments and what to expect in the near future
- Significance and implications for business operations in China

# Overview of Encryption Regulations



# Overview of Encryption Regulations

- What is commercial encryption?
  - Encryption technology and encryption products used to protect by encryption, or to carry out security authentication of information that does not involve State secrets. *Regulations for the Management of Commercial Encryption* (“**Commercial Encryption Regulations**”)



## Overview of Encryption Regulations (cont'd)

- But, commercial encryption itself is a State secret, and the State controls research, production sale and use of commercial encryption products
- All commercial encryption is regulated, regardless of encryption strength
  - China not a member of Wassenaar Agreement



## Overview of Encryption Regulations (cont'd)

### –Background

- No published and publicly available law regulating commercial encryption prior to October 1999
- Commercial Encryption Regulations, issued by the State Council, effective Oct. 7, 1999, regulating the research, manufacture, distribution, import/export, use, security and storage in the PRC
  - No unit or individual in the PRC is permitted to sell foreign encryption products

## Overview of Encryption Regulations (cont'd)

- Due to opposition in the international business community, the State Encryption Management Commission (“**SEMC**”) issued the notice on *Issues Relevant to the Management of Commercial Encryption*, in March, 2000 (“**2000 Notice**”)
- Encryption products and equipment containing equipment technology are:
  - Limited to specialized hardware and software with a core function of encrypting or decrypting



## Overview of Encryption Regulations (cont'd)

- Examples outside scope of encryption regulations:
  - Mobile phones
  - Windows software
  - Browser software

## Overview of Encryption Regulations (cont'd)

- The State Encryption Management Bureau (**SEMB**), successor to the SEMC, subsequently issued:
  - Regulations for Production of Commercial Encryption Products, effective Jan. 1, 2006 (“**Production Regulations**”)
  - Regulations for Research of Commercial Encryption Products, effective Jan. 1, 2006 (“**Research Regulations**”)
  - Regulations for Sale of Commercial Encryption Products, effective Jan. 1, 2006 (“**Sale Regulations**”)
  - Regulations for Use of Commercial Encryption Products, effective May 1, 2007 (“**Use Regulations**”)
  - Regulations for Use of Commercial Encryption by Overseas Organizations and Individuals in China, effective May 1, 2007 (“**Foreign Use Regulations**”)

## Overview of Encryption Regulations (cont'd)

- Distinguish: The encryption regulatory regime is not:
  - Part of the customs regime
  - Directly related to the categories of industries encouraged for, restricted to, etc. Foreign investment
  - Part of the technology import/export control regime
    - For comparison, certain encryption technologies also fall in restricted export categories, including:
      - Cryptography techniques for secrecy of TV and telephone (Serial No. 056001X)
      - Encryption and decryption techniques for information access (Serial No. 056101)



## Overview of Encryption Regulations (cont'd)

- Distinguish: The encryption regulatory regime is not: (cont'd)
  - Part of china's regulatory regime for value-added telecoms (e.g., Providing processing services over the internet)
  - Part of the regulations governing network security products (e.g., providing security authentication services)



## Overview of Encryption Regulations (cont'd)

- The encryption regulations are separate from and in addition to the above
  - A permit or approval from the SEMB may be required as a pre-requisite to obtaining approvals or licenses for the above



## Overview of Encryption Regulations (cont'd)

- Scope
  - Commercial encryption products Include products that contain foreign-developed encryption algorithms
  - The definition is broad and not well defined
    - Different agencies and even different agents within the same office may provide different views

## Overview of Encryption Regulations (cont'd)

- Scope (cont'd)
  - Development of SEMB's view:
    - Following issue of the 2000 Notice, products that did not have a “core function” of encryption were outside the scope of the regulations
    - More recently, only those products expressly listed in 2000 Notice are excluded, i.e., mobile phone, Windows software and browser software
    - Most recently, all products with encryption fall within the scope of the encryption regulations



## Overview of Encryption Regulations (cont'd)

- Foreign encryption
  - Chinese units and individuals may not sell encryption products sourced from outside China; imports/exports of encryption products and equipment containing encryption must be approved by the SEMB. Commercial Encryption Regulations, 1999
  - Chinese units and individuals may not use encryption products produced abroad. Use Regulations, 2007

## Overview of Encryption Regulations (cont'd)

- Foreign Encryption (cont'd)
  - Overseas organization: An organization established outside the PRC under foreign law, including branches, offices, representative offices, etc. established in the PRC
  - Subsidiaries (e.g., WFOEs) are permitted by the Use Regulations to use foreign-manufactured commercial encryption products with approval
  - The application form for use of foreign encryption products requires disclosure of algorithm and key length



## Overview of Encryption Regulations (cont'd)

- Foreign Encryption (cont'd)
  - An overseas organization may import and use foreign encryption products after obtaining:
    - “Permit for Approval to Use Foreign Manufactured Encryption Products”, and
    - “License to Import Encryption Equipment”

## Overview of Encryption Regulations (cont'd)

- Summary: Severe restrictions on importing, exporting, research, production, sale and use of foreign encryption products in China
  - It is very difficult for Chinese companies or individuals to obtain a permit or approval from SEMB to import, export, research, produce, sell or use foreign encryption products in the PRC
  - Foreign companies have obtained permits and approvals to import for their own use
- However, the encryption regulatory regime has been widely ignored in practice by market players and government agencies



## Overview of Encryption Regulations (cont'd)

- Current Practice in PRC
  - Localization of foreign encryption by producers
  - Availability of foreign encryption products in PRC market
  - SEMB appears driven by concern for both State security and protectionism
  - But has had no effective way to enforce
    - Some exceptions: e.g., foreign developed laptop computers that contained commercial encryption reportedly denied entry into China in 2006



# Introduction to Recent Developments and What to Expect in the Near Future



## New Tariff Classification for Encryption Products

- 2009 tariff classification includes new tariff lines for encryption products (encryption tariff classifications)
- Encryption tariff classifications currently only comprise of 11 tariff lines
- New encryption tariff lines came into effect January 1, 2009

## Covered Products\*

PRC Tariff Numbers	Product Description
8443.3110.10	Electrostatic-sensitive multifunctional integrated encrypting fax machines (with automatic data processing equipment or network connection)
8443.3190.20	Other multifunctional integrated encrypting fax machines (machines with the function of printing, copying or both)
8443.3290.10	Fax machines (can be connected to automatic data processing facilities of internet)
8517.1100.10	Cordless encrypting telephones
8517.1290.10	Other encrypting telephones for cellular networks or other wireless networks

\* Not exhaustive. Comprehensive list will be issued in the near future.

## Covered Products\* (cont'd)

PRC Tariff Numbers	Product Description
8517.1800.10	Other encrypting telephones
8517.6229.10	Optical communication encrypting routers
8517.6232.10	Non-optical communication encrypted exchanges
8517.6236.10	Non-optical communication encryption routers
8523.5290.10	Encrypting “intelligent cards”
8542.3100.10	Encryption electronic integrated circuits for processor and controller, with or without storage, converter, logic circuit, amplifier, clock and sequential circuits or other circuits

\* Not exhaustive. Comprehensive list will be issued in the near future.



# Tariff Classification Formulation Process

- Tariff Commission
  - Annual meetings
  - Comprises of different government agencies
  - Solicits inputs from different government agencies
  - Formulates the tariff classifications for the next year

## No Implementing Regulations for New Encryption Tariff Classifications

- No new implementing regulations were issued
- Customs tariff book does not include a new “supervision conditions” to reflect SEMB import / export license requirements
- Caused significant confusion as to the reasons for the new encryption tariff classifications



## Are SEMB Licenses Required?

- Quite a few non-encryption reasons have been suggested for the new encryption tariff classifications
  - Statistics gathering
  - CCC labeling requirements

## Are SEMB Licenses Required? (cont'd)

- Legally implementing regulations are not required
  - Existing commercial encryption regulations provide the legal basis for requiring SEMB licenses for import and export of commercial encryption products
  - “Supervising conditions” in the tariff book is a guide to the applicable import / export licenses but they are not intended to be exhaustive
  - (especially since some types of controls are not dependent on tariff classification – e.g., encryption, used electrical and electronic equipment etc.)



## Are SEMB Licenses Required? (cont'd)

- Perspectives from Customs



## Future Developments

- New encryption tariff classifications?
- Further clarifications on the licensing requirements?
- Software to be included?
- Catch all requirement – impose obligation on importers / exporters to declare whether goods contain encryption?
- Timeframe and what to expect?



# Significance and Implications for Business Operations in China



## Implications

- Importers / exporters of goods affected by new encryption tariff classifications
  - SEMB import / export licenses required
  - Formal declarations to PRC authorities identified parties that are dealing with commercial encryption products in China
  - May be forced to comply with other SEMB controls on the imported commercial encryption products (e.g., use, sale, manufacture etc.)



## Penalties – Commercial Encryption Regulations

- If encryption products are imported or exported without approval, the concerned encryption products as well as any illegal gains will be confiscated
- In serious cases, a fine of one to three times of the illegal gains can be imposed



## Penalties – Customs Regulations

- Failure to use the correct tariff numbers in the Customs declaration forms
  - Misclassification of goods
  - Treated as smuggling offence if the intention of misclassifying the goods was to avoid a licensing requirement
  - Could be treated as administrative smuggling offence or, in serious cases, as criminal smuggling offences



## Penalties – Customs Regulations (cont'd)

- Range of penalties
  - Fines
  - Confiscation of profits and goods
  - Imprisonment (for persons legally/directly responsible)
  - Downgrade enterprise Customs classification (impact on customs clearance and ability to engage in contract manufacturing)



## Implications

- Importers / exporters of commercial encryption products that are not caught by new encryption tariff classifications
  - Check the entire supply chain especially if manufacturing occurs in China
  - Note: new encryption tariff classifications to be issued



## Action Items

1. Ascertain whether any of the new tariff numbers apply to your products
  - Is there a classification defense to using a encryption tariff classification?
  - From a classification perspective, does the “essential characteristics” test in the GRIs introduce a form of “core function” requirement?
  - Tariff engineering strategies available to avoid using encryption tariff classifications?



## Action Items (cont'd)

### 2. Lobbying relevant government agencies

- Which government agencies should be approached?
- U.S. or China government agencies? Or both?
- Industry effort versus individual company effort?



## Action Items (cont'd)

3. Potential WTO based challenges to the new encryption tariff classifications
  - National treatment
  - Trade-related investment measure (“TRIM”) (imposition of a de facto requirement to use local encryption)
  - Direct application of international law in China?

Q&A

Thank you!

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# Biographies

BAKER & MCKENZIE

## Decrypting China's Encryption Regulations

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## Eugene Lim

Special Counsel, Baker & McKenzie, Hong Kong  
Co-head of the Asia Pacific Regional Customs Steering Committee  
Head of Hong Kong / China International Trade Planning and Controversies Practice

### Practice Areas

PRC Tax and Customs; WTO and International Trade.

### Practice Description

Mr. Lim's practice focuses on customs, VAT, corporate tax, export controls, international trade and corporate advisory work relating to distribution and supply chain strategies in the People's Republic of China (PRC). Mr. Lim also covers trade law developments in the WTO, APEC, ASEAN and under the various free trade agreements in the Asia Pacific region. Mr. Lim is a member of Baker & McKenzie's Global International Trade, Compliance and Customs Practice Group Steering Committee.

### Representative Clients, Cases or Matters

- Advised various multinationals on their regional supply chain strategies.
- Advised numerous multinationals on regulatory, tax and customs issues relating to structuring and implementing their contract manufacturing, procurement, distribution and after-sales strategies in China including restructuring existing operations to minimize the impact of China enterprise income tax reform and reduction in export VAT refund rates.
- Advised various multinationals on PRC Customs issues and managing disputes with PRC Customs.
- Advised various multinationals on export control issues in the Asia Pacific region.
- Advised numerous multinationals regarding the use of various preferential tariff schemes and free trade agreements to minimize their exposure to customs duty and on issues relating to the implementation of China's WTO obligations.

### Professional Affiliations

Mr. Lim is a member of the Singapore Academy of Law and the Law Society of Singapore.

### Awards & Recognition

- Leading Lawyer (International Trade: Asia-wide) – Chambers Asia 2009

### Education & Bar Admission

Mr. Lim graduated from the National University of Singapore (LLB Honors) in 1998 and from McGill University (LLM International and Comparative Law) in 2000. He was admitted to the Supreme Court of Singapore as an Advocate and Solicitor in 1998.

### Languages

English and Mandarin.



## Allan K.A. Marson

Partner

### Practice Areas

International Trade and Investment, Tax, Licensing, Protection of Intellectual Property, Distribution, Employment

### Practice Focus

Trade with the People's Republic of China (PRC); Investment in the PRC

### Practice Description

Mr. Marson is a member of Baker & McKenzie's China Practice Group and heads the China Desk at Baker & McKenzie's Palo Alto office. He served as a foreign legal adviser in Taipei, Taiwan from 1986 to 1991, resident lawyer in Baker & McKenzie's Beijing office from 1994 to 1999 and member of the Asia Desk of Baker & McKenzie's New York office in 2000.

Mr. Marson's practice focuses on licensing, protection of intellectual property, cross-border transactions, structuring investments, distribution and employment in the PRC, and related tax issues. Mr. Marson is a regular presenter at conferences on investment, tax, licensing and employment matters in the PRC.

### Representative Clients, Cases or Matters

- Assisted to structure and establish production and trading subsidiaries in the PRC
- Negotiated establishment of joint ventures and acquisition of interests in foreign-invested enterprises and private local companies in the PRC
- Advised on outsourcing operations to the PRC, including tax, employment and regulatory issues
- Advised on preferential tax policies for high technology projects in the PRC
- Drafted development (R&D) and licensing contracts for software subsidiary in the PRC and applied for related tax incentives
- Assisted with PRC tax and foreign exchange advice on payment of royalties, salaries and retained earnings
- Localized distribution contracts for software and hardware sales in the PRC
- Advised on programs to protect highly-sensitive trade secrets in the PRC
- Drafted employment contracts and advised on employment disputes in the PRC
- Assisted to resolve disputes between contract and joint venture partners

**Publications, Presentations & Articles**

- China's Tangled Web, Daily Journal
- Red Tape, Daily Journal
- Company Law Update Will Help Foreign Investment, Daily Journal
- Crucial Strategies to Protect Intellectual Property in China, Daily Journal
- New Ways Out for Venture Capital Investors in China, China Business Review
- Distribution, Retailing and Advertising After China's Accession to the WTO, Practicing Law Institute

**Education & Bar Admittance**

Mr. Marson graduated from Lewis and Clark Law School with a J.D. (1982) and Columbia University Law School with an LL.M (1992). He is admitted as an attorney in New York, Connecticut and Washington State.

**Languages**

English and Mandarin Chinese



## John F. McKenzie

Partner

### Practice Area

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### Practice Description

Mr. McKenzie's practice is focused on cross-border transactions and international trade regulation, including:

- Planning and structuring international investments
- International mergers, acquisitions, consolidation and reorganization transactions
- International commercial and technology development and transfer transactions
- Customs and import regulations, export controls and international corporate compliance

Mr. McKenzie joined Baker & McKenzie in 1976. Since that time, he has worked in Baker & McKenzie offices in Caracas, Venezuela and Taipei, Taiwan, in addition to San Francisco.

### Publications, Presentations & Articles

Mr. McKenzie has written and spoken extensively on United States export controls, import trade regulation, anti-boycott regulation, international antitrust matters, the Foreign Corrupt Practices Act and the international distribution and protection of computer software. His articles on those topics have appeared in the proceedings of the University of Southern California Tax Institute, the Vanderbilt Journal of Transnational Law, the Boycott Law Bulletin, the proceedings of the Arizona State University Computer Law Institute, the proceedings of the University of Southern California Computer Law Institute, the Computer Lawyer and the International Lawyer.

### Professional Affiliations

Mr. McKenzie is a member of the International Section of the American Bar Association, the Legislative Council of the California Council for International Trade, the District Export Council for Northern California, and an Associate member of the Northern California Chapter of the Association of Freight Forwarders and Customs Brokers.

### Education & Bar Admittance

Mr. McKenzie received his B.A. degree (Phi Beta Kappa; magna cum laude) from Williams College in 1969, and his J.D. degree (cum laude) from Harvard Law School in 1976. He was articles editor at the Harvard Law Review from 1975-1976. Between college and law school Mr. McKenzie served in the Peace Corps in the northwestern mountains of Guatemala. Mr. McKenzie is admitted to practice in California (1976), the Northern District of California (1976), the 10th Circuit Court of Appeals (1984), and the Court of International Trade.

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February 2009

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### New Chinese Tariff Classifications for Encryption Products

The 2009 Chinese tariff classifications, which came into effect on 1 January 2009, include certain tariff lines for encryption products. Importers and exporters of products with these tariff classifications will be required by Customs to obtain import and export permits from the State Encryption Management Bureau ("SEMB") or its local counterparts.

The implications of these developments are as follows.

#### 1. Covered Products

The 2009 Chinese tariff classification introduces tariff lines for certain encryption products. Some of the new tariff lines and their descriptions are as follows:

PRC Tariff Numbers	Product Description*
8443311010	Electrostatic-sensitive multifunctional integrated encrypting fax machines (with automatic data processing equipment or network connection).
8443319020	Other multifunctional integrated encrypting fax machines (machines with the function of printing, copying or both).
8443329010	Fax machines (can be connected to automatic data processing facilities of internet).
8517110010	Cordless encrypting telephones.
8517129010	Other encrypting telephones for cellular networks or other wireless networks.
8517180010	Other encrypting telephones.
8517622910	Optical communication encrypting routers.
8517623210	Non-optical communication encrypted exchanges.
8517623610	Non-optical communication encrypting routers.
8523529010	Encrypting "intelligent cards".
8542310010	Encryption electronic integrated circuits for processor and controller, with or without storage, converter, logic circuit, amplifier, clock and sequential circuits or other circuits.

\* Based on the English descriptions in the 2009 PRC Tariff Book published by the Economic Daily Press.

The above list is not exhaustive. In addition, we expect that the Chinese authorities are likely to issue a comprehensive list of encryption products with PRC tariff numbers assigned in the near future.

## **2. Licensing Requirements**

As a general rule, in order to import or export encryption technology and encryption products (collectively, “**Encryption Products**”) used to protect by encryption, or to carry out security certification for information that does not involve State secrets, importers and exporters have to apply for import and export permits from the SEMB or their local counterparts.

The licensing requirements are provided for in the *Regulations for the Administration of Commercial Encryption* issued by the State Council on 7 October 1997 (the “**Commercial Encryption Regulations**”). In 2007, the SEMB issued further notices to clarify the procedural and documentary requirements to apply for a “Permit for the Import of Encryption Products”. Please note that the SEMB licensing requirements apply when goods enter or leave China’s geographical (as opposed to Customs) territory. Hence, the SEMB licenses are required even if the Encryption Products enter or exit bonded zones and export processing zones.

Prior to the additions of the new tariff items in the 2009 tariff classification, there was no legal requirement to identify whether products contained encryption on Customs declaration forms. As such, it was difficult for Customs to enforce the SEMB encryption license requirements on Encryption Products entering and exiting China’s territory.

In light of the new tariff numbers, importers and exporters of the Encryption Products which are covered by these new tariff numbers are now required to use these tariff numbers in their Customs declaration forms. In doing so, they will be required by Customs to provide the necessary SEMB licenses.

## **3. Other Implications**

Please note that once the Encryption Products are declared to SEMB in the import and export license applications, they would also need to comply with SEMB controls on, *inter alia*, the use, sale, manufacture, and research and development of Encryption Products in China. These controls would in turn subject these Encryption Products to restrictions on their use or additional licensing requirements in China. Please see a brief overview of China’s commercial encryption rules attached to this alert for further information.

## **4. Potential Customs Penalties**

Failure to use the correct tariff numbers in the Customs declaration forms would result in a misclassification of the goods. This would in turn result in a violation of PRC Customs laws and regulations.

If Customs deems the intention behind misclassifying the goods to be for the avoidance of SEMB licensing requirements, Customs could treat the violation as an administrative offence or, in serious cases, as a criminal smuggling offence. These offences attract penalties such as fines, confiscation of profits and goods, and in the case of criminal smuggling offences, imprisonment terms for persons legally or directly responsible for the violations. This could also result in a downgrade of the importer’s or exporter’s enterprise Customs grade which would have an impact on its Customs clearance and contract manufacturing operations.

Please note that these penalties are in addition to those set out in the *Commercial Encryption Regulations* and its implementing rules.

## 5. Action Items

Importers and exporters of Encryption Products need to ascertain whether any of the new tariff numbers apply to their products. If so, they would need to submit SEMB licenses to Customs when importing and exporting these Encryption Products. The use of the products in China would also be subject to restrictions set out in the *Commercial Encryption Regulations* and their implementing rules.

More broadly, companies which deal with Encryption Products need to consider the broader implications of these developments. Specifically, the recent developments appear to indicate that the Chinese authorities (such as Customs) will take a more active role in enforcing and policing China's controls on Encryption Products. Companies which currently deal with Encryption Products without complying with the existing rules would need to consider adopting the necessary steps to bring themselves into compliance or risk being the subject to enforcement actions and penalties.

## Brief Overview of China's Commercial Encryption Rules

### 1. Introduction

On 7 October 1999, the State Council issued the *Commercial Encryption Regulations*. China is not a member of the Wassenaar Arrangement and does not control Encryption Products based on their encryption strength. The *Commercial Encryption Regulations* were promulgated by the Chinese authorities with, *inter alia*, national security concerns in mind.

### 2. 2000 Notice Disavowed

In the *Issues Relevant to the Management of Commercial Encryption*, issued by the State Encryption Management Commission (the "SEMC", now reorganized as SEMB) in March 2000 (the "2000 Notice"), the SEMB clarified that the *Commercial Encryption Regulations* would, *inter alia*, only seek to regulate specialized hardware and software that contain encryption and decryption operations as their core function.

While the *2000 Notice* has not been officially repealed by published regulations, we understand that it has been disavowed by the SEMB. Hence, adopting a strict interpretation and ignoring the core function test as set out in the *2000 Notice*, the *Commercial Encryption Regulations* would apply to all Encryption Products regardless of encryption strength or function.

### 3 Scope of Controls

The *Commercial Encryption Regulations* provide that the import and export of Encryption Products are subject to the approval from the SEMB, and Encryption Products developed overseas are not allowed to be sold in China.

Additionally, no unit or individual (in China) may use Encryption Products other than those licensed by the SEMB, or Encryption Products developed by

themselves or produced outside China. Foreign enterprises or individuals who use Encryption Products within the territory of China must also seek approval from the SEMB.

SEMB has in recent years issued a series of regulations to implement the *Commercial Encryption Regulations* and to flesh out the controls on import, scientific research, manufacture, sale and use of commercial encryption and Encryption Products in China.

#### **4. Enforcement**

The SEMB itself does not have any enforcement powers. In order to enforce the *Commercial Encryption Regulations*, it would need to rely on other Chinese government agencies with enforcement powers (e.g., Customs, Administration for Industry and Commerce, etc.) to enforce these rules.

We note that in the past, there does not appear to have been any reported cases where these rules have been enforced. However, in light of the new tariff classifications discussed above, there now appears to be an attempt by the Chinese authorities to strengthen the enforcement of the controls on importing and exporting Encryption Products.

#### **5. Penalties**

The *Commercial Encryption Regulations* stipulate penalties for the violation of China's commercial encryption controls. Depending on the nature of the violations, penalties range from warnings, requests for rectification, confiscation of the concerned Encryption Products, confiscation of illegal gains, and fines.

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