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CONTENTS

ARTICLES

EMPOWERING INSTITUTIONAL INVESTORS IN CONCENTRATED OWNERSHIP CONTEXTS: THE CASE OF ITALY

Gaia Balp & Giovanni Strampelli 1

ALL THE GUCCI IN CHINA: PARALLEL IMPORTATION RULES FOR BRINGING TRADEMARKED GOODS TO CHINA

Yumei Xia 63

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EMPOWERING INSTITUTIONAL INVESTORS IN CONCENTRATED OWNERSHIP CONTEXTS: THE CASE OF ITALY

Gaia Balp & Giovanni Strampelli***

I. INTRODUCTION 3

II. SETTING INSTITUTIONAL INVESTOR-ORIENTED CORPORATE GOVERNANCE: THE ITALIAN BASIC REGULATORY FRAMEWORK 14

III. STIMULATING INSTITUTIONAL INVESTOR VOTING AND ENGAGEMENT IN ITALY 20
A. ASSET MANAGERS' QUASI-DUTY TO VOTE AND INSTITUTIONS' ENGAGEMENT POLICY *21*
B. PARTICIPATION IN THE SHAREHOLDER MEETING: INFORMATION AND DUTY TO CALL 24
C. REGULATORY INCENTIVES TO PARTICIPATE IN THE SHAREHOLDER MEETING 26
1. The Limited Relevance of Loyalty-Based Dividend and Vote Rewards for Supporting Institutional Shareholder Engagement 27
2. Proxy Voting and Remote Voting 30
3. Say-on-Pay Votes on the Remuneration Policy and Director Compensation Transparency 34
4. Related Party Transactions and Shareholder Oversight 36

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Although this Article is the result of the authors' joint work, Parts II and IV are attributable to Gaia Balp, while Parts Ill and V are attributable to Giovanni Strampelli; the introduction and the conclusions are attributable to both authors.

5. The Pivotal Impact of the Record Date System on Boosting Institutional Investors' Voting 40

D. SHAREHOLDER ENGAGEMENT 41

1. Director (and Statutory Auditor) Elections Through Slate Voting 43
2. Shareholder Identification as a Tool for favoring Collective Shareholder Initiatives 49

IV. THE PRACTICE OF SHAREHOLDER VOTING AND ENGAGEMENT IN ITALY 51

A. SAY-ON-PAY VOTES 51

B. SLATE VOTING 55

V. HEDGE FUND-DRIVEN ACTIVISM AND ENGAGEMENT 57

VI. CONCLUSION 60

I. INTRODUCTION

The ever-increasing diffusion of institutional ownership is reshaping corporate governance at publicly traded companies worldwide.[1] In line with this global trend, a key structural development in recent years has been the growth of institutional investors throughout the European Union, where corporate ownership and voting are becoming increasingly institutionalized and the relevance of other owner categories is decreasing.[2] Indeed, individual investors directly hold no more than 10-11% of the market capitalization, while they held 28% in 1975, and the proportion of retail investors among all shareholders is less than half the level it was in the 1970s.[3]

In spite of the fact that the number of listed companies with a controlling shareholder is still fairly high in the EU as well as in other areas,[4] institutional investors have become the dominant

---

[1] *See* A. DE LA CRUZ ET AL, OWNERS OF THE WORLD'S LISTED COMPANIES 5 (2019), http://www.oecd.org/corporate/Owners-of-the-Worlds-Listed-Companies.pdf.

[2] *Id.* at 11 (noticing that "in European listed companies strategic individuals and families own 8% of the total market capitalisation; the public sector owns 9%; private corporations own 13%; institutional investors own 38% and the remaining ownership share corresponds to other free-float including retail investors."). *See also* OBSERVATOIRE DE L'ÉPARGNE EUROPÉENNE [OEE] & INSEAD OEE DATA SERVICE [IODS], UNDER THE TENDER: WHO OWNS THE EUROPEAN ECONOMY? EVOLUTION OF THE OWNERSHIP OF EU-LISTED COMPANIES BETWEEN 1970 AND 2012, 55 (2013), https://publications.europa.eu/en/publication-detail/-/publication/db5b2604-e1d7-11e5-8a50-01aa75ed71a1/language-en.

[3] *See* Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, *Action Plan on Building a Capital Markets Union*, at 18, COM (2015) 468 final (Sept. 30, 2015).

[4] *See* Julian Franks, *Institutional Ownership and Governance*, EUR. CORP. GOVERNANCE INST., Feb. 12, 2020, at 5-8, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3530849 (click "Open PDF in Browser").

owners of public equity,[5] as they "hold 41% of global market capitalisation and in advanced economies they have also become significant owners in individual companies."[6]

The rise in institutional ownership in the EU has come with a significant impact on European issuers' corporate governance. Crucially, institutional investors have grown into prominent players in corporate voting. Indeed, voting turnout at European general meetings increased over the last decade,[7] chiefly as a consequence of institutional investors' more active engagement with investee companies, including voting.[8] On EU-average, the level of voter turnout increased by some 10% between 2008 and 2018, from 60.4% to 70.2%, "including an increase of more than one percentage point from 2017 to 2018."[9] In many EU Member States, such an outcome was driven to a significant degree by the

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[5] Christoph Van der Elst, *The Corporate Response to Shareholder Activism*, 15 ERA F. 229, 231 (2014) (noting that over the last several years "large companies in several continental European countries have experienced a significant drop in ownership concentration levels," and "the ownership structure of the largest companies became more dispersed.").

[6] DE LA CRUZ ET AL., *supra* note **Error! Bookmark not defined.**.

[7] *See* European Securities and Markets Authority, *Undue Short-Term Pressure on Corporations*, at 56 (ESMA30-22-762) (Dec. 18, 2019) (stating that "evidence collected at national level shows that both the attendance and exercise of voting rights in the shareholders' meeting have picked up in certain cases […]. However, this tendency is not consistent across countries, mainly due to entrenched and markedly differing sets of rules and approaches to holding general meetings which frequently provide barriers to foreign shareholder participation in meetings.").

[8] *See* Serdar Celik & Mats Isaksson, *Institutional Investors and Ownership Engagement*, 2013/2 OECD J. FIN. MKT. TRENDS 93, 94 (2013), https://read.oecd-ilibrary.org/finance-and-investment/institutional-investors-and-ownership-engagement_fmt-2013-5jz734pwtrkc#page1.

[9] ARNAUD CAVÉ ET AL., INSTITUTIONAL SHAREHOLDER SERVICES, INC., EUROPEAN VOTING RESULTS REPORT 2 (2018), https://www.issgovernance.com/file/publications/2018_European_Voting_Results_Report.pdf.

mandatory implementation, following the 2007 SRD I,[10] of the record date regime throughout the Union,[11] by enhanced regulatory and market pressure on institutional investors and asset managers to take on stewardship responsibilities as a part of intermediaries' investment management activities,[12] and by the rise of the proxy advisory industry.

Proxy advisory services—particularly proxy analysis and voting recommendations—are a cost-effective solution to help institutions comply with stewardship and voting requirements. Proxy analysis fills information gaps and, for a fee, provides relief from the costly and time-intensive work required to gather and process the relevant information; voting recommendations ultimately provide a cognitive shortcut helping client investors to make informed voting decisions and be compliant with regulatory requirements that enhance institutions' stewardship and engagement role with investee companies. More so, the notion that proxy advisors wield influence on voting outcomes is widespread in

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[10] Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies, 2007 O.J. (L 184) 17 [hereinafter SRD I].

[11] *See, e.g.,* Christoph Van der Elst, *Shareholders as Stewarts: Evidence of Belgian General Meetings* 5 (Fin. Law Inst. Working Paper Series, WP 2013-05, 2013), https://ssrn.com/abstract=2270938 (assuming that the increase in attendance rates at Belgian listed companies' 2012 annual meetings "is due to the abolishment of the 'blocking of shares'"). Prior to the SRD I, share blocking during a certain period prior to the general meeting, and up to the end of the meeting, was a requirement for participation and voting in many Member States. Share blocking was found to inhibit institutional shareholder voting since it overly restricted the ability to trade shares and was therefore prohibited and replaced by a system based on a "record date" (Article 7 of SRD I) under which only shareholders of record as of a specified cut-off date in advance of the general meeting are entitled to vote, irrespective of whether such shareholders will actually still hold their shares on the day of the meeting.

[12] *See* ARNAUD CAVE ET AL., *supra* note **Error! Bookmark not defined.**, at 2.

Europe.[13] For example, as far as Italy is concerned, it is especially worth noting that the Italian Supervisory Market Authority (Consob) found that the effect of proxy advisors on investors' voting regarding say-on-pay is "at least as strong as (and probably stronger than) that observed in the US," consistent with the weight of foreign institutions in the shareholder base of Italian listed companies and with the features of listed companies in terms of small or medium cap firms on a comparative basis.[14]

European corporate ownership is also growing ever more international, with non-EU shareholders—most of which are institutional intermediaries—holding about 44% of the shares issued by companies listed in the EU.[15] Given that a substantial proportion of the shares under foreign ownership is held by large U.S.-based investors,[16] this factor has, not unpredictably, fueled voting at

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[13] *See* Eur. Comm'n, *Green Paper on The EU Corporate Governance Framework*, COM (2011) 164 final (Apr. 5, 2011); Eur. Comm'n, Proposal for a Directive of the European Parliament and the Council amending Directive2007/36/EC as regards the encouragement of long-term shareholder engagement and Directive 2013/34/EU as regards certain elements of the corporate governance statement, 2, COM (2014) 0213 final, (2014) 0121 (COD), (Apr. 9, 2014) [hereinafter Eur. Comm'n, Explanatory Memorandum]; EUR. SEC'S MKT. AUTH., AN OVERVIEW OF THE PROXY ADVISORY INDUSTRY. CONSIDERATIONS ON POSSIBLE POLICY OPTIONS 17 (ESMA/2012/212, No. 66) (Mar. 22, 2012); EUR. SEC'S MKT. AUTH., FINAL REPORT. FEEDBACK STATEMENT ON THE CONSULTATION REGARDING THE ROLE OF THE PROXY ADVISORY INDUSTRY 12 (ESMA 2013/84) (Feb. 19 2013).

[14] Massimo Belcredi et al., *Proxy Advisor and Shareholders Engagement. Evidence from Italian Say-on-Pay* 26-28 (CONSOB, Working Paper no. 81, 2015), ssrn.com/abstractid=2616258.

[15] Eur. Comm'n, Explanatory Memorandum, *supra* note **Error! Bookmark not defined.**, at 3. *See also* DE LA CRUZ ET AL., *supra* note **Error! Bookmark not defined.**, at 14.

[16] *See* DE LA CRUZ ET AL., *supra* note **Error! Bookmark not defined.**, at 15, fig 6. Regarding Italy *see* NADIA LINCIANO ET AL., 2016 REPORT ON CORPORATE GOVERNANCE OF ITALIAN LISTED COMPANIES, 13-14 (CONSOB Statistics and Analyses) (2016),

European corporations. In effect, also due to a number of regulatory measures adopted over time, U.S.-based institutions have a longer-standing tradition of being more active voters.

Within the institutionalized scenario for corporate ownership and voting in the EU, the Italian landscape is no exception, in spite of concentrated corporate ownership of publicly listed corporations and the fact that Italy's stock market development still lags behind other European countries.[17] According to the OECD, "[t]he proportion of households' financial assets managed by institutional investors has been growing in recent years."[18] If, in 2017, "only one-third of Italian households' financial assets were managed by institutional investors compared to 40% in the Euro area and two-thirds in the United Kingdom," this is largely because the share of household financial assets held by pension funds is low compared

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https://ssrn.com/abstract=2947709 (reporting that, at the end of 2015, institutional investors were major shareholders in nearly 36% of the market, holding on average 6.9% of the share capital in 83 firms; foreign institutional investors owned major holdings especially in larger firms and in the financial sector). Referred to the UK, *see* OFF. FOR NAT'L STAT., OWNERSHIP OF UK QUOTED SHARES: 2016, para. 3, 5, 11, https://www.ons.gov.uk/economy/investmentspensionsandtrusts/bulletins/ownershipofukquotedshares/2016.

[17] At the end of 2018, total market capitalisation decreased by 15 percent compared to 2017, reaching around 542 billion euros; companies listed on the MTA increased slightly, from 237 to 240, as also did those traded on the AIM Italia-MAC market, from 95 to 113. *See* COMMISSIONE NAZIONALE PER LE SOCIETÀ E LA BORSA (CONSOB), REPORT ON CORPORATE GOVERNANCE OF ITALIAN LISTED COMPANIES 2019 5-6 (2020), http://www.consob.it/web/consob-and-its-activities/report-on-corporate-governance [hereinafter CONSOB REPORT 2019]. *See also* ORG. FOR ECON. CO-OPERATION & DEV., OECD CAPITAL MARKET REVIEW OF ITALY 2020: CREATING GROWTH OPPORTUNITIES FOR ITALIAN COMPANIES AND SAVERS 17, 23 (2020), http://www.oecd.org/corporate/ca/OECD-Capital-Market-Review-Italy.pdf [hereinafter OECD] (noticing that "During the last ten years, on average less than four companies per year became listed on the regulated market of the Italian stock exchange and the Italian market capitalisation as per cent of GDP remains well below that of its European peers.").

[18] OECD, *supra* note **Error! Bookmark not defined.**, at 42.

to other European peers.[19] In fact, private pension plans are merely voluntary in Italy, and the public pension system is predominant.

As regards ownership structure, Consob found that, by the end of 2018, 203 out of 231 companies listed on the Italian Stock Exchange (accounting for 88% of the total number of publicly listed corporations) were controlled companies, and about 77% of which were controlled by a single stockholder holding either more than half of the share capital (123 companies) or a lower stake (57 firms).[20] Consob also reported that the ultimate controlling agent is the family in 152 listed firms, accounting for the 33% of the market capitalization; the State (and other local authorities) in 23 large companies (37.8% of the market capitalization); a financial entity in 11 cases (mainly small firms).[21]

Non-controlled, widely held companies are thus clearly still limited in number, although they grew from 11 in 2010 to 13 in 2018 (5.6% of the total number of listed firms, representing 20.5% of market capitalization). Concentrated ownership is also an explanation for the low free-float ratios in the Italian regulated market.[22] Ultimately, however, "the differences between the concentration level of the Italian listed corporate sector and those of France, Germany, and Spain are insignificant."[23] Moreover, the use of control-enhancing mechanisms in Italian listed companies

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[19] *Id.* (emphasizing that "[t]he assets held by Italian pension funds account for a modest 9.4% of GDP, which is far below the OECD average of 50.7%.").

[20] *See* CONSOB REPORT 2019, *supra* note **Error! Bookmark not defined.**, at 13.

[21] *Id.* at 16.

[22] *See* OECD, *supra* note **Error! Bookmark not defined.**, at 34 (illustrating that "[a]t 60%, the Italian stock market has the lowest free-float ratio among comparable European countries and well below the European average of 75%. Moreover, only 29% of the companies listed in the Italian regulated market have more than 50% of their shares readily available in the market (free float), compared to 41% in France and 45% in Germany.").

[23] *Id.*, at 94.

significantly decreased over the last twenty years.[24] Indeed, in 2016, 18.2% of MTA-listed issuers belonged to pyramidal or mixed business groups compared to 44% in 1998.[25] In addition, while nonvoting shares gradually decreased over time,[26] three firms have provided for a category of multiple voting shares and forty-seven issuers have introduced loyalty shares in their bylaws.[27]

In line with the trend observed in other countries, despite the predominance of controlled companies, institutional investors are relevant shareholders in a not-negligible number of Italian listed companies.[28] As the OECD confirmed, "in Italy, institutional investors hold, on average, lower stakes in listed companies compared to the global average (41%), but at similar levels with many European peers."[29] In fact, institutional investors hold relevant stakes in sixty companies listed in Italy, accounting for 26.9% of the market.[30] Noticeably, Italian institutional investors are relevant shareholders[31] in twelve companies only, whereas foreign

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[24] *See* CONSOB REPORT 2019, *supra* note **Error! Bookmark not defined.**, at 22.

[25] *See* CONSOB REPORT 2019, *supra* note **Error! Bookmark not defined.**, at 20.

[26] *Id.*, at 14, 21 (reporting non-voting shares were issued by 14 listed companies by the end of 2018, compared to 70 by the end of 1998, and 120 by the end of 1992).

[27] *Id.* (showing that "[l]oyalty shares have vested their increased voting power (active loyalty shares) in 28 firms, where the leverage and the wedge are equal respectively to 1.3 and to 12%").

[28] *See supra* note **Error! Bookmark not defined.**.

[29] OECD, *supra* note **Error! Bookmark not defined.**, at 92 (with institutional investor ownership weighted by total market capitalization as of end 2018 averaging 26.9% in Italy, compared to 27.5% in France, 28.3% in Germany, 26.5% in Spain, 38.3% in Sweden, 23.1% in Norway, and 32.1% in Finland—but 61.0% in the United Kingdom).

[30] *Id.*

[31] For the purposes of Consob's statistics, major institutional investors are defined as investment funds, banks and insurance companies subject to reporting obligations according to Consob rules and whose shareholdings are lower than 10%.

institutional investors hold relevant stakes in fifty-one companies.[32] In effect, domestic and foreign ownership of publicly listed equities evolved along opposite lines over the last decade, with Italian institutions' holdings steadily decreasing since 2011, and nonresident institutions' holdings increasing and stabilizing since 2015 onwards.[33] National and foreign institutional share ownership differ also in regard of the size of investee companies and the industry they belong to. Italian institutions tend to more frequently concentrate major stakes on small-sized and industrial companies, while foreign institutions' investments rather target large firms and the financial industry, with 35% of FTSE MIB firms,[34] and 25% of financial industry firms, featuring major foreign holdings.[35] Such

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[32] CONSOB REPORT 2019, *supra* note **Error! Bookmark not defined.**, at 19-20.

[33] *See* OECD, *supra* note **Error! Bookmark not defined.**, at 17 (illustrating that "[t]he limited size of the Italian market is also reflected in the fact that only 7% of the Italian institutional investors' portfolios were invested in corporate shares and bonds issued by Italian firms at the end of 2017. Instead, Italian investors had directly or indirectly through foreign investment funds, allocated around EUR 190 billion to equity investments in foreign firms. In terms of value, this sum represents almost two-thirds of the total free-float market capitalisation of all Italian listed companies.").

[34] *See FTSE MIB*, BORSA ITALIANA, https://www.borsaitaliana.it/borsa/indici/indici-in-continua/dettaglio.html?indexCode=FTSEMIB&lang=en (last visited Mar. 17, 2020) ("The FTSE MIB is the primary benchmark index for the Italian equity markets capturing approximately 80% of the domestic market capitalization . . . The FTSE MIB Index measures the performance of 40 Italian equities and seeks to replicate the broad sector weights of the Italian stock market.").

[35] CONSOB REPORT 2019, *supra* note **Error! Bookmark not defined.**, at 19-20. According to further Consob Staff analysis, institutional ownership in the 100 largest non-financial companies publicly listed in Italy by active national and foreign asset managers (mutual, sovereign, and hedge funds) averaged 13.5% over the period 2010-2015 (compared to 15% in Spain, through to nearly 25% in France and Germany, and up to nearly 50% in the UK)*; see* Francesco Fancello et al., *Non-bank*

divergent evolutionary patterns for domestic and foreign institutional ownership might possibly be explained by the fact that corporate ownership of publicly listed companies in the financial industry, especially the banking industry, is radically different from that of industrial companies. At the end of 2014, only six listed banks were actually controlled companies, whereas the remaining twelve, accounting for 21% of the total market capitalization, were either widely held companies or cooperative companies, which typically feature one-member-one-vote voting structures.[36] In turn, dispersed bank ownership was largely a consequence of the privatization process the industry underwent over the 1990s, which then triggered large-scale acquisitions and mergers.[37]

In line with the developments at the EU level, the increasing weight of institutional investors within the shareholder base of Italian listed companies has been accompanied by a tendency for investors to be more active owners. In 2018, the annual general meeting season recorded record highs in terms of the share capital represented at the meeting (72.6% on average) and the institutional investors' participation (exceeding 21% of the company's capital).[38] Over the period 2012-2018, institutional investors' attendance rates grew significantly in terms of the investors attending and the percentage of the share capital represented at the meeting.[39] Significantly, foreign institutions have attended the meetings of all of the hundred largest Italian companies since 2015; in 2018, they cast on average around 29% of the votes.[40] More so, in the 2018

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institutional investors' ownership in non-financial companies listed in major European countries 7-29, (CONSOB, Working Paper No. 86 2018), http://www.consob.it/documents/46180/46181/wp86.pdf/e12aebb0-3f2c-45b7-964c-71d0198a8613.

[36] *See* Angela Ciavarella et al., *La corporate governance delle società quotate italiane. Focus sul settore bancario* [Corporate governance trends in Italian listed banks], BANCARIA 82, 82 (It.) (Apr. 2016), https://bancaria.it/assets/PDF/2016-04.pdf.

[37] *Id.* at 84-85.

[38] *See* CONSOB REPORT 2019, *supra* note **Error! Bookmark not defined.**, at 40-41.

[39] *Id.*

[40] *Id.* at 7.

proxy season, institutional investors collectively held a majority of the votes cast at the general meetings at one-third of the thirty-five most capitalized Italian listed companies.[41] Altogether, as noticed by Consob, "[l]arger institutional investors or those with a stronger stewardship vocation are increasingly active in direct communication with companies for a number of issues, including corporate governance. In addition, investors have shown increasing interest in issuers' approach to social and environmental issues."[42]

The Italian experience clearly shows that the structure of corporate ownership does not necessarily affect shareholder engagement with investee companies and that non-activist institutional investors can play a major stewardship role also in concentrated ownership contexts. Indeed, institutional investor engagement with Italian publicly listed corporations is not only focused on a few companies with widely dispersed ownership and no one shareholder holding a stake large enough to secure voting control but also concerns controlled companies, where a stockholder or a coalition of shareholders hold the (absolute or relative) majority of the votes.

Importantly, the Italian case also helps explain how the regulatory framework can contribute to create an environment favorable to non-activist institutional investors' active ownership. The Italian regime for corporate elections at listed companies is particularly illustrative of this aspect. In fact, the right to appoint directors on the board is key to encourage institutional investors' stewardship at controlled companies and has proven to be one of the most effective means of ensuring consideration for minority interests and enhancing oversight over the controlling shareholders or management. More generally, at Italian companies, institutional investors can exercise a wider range of powers granted to the shareholders as compared to the powers available to U.S.

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[41] Antonella Olivieri, *'L'avanzata dei fondi: in Borsa comandano in una blue chip su tre'* [The rise of mutual funds: They control one third of blue chips], IL SOLE24ORE (It.) (Aug. 4, 2019).

[42] *See Annual Report 2018*, CONSOB 5, 25 (2019), http://www.consob.it/documents/46180/46181/ar2018.pdf/cdc8a77f-f096-4e92-af53-94305683aec9.

shareholders. Institutions can exert pressure on the controlling shareholder and the company's management by exploiting further minority shareholder rights provided for under national law, such as say-on-pay votes and the enhanced role to be played by the shareholders in the context of related party transactions.

All the above confirms that there is indeed a link between shareholders' rights and institutions' ability to engage convincingly with investee companies regarding corporate governance. Given that, in recent years, controlled companies have been on the rise at the international level, partly as a consequence of going public with a dual-class structure,[43] the issue this Article deals with is of interest for many countries, including the U.S., where controlled companies "constitute a sizeable minority of large, publicly[-]traded firms."[44]

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[43] *See* Clifford G. Holderness, *The Myth of Diffuse Ownership in the United States*, 22 REV. FIN. STUD. 1377, 1378 (2009); Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 HARV. L. REV. 1641, 1660 (2006); Ronald J. Gilson & Alan Schwartz, *Corporate Control and Credible Commitment*, 43 INT'L REV. L. & ECON. 119, 119-20 (2015); María Gutiérrez & Maribel Sáez Lacave, *Strong Shareholders, Weak Outside Investors*, 18 J. CORP. L. STUD. 277, 281 (2018) (noting that "[a]s controlled firms grow in importance, tunneling, self-dealing, and other types of investor expropriation could become significant concerns in the US.").

[44] Lucian A. Bebchuk & Assaf Hamdani, *Independent Directors and Controlling Shareholders*, 165 U. PA. L. REV. 1271, 1279 (2017)*; see also* Albert H. Choi, *Concentrated Ownership and Long-Term Shareholder Value*, 8 HARV. BUS. L. REV. 53, 54-56 (2018); Ronald J. Gilson & Alan Schwartz, *Corporate Control and Credible Commitment*, 43 INT'L REV. L. & ECON. 119, 119-20 (2015); Jens Dammann, *The Controlling Shareholder's General Duty of Care: A Dogma that Should Be Abandoned*, 2015 U. ILL. L. REV. 479, 483 (2015); Edward Kamonjoh, *Controlled Companies in the Standard & Poor's 1500: A Follow-up Review of Performance & Risk,* IRRC INST. 15 (2016), https://www.issgovernance.com/library/controlled-companies-standard-poors-1500-follow-review-performance-risk/ (reporting that, as of October 2015, 7% of the constituents of the S&P 1500 index were controlled firms:

Against this backdrop, this Article proceeds as follows. Part II briefly draws the Italian basic corporate governance framework. Building on the Italian case, Part III sets the scene by illustrating how minority-empowering shareholder rights can contribute to creating an environment favorable to non-activist institutional investors active ownership. While acknowledging that not all of the many tools introduced by the Italian legislature have proven successful in driving increased institutional investor engagement with Italian investee companies, it shows that some indeed have, as is most notably the case for say-on-pay votes, alongside the record date regime with regards to attendance at the shareholder meeting and the slate voting system with regards to director elections. Part IV follows up on the previous analysis by reporting some evidence regarding the practice of shareholder voting and engagement in Italy. Part V illustrates how the rise in activist, hedge fund-driven intervention can impact non-activist institutions' stewardship role at controlled companies. Part VI sets out some concluding remarks.

II. SETTING INSTITUTIONAL INVESTOR-ORIENTED CORPORATE GOVERNANCE: THE ITALIAN BASIC REGULATORY FRAMEWORK

The basic regulatory framework for shareholder voting and engagement in Italy is set by the Civil Code, applicable to any corporation, and Legislative Decree No. 58 of February 24, 1998 (so-called Consolidated Law on Finance – *Testo unico della finanza*, hereinafter referred to as 'CLF'), which lays down additional rules for publicly listed corporations. Regulations implementing the CLF

"there are two primary control mechanisms in the updated study group: 1) multi-class capital structures with unequal voting rights (78 study companies); and 2) control through ownership of at least 30 percent of a class of single-vote stock by a person or group (27 firms).").

are drawn by Consob, the Italian Financial Markets Supervisory Authority.[45]

Another distinctive feature of the corporate governance framework in Italy and in other European countries is the crucial played by soft law.[46] As far as Italy is concerned, the Corporate Governance Code sponsored by Borsa Italiana, the Italian Stock Exchange, provides for nonbinding best practice principles and recommendations applicable to publicly listed companies based on a comply-or-explain approach that is explicitly endorsed by the law.[47] In effect, under Article 123-bis(2)(a) CLF, publicly listed corporations are required, ahead of the annual general shareholder meeting, to publicly file a corporate governance report detailing,

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[45] *See* Commissione nazionale per le società e la borsa (Consob), Regulation no. 11971 of May 14, 1999 (Regulation implementing Italian Legislative Decree No. 58 of 24 February 1998, concerning the discipline of issuers), http://www.consob.it/web/consob-and-its-activities/laws-and-regulations/documenti/english/laws/reg11971e.htm?hkeywords=&docid=2&page=0&hits=21&nav=false [hereinafter Consob Regulation No. 11971]. Additional rules and regulations relevant to corporate governance may also apply, depending on the industry the company belongs to. Most noticeably, banks and the parent companies of banking groups are subject to a set of rules set by Legislative Decree No. 385 of September 1, 1993 (so-called Consolidated Law on Banking – *Testo unico bancario*), as well as the Bank of Italy in implementing Circular no. 285 of December 17, 2013 (‘*Disposizioni di vigilanza per le banche*’), as subsequently amended. Similarly, insurance companies are subject to specific rules imposed on them by Legislative Decree No. 209 of September 7, 2005 (so-called Private Insurance Code – *Codice delle assicurazioni private*) and implementing regulations set by Ivass, the supervisory authority.

[46] Klaus J. Hopt, *Comparative Company Law 2018* 24-26 (Eur. Corp. Governance Inst. (ECGI), Law Working Paper No. 460/2019, 2019) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3421389.

[47] First released in 1999, the Corporate Governance Code was updated several times; most recently, the Code underwent major reviews following the model of the UK Stewardship Code 2020. The new January 2020 version of the Italian Code will apply starting in 2021. *See* CORP. GOVERNANCE COMM., CORPORATE GOVERNANCE CODE (2020), https://www.borsaitaliana.it/comitato-corporate-governance/codice/2020eng.en.pdf.

amongst other things, compliance with the Corporate Governance Code, or explaining the reasons for not adopting any of the Code's provisions. Based on corporate governance reports, 94% of the companies listed on the MTA (the leading regulated equity market managed by Borsa Italiana for mid and large-size companies[48]) on December 31, 2018 had adopted the then current version of the Corporate Governance Code.[49] Eleven out of the fourteen companies not adopting the Code referred to specific firm characteristics—particularly small size and concentrated ownership—as an explanation for the determination not to adopt the Code.

Traditionally, the Italian corporate structure is based on the shareholder-elected board of directors,[50] which may delegate managing powers to a executive managing director or an executive committee,[51] and the board of statutory auditors (*collegio*

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[48] Borsa Italiana currently manages three equity markets, with companies being listed on Mercato Telematico Azionario (MTA) and Alternative Investment Market (AIM Italia), and financial vehicles being listed on the Market for Investment Vehicles (MIV) and the Partnership Equity Markets. As of end 2018, 242 companies were listed on MTA and 113 on AIM Italia. The MTA market is split into two segments, the Standard listing segment and the Star segment, which requires additional corporate governance standards to be adopted and is open to companies that have less than EUR 1 billion market capitalisation. *See* OECD, OECD CAPITAL MARKET REVIEW OF ITALY 2020: CREATING GROWTH OPPORTUNITIES FOR ITALIAN COMPANIES AND SAVERS, 33 (2020), https://www.oecd.org/corporate/ca/OECD-Capital-Market-Review-Italy.pdf.

[49] *See* ASSONIME & EMITTENTI TITOLI, REPORT ON CORPORATE GOVERNANCE IN ITALY: THE IMPLEMENTATION OF THE ITALIAN CORPORATE GOVERNANCE CODE, 4 (2019), http://www.assonime.it/_layouts/15/Assonime.CustomAction/GetPdfToUrl.aspx?PathPdf=http://www.assonime.it/attivita-editoriale/studi/Documents/nsexecutivesummary.pdf.

[50] *See* Codice civile [C.c.] [Civil Code] art. 2364 (It.) (laying down the decision-making authority of the shareholders meeting, amongst which the appointments to the board of directors and the board of statutory auditors).

[51] *See* C.c. [Civil Code] art. 2381 (It.).

sindacale). The board of directors thus includes executive and nonexecutive members elected for a term of up to three years.[52] The board of statutory auditors, whose members are elected by the shareholders as well, is in charge of overseeing compliance with the law and the adequacy of the company's organizational and accounting systems.[53] If it is considered that nonexecutive members of the board of directors chiefly play a supervisory role, given that most of the management functions are delegated to executives, Italian listed companies feature a corporate structure which, as a matter of fact, owes most of its substantive inspiration to the Anglo-American one-tier board system, rather than the German two-tier system. The board of statutory auditors cannot be regarded as a functional equivalent to the German *Aufsichtsrat*, since, unlike the latter, it lacks any power to interfere with the board of directors' decision making, either strategic or managerial, and are left alone the power to appoint the members of the board of directors.

Following a wide-reaching company law reform enacted in 2003, a corporation may choose to adopt a one-tier or a two-tier management and control system as an alternative to the traditional structure, which applies as a default rule unless it is opted out in the articles of association.[54] Under the one-tier structure, an oversight committee is appointed within the shareholder-elected board of directors, whose members must be nonexecutive and independent.[55] Under the two-tier structure, a supervisory board is elected alongside the management board. The supervisory board is elected by the shareholders, whereas the authority to elect the members of the management board is vested with the supervisory board.[56] Additional powers vested with the supervisory board render the Italian two-tier system the nearest equivalent the German model, though differences persist. Despite the availability of such set of

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[52] *See* C.c. [Civil Code] art. 2388 (It).

[53] *See* C.c. [Civil Code] art. 2400, 2403, and 2403-bis (It.).

[54] *See* C.c. [Civil Code] art. 2380, 2409-octies, and 2409-sexiesdecies (It.).

[55] *See* C.c. [Civil Code] art. 2409 septiesdecies and 2409-optiesdecies (It.).

[56] *See* C.c. art. 2409-novies and 2409-duodecies.

corporate structures, more than fifteen years after reform, the vast majority of Italian listed companies have maintained the traditional corporate structure. At the end of 2017, Italian listed companies adopting the traditional corporate structure accounted for 91% of the market capitalization, with just four firms adopting the one-tier structure or the two-tier structure.[57] We will, therefore, only refer to the so-called traditional corporate structure under which corporate power is vested with the board of directors, while the shareholders are essentially intended to take on a monitoring role to be backed up by the board of statutory auditors.

The fact that the board of directors is key within the corporate structure does not, however, entail the irrelevance of the shareholders meeting. The shareholders meeting actually retains its role as the ultimate tool for director accountability, since it holds the power, above all, to elect (and remove) the members of the board of directors and to approve any amendments to the articles of association.[58] It should be noted that, within corporate ownership structures characterized by the principal-principal agency problem, such as those of many Italian listed companies,[59] shareholder monitoring becomes a matter of minority oversight and minority challenges to the authority of the board and the controlling stockholders. Therefore, unsurprisingly, the evolutionary process that the national corporate governance regulation underwent historically, ever since the enactment of the unified Civil Code in 1942, through to the 1998 CLF and further subsequent developments, including the transposition of SRD I and SRD II,[60] has been a process strongly shaped around the direct and indirect empowerment of minority shareholders: whether by enhancing

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[57] *See* CONSOB REPORT 2019, *supra* note **Error! Bookmark not defined.**, at 17.

[58] *See* C.c. art. 2364 and 2365 (laying down the decision-making powers that rest with the shareholders meeting, either ordinary or extraordinary).

[59] *See infra* Part II.

[60] *See* Council Directive 2017/828, of the European Parliament and of the Council of 17 May 2017 Amending Directive 2007/36/EC as Regards the Encouragement of Long-Term Shareholder Engagement, 2017 O.J. (L 132/1) 3 [hereinafter SRD II].

minority shareholder rights and prerogatives, supporting minority shareholders' actual ability and even willingness to exercise those rights, or strengthening oversight by the board of statutory auditors and further gatekeepers.

A parallel force shaping corporate governance in Italy is the development of financial intermediaries' regulation, starting from reforms enacted in 1974 (which established the Consob as the national financial markets supervisory authority) onwards. With the aim of ensuring end-investor protection, intermediaries' regulation has wielded indirect influence on corporate governance. In a context increasingly characterized by intermediated investments, regulation has progressively focused on institutional investors as owners and has enhanced their oversight role, especially regarding voting obligations.[61] Regulatory action in this area is further supported by self-regulation. Following the EFAMA Stewardship Code,[62] first adopted in 2011, Assogestioni, the Italian asset managers' non-profit association, adopted Stewardship Principles in 2013. The Italian Stewardship Principles were last revised in 2016.[63] In line with the EFAMA Code, as well as a growing number of similar stewardship initiatives, the Italian Stewardship principles target collective investment management and portfolio management companies with the aim of "promot[ing] discussion and cooperation between Investment Management Companies and listed companies

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[61] *See infra* Part III.A.

[62] *See* EUR. FUND AND ASSET MGMT ASS'N, STEWARDSHIP CODE. PRINCIPLES FOR ASSET MANAGERS' MONITORING OF, VOTING IN, ENGAGEMENT WITH INVESTEE COMPANIES (2018), https://www.efama.org/Publications/Public/Corporate_Governance/EFAMA%20Stewardship%20Code.pdf.

[63] MASSIMO BELCREDI & LUCA ENRIQUES, INSTITUTIONAL INVESTOR ACTIVISM IN A CONTEXT OF CONCENTRATED OWNERSHIP AND HIGH PRIVATE BENEFITS OF CONTROL: THE CASE OF ITALY 8–9 (Eur. Corp. Governance Inst. (ECGI), Law Working Paper No. 225/2013 2014) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2325421; *See* ASSOGESTIONI, ITALIAN STEWARDSHIP PRINCIPLES FOR THE EXERCISE OF ADMINISTRATIVE AND VOTING RIGHTS IN LISTED COMPANIES (2016), https://ecgi.global/code/italian-stewardship-principles-2016 [hereinafter ITALIAN STEWARDSHIP PRINCIPLES 2016].

in which they invest," thereby indirectly impacting listed companies "which are called upon to promote dialogue with investors, asset managers and their respective advisors," as well as institutional investors "that entrust the management of their assets to third parties, and are requested to share with their managers certain decisions on how to interact with the investee companies."[64]

As will be shown, by leveraging enhanced shareholder rights and further shareholder-friendly regulatory measures,[65] Assogestioni has greatly contributed to shaping the practice of institutional investor engagement in Italy. In particular, the enabling and coordinating role performed by the Association actually underpins the rise of effective forms of collective engagement by mainstream, non-activist institutions,[66] thus providing an alternative to hedge fund-driven activist intervention, which has become quite popular in Italy in spite of the still predominant ownership concentration of publicly listed corporations.[67]

III. STIMULATING INSTITUTIONAL INVESTOR VOTING AND ENGAGEMENT IN ITALY

In and of itself, the surge of institutional ownership is not enough to stimulate institutional investors to take on a more active corporate governance role. The Italian case clearly shows that regulatory factors also contributed to supporting the increase in institutional shareholder voting and engagement at publicly listed companies. Over the last two decades, Italy gradually reshaped the legal framework for participating in shareholders meetings and voting so as to craft an engagement-friendly regulatory environment.[68] In fact, "a number of self-enforcing rules (especially

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[64] *Id*. at 11.

[65] *See infra* Part III.A-C.

[66] *See infra* Part III.D. and Part IV.A. *See* Gaia Balp & Giovanni Strampelli, *Institutional Investor Collective Engagements: Non-Activist Cooperation vs Activist Wolf Packs*, in 14 OHIO ST. BUS. L.J. (forthcoming).

[67] *See infra* Part V.

[68] *See* Belcredi & Enriques, *supra* note 63, at 7.

on voting) and a broader set of minority shareholder rights have made today's Italian legal environment no less friendly to activist investors than most other jurisdictions."[69] Enhanced shareholder rights and asset managers' quasi-duty to vote as a part of their fiduciary duties to end-investors can be regarded as parallel forces driving increased voting in spite of non-activist, traditional institutions' weak incentive structures.

Soft regulation in the form of corporate governance and stewardship principles also contributed support to institutions' more active ownership. In effect, "provisions strengthening shareholders' rights operate in conjunction with those set by stewardship and corporate governance codes that target institutional investors as shareholders in order to foster their constructive engagement with investee companies as a part of institutions' investment management activities."[70]

A. Asset Managers' Quasi-Duty to Vote and Institutions' Engagement Policy

When analyzing the EU regulatory environment as a supportive factor for shareholder voting, one relevant issue to consider is that, based on the framework for discretionary portfolio and collective investment management, intermediaries are entitled to vote on behalf of the shares owned by the funds they manage. Because of this entitlement, according to Article 21 of Directive 2010/43/EU and Article 37 of the Commission Delegated Regulation (EU) No. 231/2013, mutual funds and alternative investment funds are required to set up a voting policy determining *when and how* to exercise voting rights, whereas voting determinations are to be made

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[69] *Id.*

[70] Gaia Balp, *The Corporate Governance Role of Retail Investors*, 31 LOY. CONSUMER L. REV. 47, 59-60 (2019).

to the exclusive benefit of the funds and the investors in the funds.[71] Voting is thus conceived of as a duty that intermediaries owe to end-investors wherever—based on a cost-benefit analysis—it is in the best interest of the beneficial owners of the shares. The end-investor best-interest standard overarching the entire regulation of investment intermediaries does not, in itself, entail a duty to vote *every share*.[72] However, investment managers are clearly not allowed to simply remain passive and choose not to vote because, depending on the investment strategies adopted, voting passivity can be at odds with institutions' duty to manage investments in the best interest of their clients.[73] Regulation thus provides an incentive structure which, "rel[ying] on the presumption that shareholder voting preserves, or even increases, the long-term value of the

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[71] Commission Directive 2010/43/EU of 1 July 2010 implementing Directive 2009/65/EC of the European Parliament and of the Council as regards organisational requirements, conflicts of interest, conduct of business, risk management and content of the agreement between a depositary and a management company, 2010 O.J. (L 176) 42, 53-54 [hereinafter Commission Directive 2010/43/EU]; Commission Delegated Regulation (EU) No 231/2013 of 19 Dec. 2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision, 2013 O.J. (L 83) 1, 31.

[72] *See* Commission Directive 2010/43/EU, *supra* note 71, at 44 (explicitly considering that "[a]s the case may be, the decision not to exercise voting rights could be considered in certain circumstances as being to the exclusive benefit of the UCITS depending upon its investment strategy. However, the possibility for an investment company to vote itself or to give specific voting instructions to its management company should not be excluded.").

[73] *See* Christian Strenger & Dirk A. Zetzsche, *Corporate Governance, Cross-Border Voting and the (Draft) Principles of the European Securities Law Legislation—Enhancing Investor Engagement Through Standardisation*, 13 J. CORP. L. STUD. 503, 515-17 (2013).

investment," eventually translates into some kind of "implicit duty to vote."[74]

In keeping with the EU provisions, Article 35-decies 1(e) of the Italian CLF states that asset management companies "must provide, in the investors' interests, for the exercise of the voting rights associated with the financial instruments of the collective investment schemes managed unless required otherwise by law."[75] Despite the wording used within the legislation ("must provide"), the prevailing view is that Article 35-decies CLF does not establish an obligation for asset management companies to exercise their voting rights under all circumstances.[76] In keeping with their general duty to "operate diligently, correctly, and with transparency in the best interests of the collective investment schemes managed, the relevant investors and the integrity of the market," as set by Article 35-decies 1(a) CLF, asset management companies are

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[74] *Id.* at 515; *see also* Marco Maugeri, *Proxy advisors, esercizio del voto e doveri "fiduciari" del gestore* [Proxy advisors, voting rights and asset managers' fiduciary duties], PROFILI EVOLUTIVI DELLA DISCIPLINA SULLA GESTIONE COLLETTIVA DEL RISPARMIO 667, 680-682 (Roberta D'Apice ed., 2016) (It.) (further explaining that requirements to adopt voting strategies are organizational in nature and impose upon recipient investment services providers a duty concerning their internal set-ups in terms of the procedures to be applied. Hence, if exercising voting rights is conceived of as a standard of conduct, then it is in the interest of end-investors, not in that of investee companies).

[75] Commissione Nazionale per le Società e la Borsa (CONSOB), Legislative Decree No. 58 of 24 Feb. 1999, http://www.consob.it/web/consob-and-its-activities/laws-and-regulations/documenti/english/laws/fr_decree58_1998.htm?hkeywords=&docid=0&page=0&hits=21&nav=false [hereinafter CONSOB].

[76] *See* Renzo Costi, *Risparmio gestito e governo societario* [Asset management and corporate governance], *in* GIURISPRUDENZA COMMERCIALE 313, 322 (1988) (It.); *see also* Renzo Costi & Luca Enriques, *Il mercato mobiliare* [The Financial Market], 8 TRATTATO DI DIRITTO COMMERCIALE, 420 (Gastone Cottino ed., 2004) (It.).

expected to vote only when it is in the interest of the ultimate beneficiaries of the funds managed.[77]

In addition, Article 124-quinquies CLF—implementing Articles 3g and 3f SRD II—requires institutional investors and asset managers, if only based on a comply-or-explain approach, to adopt an engagement policy that, inter alia, illustrates how they exercise voting rights and other shareholder rights.[78] In addition, institutional investors and asset managers are required to publicly disclose each year how their engagement policy has been implemented and provide a general description of their voting behavior, an explanation of the most significant votes, and the use they made of proxy advisory services.[79] Although it remains questionable whether the newly added rules for institutional investors and asset managers may actually contribute to increasing the quality of investors' engagement with investee companies, the requirement that institutions disseminate information regarding their engagement and actual voting conduct, and the reasons thereof, indirectly adds to pressure on exercising voting rights.[80]

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[77] Mario Stella Richter Jr., *L'esercizio del voto con gli strumenti finanziari gestiti* [Asset managers' voting], *in* I CONTRATTI DEL MERCATO FINANZIARIO 791, 800 (Enrico Gabrielli & Raffaele Lener eds., 2nd ed. 2010) (It.).

[78] CONSOB, *supra* note 75.

[79] *Id.*

[80] In particular, investors with less commitment towards shareholder engagement could take on a formalistic stance in complying with Article 3f and further promote over-reliance on advisory services. In addition, "disclosure of engagement dialogue may undermine its essential deftness, fluidity, and focus on achieving a 'win-win' outcome for both parties. Public disclosure may fundamentally change the type and frequency of engagement and more robust and adversarial-type interactions may result," thereby "undermining the success of informal private engagement by institutional investors." Deirdre Ahern, *The Mythical Value of Voice and Stewardship in the EU Directive on Long-term Shareholder Engagement: Rights Do Not an Engaged Shareholder Make*, 20 CAMBRIDGE YEARBOOK OF EUR. LEGAL STUD. 88, 106 (2018).

B. Participation in the Shareholder Meeting: Information and Duty to Call

Reforms enacted in 2010 to transpose the SRD I into Italian law[81] contributed to shifting the making of voting decisions prior to, and outside of, the shareholders meeting and to promoting better shareholder information and the efficiency in the mechanics of shareholders meetings, thereby contributing to the smoothening of any disincentives institutional investors may have previously encountered in participating in the meetings.

One clear example of such pro-shareholder regulatory efforts may be drawn from Article 125-bis (4) CLF concerning the contents of the notice of call to shareholders meetings. Article 125-bis (4) CLF requires that the notice include, among further items, "a clear, precise description" of the procedures to be applied in order to attend and vote at the shareholders meeting and to exercise further shareholder rights, such as the right to ask questions ahead of the meeting or to prompt the board of directors to take action (typically by requiring that additional items be put on the agenda or by submitting further proposals on items already on the agenda).[82]

Article 125-bis (4) CLF can be viewed as the summary of a wider set of provisions all emphasizing the active role investors are expected to play in regard of the shareholders meeting. First, acknowledging that being active owners requires adequate and timely information, Article 125-ter CLF requires that the board of directors make a report on each item on the agenda available by a specified deadline significantly ahead of an upcoming shareholder meeting, thereby obliging institutions' needs to organize and prepare for appropriate voting determinations and by limiting the chilling effect associated with the delivery of relevant company information much too close to the date of the meeting.[83] In effect, prior to the introduction of the record date system into national

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[81] SRD I was transposed into Italian law by Legislative Decree No. 27/2010.

[82] CONSOB, *supra* note 75.

[83] *Id*.

law,[84] inadequate timings for information delivery had proven to adversely affect participation in the meeting and voting.[85]

Second, a shareholder-friendly, efficiency-promoting intent clearly underpins Article 127-ter (1) CLF, which grants any shareholder the right to submit questions on the items on the agenda prior to the shareholders meeting and to receive the relevant answers "at the latest" during the meeting.[86]

Finally, active ownership is further incentivized by the right granted to shareholders who hold a specified minimum shareholding threshold—usually institutional investors[87]—to directly activate the shareholders meeting. First, shareholders holding—either individually or collectively—at least 5% of the share capital have the right to call a general meeting.[88] In addition, shareholders holding—either individually or collectively—at least 2.5% of the

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[84] *See infra* Part III.C.5.

[85] *See* Fabio Bianconi, *L'attivismo delle minoranze in Italia: un commento* [Minority Shareholder Activism: A Comment], *in* FTSE MIB Proxy Season 2010 70-71 (2011), http://www.proxitalia.com/dld/files/Downloads/Pubblicazioni/FTSE%20 MIB%202010%20-%20Georgeson.pdf (It.) (finding a negative correlation to exist between the delayed delivery of the board's report (less than 20 days ahead of the meeting), institutional investors' attendance to the meeting, and the level of consensus to the board's voting proposals). Still another relevant disincentive for foreign institutions' participation is the unavailability of the board's reports in English: *see* Valentina Allotti & Paolo Spatola*, Le assemblee delle società quotate: il d.lgs. n. 27 del 27 gennaio 2010, le prime esperienze applicative nel 2011 e il decreto correttivo del 2012* [Listed Companies and Shareholder Meetings in Italy] (Note e Studi Assonime 14/2012) 21 (2012), https://www.eticanews.it/wp-content/uploads/2013/04/Assonime.pdf (It.) (according to which over 70% of respondent companies only deliver the notice of call to shareholder meetings also in English); referred to the EU context, *see also* Chris Mallin, *Institutional Investors: The Vote as a Tool of Governance* 16 J. MANAG. GOV., 177, 194 (2012).

[86] *See* Pederzini Elisabetta, *Commento all'articoolo 127-ter* [Comment on Article 127-ter], COMMENTARY ON THE CONSOLIDATED LAW ON FINANCE, 995-998 (Vincenzo Calandra Buonaura ed., 2020) (It.).

[87] Stella Richter, *supra* note 77, at 800.

[88] *See* CODICE CIVILE [CIVIL CODE], art. 2367 (It.).

share capital may ask for additional matters to be put on the agenda of the general meeting and may table new proposed resolutions for a vote.[89] Making voting proposals can serve not only to oppose the board and controlling stockholders but also to remedy the much criticized board-friendly practice of bundling together two or more issues into the same item on the agenda in such a way as to prevent these issues to be voted on separately. Noticeably, bundling—most typically concerning the approval of the financial statements and dividend distributions, the approval of a set of changes to the articles of association, or director elections and compensation—has been targeted in Italy also by proxy advisors for being in contrast to best practice and inhibiting voting by proxy.

C. Regulatory Incentives to Participate in the Shareholder Meeting

Beyond enhancing shareholder information rights, both passive and active, and providing shareholders with the power to proactively initiate the calling of a shareholders meeting and make voting proposals, regulatory action taken ahead and in the wake of SRD I was intended to also provide a set of tools incentivizing active and long-term ownership. These tools range from additional voting rights or dividends, conceived of as a reward for shareholder loyalty, to multiple voting rights, in such a way simplified proxy voting and proxy solicitation, say-on-pay votes, and the enhanced role to be played by the shareholders in the context of related party transactions. While not all of these tools have proven successful in accomplishing the policy goal set and actually driving increased shareholder engagement with Italian investee companies, some indeed have, as is most notably the case for say-on-pay votes, alongside the record date regime as regards attendance at the shareholder meeting and the slate voting system as regards director elections.

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[89] *See* Article 126-bis CLF. Both the right to call a special meeting and to put items on the agenda cannot be exercised for items in relation to which, under Italian law, shareholders may be called to resolve on draft resolutions that have to be submitted or drafted by directors.

1. The Limited Relevance of Loyalty-Based Dividend and Vote Rewards for Supporting Institutional Shareholder Engagement

With the explicit aim of encouraging longer-term investments, two mechanisms were introduced in 2010 and 2014 to reward shareholder loyalty in terms of cash flow rights or control rights. On the one hand, Article 127-quarter CLF allows for a dividend-increasing mechanism to be adopted in the articles of association by which "each share held by the same shareholder for a continuous period of time indicated in the articles, in any case of no less than one year or the lesser period running between two consecutive payment dates of the annual dividend, shall assign the right to an increase of no more than 10% of the dividend distributed to the other shares." Significantly, additional dividends may not be granted to, de jure or de facto, controlling stockholders, whether individually or jointly in control, nor to any shareholder wielding a significant influence on the company or taking part in a shareholder agreement accounting for more than the shareholding thresholds relevant to the rules on the mandatory bid laid down in Article 106 CLF. Therefore, quite evidently, the investor category especially targeted by the dividend-increasing incentive is that of mainstream institutional investors, which typically do not seek to gain control over the company, who are unwilling to take part in shareholder agreements due to the chilling effect associated with the rules on concerted action and the triggering of mandatory bids, and whose holdings, unlike those of some activist hedge funds, usually do not allow them to individually exert any significant influence over the company. It is thus traditional institutions, such as pension and mutual funds, whether actively managed or passive, that are candidates to possibly be rewarded for loyalty.

On the other hand, Article 127-quinquies CLF allows for loyal shareholders to enjoy additional, time-phased voting rights—up to two votes depending on the arrangements made in the articles of association—for each share uninterruptedly held by them for no less than two years, with additional voting rights expiring upon the sale of the shares. Tenured voting may be adopted by any listed company as an incentivizing tool, provided, however, that no multiple voting structure is in place. Hence, additional voting rights and multiple voting may only be alternative. Noticeably, multiple voting structures—up to three votes per share—are allowed under

Italian law since 2014 when they were introduced with the aim of inducing family-owned firms (which make up the core of business organizations in Italy) to list more shares on the stock market without necessarily losing control and thus rendering Italian companies less reliant on bank lending.[90] Shares with multiple voting rights can be issued by private companies only; companies that issued such shares prior to listing are, however, allowed to maintain such shares but prevented, if they so choose, from issuing new such shares and from adopting additional, time-phased voting rights. At the same time, eliminating the ban on multiple voting rights, which had characterized corporate voting in Italy ever since the enactment of the Civil Code in 1942, was also the reaction to the migration of some leading Italian companies from Italy to the Netherlands.[91]

Private ordering showed little interest in dividend-increasing mechanisms, whether due to the many practical problems associated with the implementation of the relevant provisions or simply because, arguably, the long-term related financial incentive provided by heightened dividends cannot outweigh short-term opportunities associated with trading stocks.[92]

To the contrary, time-phased voting has proven to be more successful if it is considered that 51 out of 231 companies listed on the Italian exchange had adopted tenured voting.[93] Importantly, however, given that time-phased voting requires the articles of

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[90] *See* OECD, *supra* note **Error! Bookmark not defined.**, at 34-35.

[91] *See, e.g.*, Marco Ventoruzzo, *The Disappearing Taboo of Multiple Voting Shares: Regulatory Responses to the Migration of Chrysler-Fiat* 1 (Eur. Corp. Governance Inst., Working Paper No. 288/2015, 2015), http://ssrn.com/abstract_id=2574236.

[92] *See generally* Mario Stella Richter Jr., *I troppi problemi del dividendo maggiorato* [The Too Many Problems of Increased Dividends], 117 RIVISTA DI DIRITTO COMMERCIALE 89 (2011) (It.).

[93] *See* OECD, *supra* note **Error! Bookmark not defined.**, at 35. *See also* Chiara Mosca, *Should Shareholders Be Rewarded for Loyalty? European Experiments on the Wedge Between Tenured Voting and Takeover Law*, 8 MICH. BUS. & ENTREPRENEURIAL L. REV. 245, 246 (2019).

association to be amended, and that in order to enjoy the loyalty reward a shareholder is required to file a request with the company, the findings that adopters are almost exclusively family-owned controlled firms and that registrant shareholders are almost exclusively controllers, especially de jure controllers, are quite deceiving from the standpoint of the achievement of the policy goal to incentivize institutional shareholder long-term engagement, if not unsurprising.[94] Altogether, the clear dominance of controlling shareholders in the ownership of companies adopting time-phased voting seems to contradict the reasoning according to which tenured voting encourages longer-term investments by investors other than controlling shareholders. Quite to the opposite, the practice of time-phased voting in Italy questions the effectiveness of such mechanism as a means for retaining shareholders over the long term or, at any rate, as a tool for encouraging institutional investor engagement with investee companies. In a context of high levels of ownership concentration, tenured voting rather appears to further empower pre-existing long-term shareholders. In effect, since controllers did not reduce their stake despite enjoying additional voting rights, the overall net effect of time-phased voting actually allowed those who were already in control to gain control over the extraordinary shareholders meeting as well, where a two-thirds majority of the share capital represented at the meeting is required for making any decision.[95] Similarly, the fundamental lack of institutional investors and asset managers among the beneficiaries of time-phased voting supports the view that time-phased voting seems not, in and of itself, to subsidize institutional shareholder engagement.[96]

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[94] Emanuele Bajo et al., *Bolstering Family Control: Evidence from Loyalty Shares* (Eur. Corp. Governance Inst. 25 (ECGI, Finance Working Paper No. 619/2019, 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3428887.

[95] *See* Mosca, *supra* note 93, at 271.

[96] *See* Giovanni Strampelli, *Are Passive Index Funds Active Owners? Corporate Governance Consequences of Active Investing*, 55 SAN DIEGO L. REV. 803, 843 (2018) (highlighting that tenure voting and loyalty

2. *Proxy Voting and Remote Voting*

As mentioned above, one aim of the SRD was to remove some procedural hurdles which could have inhibited shareholder participation in the shareholders meeting. Along the same lines, Italian rules on proxy voting and proxy solicitation were simplified in 2010 so as to render them less restrictive than they previously were. Changes were also made to the rules on voting by correspondence and electronic means.

Removing unnecessary restrictions to proxy voting is a tool for facilitating shareholder participation. Additionally, other tools that allow cost-effective participation at a distance and in absentia or voting in advance of the meeting, such as electronic real-time transmission of the meeting, real-time two-way communication enabling shareholders to address the meeting from a remote location, electronic voting, and voting by correspondence. However, in regards to voting at a distance or in absentia, practical experience in Italy casts doubts on the efficacy of the measures adopted to achieve the policy goal set.

Under Article 2370 (4) Civil Code and Article 127 CLF, voting at a distance is allowed both by correspondence and by remote. Unlike voting by correspondence, voting by remote theoretically allows for direct and potentially interactive participation in the meeting. However, electronic and online voting are not mandatory under Italian law, but neither is voting by correspondence. It rests with the issuers to determine whether or not to adopt any of these

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dividends, cannot alter the conduct of institutional investors and, especially of the so-called passive index fund managers "[b]ecause passive investors as permanent shareholders cannot sell shares included in the reference index, they commit to the long term—irrespective of the level of their voting rights—and may forego loyalty benefits simply because of portfolio rebalancing").

enabling tools.[97] Thus, despite the alternative-design approach adopted at the regulatory level, enhanced shareholder empowerment relies primarily on the arrangements that individual companies may take in this respect, and a shareholder willing to vote her shares without appointing a proxy agent will, or will not, be enabled to do so remotely or in advance of the meeting depending on whether her investee company actually offers her (one or more of) those tools. As a matter of fact, in Italy voting by correspondence has remained virtually ignored.[98] Similarly, Italian-listed companies do not necessarily offer investors the opportunity to participate in the meeting and vote the shares at a distance via electronic means, possibly to account for cost considerations concerning the relevant technology. At any rate, it is unclear whether large institutional investors, who routinely employ proxy advisors to help them make voting determinations, would really refrain from voting the shares only because of the need, absent electronic voting, to appoint a local proxy agent.[99] This state of affairs helps explain why appointing a

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[97] Interestingly, out of the 28 countries in the European Economic Area that responded to a query by the European Securities and Markets Authority, only Hungary and Iceland reported that they had mandated provision of electronic means to enable shareholders attend the meeting, including for voting. *See* EUR. SEC'S MKT. AUTH., REPORT ON SHAREHOLDER IDENTIFICATION AND COMMUNICATION SYSTEMS, 28-29 (ESMA 31-54-435) (Apr. 5, 2017). Detail implementing provisions for voting by correspondence and voting via electronic means are set by Articles 140 to 143-ter Consob Regulation no. 11971.

[98] *See* Carlo Bellavite Pellegrini, *Corporate Governance e assemblea delle società quotate in Italia: un'indagine empirica* [An empirical inquiry into corporate governance and the shareholders meeting at corporations publicly listed in Italy], 51 RIVISTA DELLE SOCIETÀ 416 (2006) (It.). The changes made to Article 127 CLF in the SRD I transposition process were minor in nature and did not change the substance of voting by correspondence in any meaningful way.

[99] *See* Marco Cian, *Intervento e voto in assemblea: le nuove tecnologie come mezzo per promuovere l'attivismo degli investitori istituzionali?* [Participating and voting in the shareholders meeting: new technologies as a tool to promote institutional investor activism?], *in* GOVERNO DELLE SOCIETÀ QUOTATE E ATTIVISMO DEGLI INVESTITORI ISTITUZIONALI (Corporate governance and institutional investor activism) 104 (Marco Maugeri ed., 2015).

proxy agent remains the voting tool most used by institutional shareholders.[100] Voting by proxy is possible under Italian law in different ways, either according to the regime set by Article 2372 Civil Code, or that provided for by Articles 135-novies to 135-undecies CLF for publicly listed corporations, which underwent major simplification over time.

On the other hand, proxy fights based on the proxy solicitation regime set by Articles 136 to 138 CLF remain episodic in the Italian context despite the changes made in 2010 to the relevant rules. The changes aimed to remove the many substantive limitations which, alongside high costs, had previously prevented proxy solicitations from ever growing into a workable pathway for active share ownership. A shareholder willing to solicit proxies is no longer under the obligation to enlist an intermediary to carry out the process, as she was before the 2010 changes. In addition, a soliciting shareholder is no longer required to meet certain requirements in terms of minimum shareholding thresholds, nor to solicit proxies from all of its fellow shareholders. In its current version, Article 136 (1)(b) CLF allows for a soliciting party to address a minimum of 200 shareholders, hence allowing the soliciting party to selectively address its fellow shareholders.[101] Alongside the possibility to disseminate proxy materials (a proxy statement and a proxy form) via a website chosen by the soliciting person, which may also be the issuer's site if the issuer so agrees,[102] such measures

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[100] It remains to be seen whether implementation of Articles 3a and 3b of SRD II concerning shareholder identification and the transmission of information along the investment chain, by allowing companies to improve communication with their shareholder base and facilitating the exercise of shareholder rights, will also encourage issuers' voluntary adoption of electronic means for participating in the voting process as a tool by which to support shareholder engagement.

[101] Under Italian Consolidated Law on Finance, Article 136 (1)(b) CLF, proxy solicitation is defined as "a request to more than two hundred shareholders for proxy to be conferred in relation to specific voting proposals, or accompanied by recommendations, statements or other indications capable of influencing the vote".

[102] *See* Italian Consolidated Law on Finance, Article 136 (3) of Consob Regulation No. 11971.

contributed to reducing the costs associated with the process, to be borne by the soliciting party, thus theoretically enabling a shareholder to more cost-effectively strengthen its voting power in regard to specific voting proposals by soliciting proxies from like-minded fellow shareholders. Moreover, one-way proxies are no longer mandatory for any soliciting shareholder as they previously were. Enabling two-way proxies, which, importantly, are mandatory where the soliciting person is the issuer itself,[103] reduces the chilling effect associated with one-way proxies for solicited shareholders actually wishing to vote by proxy, but to do so in a way other than that proposed by the soliciting party. Lower costs and greater flexibility seem to have revitalized proxy solicitation as a lever for active share ownership, at least to some extent. Although soliciting proxies is still not commonplace in Italy, probably as a consequence of concentrated ownership with major stakeholders able to control the voting outcomes at shareholders meetings, it has become increasingly frequent, at least under specific circumstances concerning the issuer.[104]

3. *Say-on-Pay Votes on the Remuneration Policy and Director Compensation Transparency*

In order to empower shareholders, the Italian legislature broadened the list of the issues falling within the remit of the general meeting over time.[105] For example, defensive measures against

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[103] *See* Italian Consolidated Law on Finance, Article 138 (2) of Consob Regulation No. 11971.

[104] One proxy fight that became famous for being "Italy's fiercest proxy contest in decades" occurred in 2012 when a shareholders meeting was called by Salini at Impregilo to remove the Gavio group-dominated board; the context in which the case occurred was a peculiar one, since it was characterized by both hedge fund activism targeting Salini and an unstable ownership structure as a consequence of shareholder coalitions dominating the company with stakes less than 30% of the share capital. *See* Belcredi & Enriques, *supra* note 63, at 26-27. *See also* Proxitalia, http://www.proxitalia.com/Page.asp/id=404/operazioni-concluse, accessed February 12, 2020 (providing an illustrative list of proxy fights managed at Italian listed companies).

[105] Belcredi & Enriques, *supra* note 63, at 7-8.

hostile takeovers, unless the company has opted out of the so-called board neutrality rule, need to be authorized by the shareholders meeting. Similarly, the requirement that any amendments to the articles of association be approved by a supermajority of two-thirds of the share capital represented at the meeting is clearly aimed at incentivizing attendance by minority shareholders.

Further still, after introducing a precatory say-on-pay vote in regard of the company's remuneration policy in 2012, the current version of Article 123-ter CLF—as amended by Legislative Decree no. 49 of 10 May 2019 implementing Article 9a SRD II—has made say-on-pay votes binding. The company must hold Say-on-pay at least every three years, or whenever the board proposes any changes to the remuneration policy last approved by the shareholders. Hence, companies "shall only allocate fees in compliance with the remuneration policy most recently approved by the shareholders."[106] As an explanation for rendering say-on-pay binding in nature, the draft explanatory report to Legislative Decree no. 49/2019 emphasizes the need to align the provisions on the remuneration policy of all listed companies to those that were already in force for banks and insurance companies, which provide for a binding say-on-pay votes.[107] In addition, the scope of application of binding say-on-pay votes on the remuneration policy was broadened to also include compensation to the members of the board of statutory auditors, alongside that regarding the members of the board of directors, general managers and executives with strategic responsibilities (see Article 123-ter (3)(a) CLF).

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[106] *See* CONSOB, Article 123-ter (3-bis) CLF.

[107] *See* Draft Explanatory Report to Legislative Decree, no. 49/2019 (February 8, 2019), 7 (in Italian only), http://documenti.camera.it/apps/nuovosito/attigoverno/Schedalavori/getTesto.ashx?file=0071_F001.pdf&leg=XVIII#pagemode=none. *See also* BANK OF ITALY, *Circular no. 285/2013,* Part I, Title IV, Chapter 2, Sec II, para 1 (Dec. 2013), https://www.bancaditalia.it/compiti/vigilanza/normativa/archivio-norme/circolari/c285/aggiornamenti/Testo-int-30-agg.pdf (It.) (providing that remuneration policies for corporate boards be approved by the shareholders meeting by a binding vote).

As a tool for enhanced director accountability, say-on-pay votes are meant to strengthen institutional investor monitoring.[108] First, from the standpoint of shareholder oversight, significant levels of against and withhold say-on-pay votes quite clearly shows that a portion of the shareholders withdrew support from the board, and their dissent is made public.[109] Second, say-on-pay votes can be regarded as being functionally complimentary to the rights granted to shareholders under the slate voting system for director elections,[110] to obtain that at least one director be elected by minorities. If it is considered that minority-elected directors are very often elected to the remuneration committee within the board, the combined potential effect of say-on-pay votes and slate voting can provide minorities with a form of intra-board monitoring over the determinations concerning board compensation that may favor alignment with international best practices (first and foremost in regard to enhanced transparency), thus further encouraging shareholder engagement.[111] Interestingly, following the first implementation of precatory say-on-pay, a positive correlation has been found to exist between the presence of minority-elected directors within the remuneration committee and increased institutional investor participation in the shareholder meetings.[112] Moreover, low-quality information in the remuneration report has been found to be positively correlated with higher levels of against and withhold say-on-pay votes, suggesting that shareholders do lever say-on-pay votes as a tool for corporate stewardship.[113] The

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[108] *See, e.g.*, Commission Recommendation (EC) No. 385/2009, recital 10, according to which "to increase accountability, shareholders should be encouraged to attend general meetings and make considered use of their voting rights. In particular, institutional shareholders should take a leading role in the context of ensuring increased accountability of boards with regard to remuneration issues", https://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:120:0028:0031:EN:PDF.

[109] *See infra* Parts III.D.1 and IV.

[110] *See infra* Parts III.D.1 and IV.

[111] *See infra* Part IV.

[112] *See infra* Part IV.

[113] *See* Belcredi et al., *supra* note **Error! Bookmark not defined.**, at 20, 25-26.

significance of say-on-pay votes on the remuneration policy is, in fact, further heightened by the fact that the fees actually paid to directors, general managers, executives with strategic responsibilities, and members of the board of statutory auditors during the financial year need to be submitted to a shareholders' vote, if still non-binding.[114] Moreover, the board of directors is required to illustrate yearly how the company has taken account of the vote cast the previous year on the fees paid.[115]

4. *Related Party Transactions and Shareholder Oversight*

The rulings on related party transactions are among the most significant rulings intended to reduce principal-principal agency costs associated with controllers' potential for self-dealing,[116] which was first introduced in Italy as early as 2010 to be only slightly amended in 2019 in the process of transposing Article 9 (c) SRD II into national law. The general provisions on related party transactions are drawn in Articles 2391-bis of the Civil Code, which vests Consob with the authority to lay down rules aimed at ensuring that related party transactions are transparent, are illustrated in the board's annual report to the financial statements and comply with procedural and substantive fairness requirements, and Article 154-ter (4) CLF, which requires the board's interim report to half-yearly financial statements to also include information on significant, related party transactions.[117] The contents of such information, as

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[114] *See* ArticleCLF [C.c.] art. 123-ter (6) (It.) (providing that the shareholders meeting resolves in favor or against the section of the remuneration report to be drawn by the board of directors illustrating, in a clear and understandable manner, each of the items comprising remuneration, as well as the fees paid during the financial year, and that such resolution is not binding).

[115] *See* CLF [C.c] art. 123-ter (4) (b-bis) (It.).

[116] *See generally* Luca Enriques, *Related Party Transactions: Policy Options and Real-World Challenges (With a Critique of the European Commission Proposal)*, 16 EUR. BUS. ORG. L. REV. 1 (2015).

[117] *See* CIVIL CODE [C.c] art. 2391-bis (It.); CLF [C.c] art. 154-ter (4) (It.).

well as substantive regulation of related party transactions, are laid down by Consob in Regulation no. 17221 of March 12, 2010, which envisages safeguards aimed at protecting the company and its non-controlling shareholders against potential value diversion or misappropriation by controllers and further related parties, including detailed provisions involving independent directors in the decision-making process and, in some cases, empowering dissenting minorities to prevent the transaction. Regulation 17221 is currently in the process of being updated following the SRD II.[118] However, if it is considered that such regulation will not undergo major changes, its current version is still fully meaningful to provide an overview of the general regime related party transactions are subjected to in Italy.

First, Article 4 of Regulation no. 17221 requires that the board of directors adopt a specified internal procedure to ensure transparency as well as substantial and procedural fairness of related party transactions.[119] Second, Article 5 of the same regulation requires that the company publicly disclose material transactions in accordance with Article 114 (5) CLF[120] and Article 17 of Regulation (EU) no. 596/2014.

Further, according to Article 8 of Regulation no. 17221, the board of directors may approve material, related party transactions (transactions "of greater importance," as identified through a set of

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[118] *See* Commissione nazionale per le società e la borsa (Consob), Resolution No. 17221 (Mar. 12, 2010),

http://www.consob.it/web/consob-and-its-activities/laws-and-regulations/documenti/english/laws/reg17221e.htm?hkeywords=resolution+17221&docid=9&page=0&hits=20&nav=false,

(regulations containing provisions relating to transactions with related parties). Public consultation concerning the proposed amendments to Regulation 17221/2010 was launched on October 31, 2010.

[119] *See* Consob Regulation No. 17221, art. 4 (2010).

[120] *See* CLF [C.c] art. 114 (5) (It.) (Providing that Consob may require the issuers, the subjects which control them, board members, managers and persons who hold major holdings or who are parties to a shareholders' agreement to publish the information and documents needed to inform the public); Commission Regulation 596/2014, art. 17, 2014 J.O. (L 173) 1 (EU).

quantitative parameters) only if favorable advice has been previously given by a committee of independent directors involved in the negotiations; however, company-specific related party procedures may stipulate that the board may approve the transaction despite the negative opinion from the committee if and only if a shareholders meeting is convened and a majority of unrelated shareholders approve the transaction (the so-called 'whitewash').[121] Instead, the board may approve transactions "of lesser importance" notwithstanding the negative opinion of the committee, which, in addition, is not required to lead the negotiations and is without recourse to the shareholders meeting whitewash.[122] According to Annex 1 of Regulation no. 17221 (concerning definitions functional to the definitions of related parties and related party transactions), an entity is a related party to a company if, among others, the party "controls the company, is controlled by, or is under common control."[123]

Once again, the interaction between the Italian regimes for related party transactions and for director elections through the mandatory slate voting system needs to be considered in order to fully understand how such interaction can support active shareholder monitoring and stewardship. In effect, since ex ante independent scrutiny of related party transactions is required to ensure that the transaction is fair for the company and all of its shareholders, minority board representation ensured by slate voting can also improve self-dealing oversight. At Italian-listed companies, the presence of minority-elected directors appointed by institutional investors has had a positive impact on the adequacy of internal procedures for addressing related party transactions.[124] In

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[121] *See* Consob Regulation No. 17221, art. 8, 2010,

[122] *See* Consob Regulation No. 17221, art. 7, 2010.

[123] *See* Consob Regulation No. 17221, annex 1, 2010 (emphasis added).

[124] *See* Marcello Bianchi et al., *Regulation and Self-Regulation of Related Party Transactions in Italy: An Empirical Analysis* (Eur. Corp. Governance Inst. 25 (ECGI, Finance Working Paper No. 415/2014, 2014),

particular, "the presence of at least one minority director is indeed associated with adoption of stricter internal codes, not only when minority directors are members of the committee of independent directors vetting internal codes, but also when they merely sit on the board."[125] Indeed, the very reason why mandatory slate voting was originally adopted in Italy for board elections at listed companies was to secure minority board representation as a monitoring tool deployed by active shareholders, in keeping with the view that institutional investors should be encouraged to act as corporate stewards.[126] Further findings from the Italian context seem to support the hypothesis that non-executive minority directors reduce principal-principal agency costs associated with controllers' potential self-dealing, and positively affect firm value, "even in presence of factors (uncertainty about future financial results and high information asymmetry) that might exacerbate the risk of hold-up by minority shareholders."[127] Thus, "the benefits associated to the active monitoring role by the independent minority directors outweigh the costs of potential frictions within the board."[128]

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https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2383237. It should be noticed that Regulation no. 17221 introduced both stricter procedural requirements and heightened disclosure obligations, however leaving some freedom to the board of directors in drawing the individual company's internal procedure for RPTs: the board is thus allowed to opt-up or opt-down from some of the provisions set forth in the regulation as defaults.

[125] *Id.* at 25 (also finding that, to the contrary, the degree of board independence, as measured by the percentage of independent directors sitting on the board, does not have an impact on the strictness of such internal procedures).

[126] *See* Giovanni Strampelli, *How to Enhance Directors' Independence at Controlled Companies*, 44 J. CORP. L. 103, 135-36 (2018). *See also* Marco Ventoruzzo, *Empowering Shareholders in Directors' Elections: A Revolution in the Making,* 8 EUR. CO. & FIN. L. REV. 105, 141 (2011).

[127] Nicola Moscariello et al., *Independent Minority Directors and Firm Value in a Principal–Principal Agency Setting: Evidence from Italy*, 23 J. MGMT. AND GOV. 18–19 (2019).

[128] *Id.*

5. *The Pivotal Impact of the Record Date System on Boosting Institutional Investors' Voting*

Although they do significantly empower minority shareholders, most of the regulatory measures illustrated above would still not have provided institutional investors with an incentive strong enough to subsidize increased participation in the shareholders meeting had it not been for the mandatory adoption of the record date regime to regulate attendance and voting in the meeting. In fact, the blocking requirement imposed on the shares for up to two days prior to the meeting, which was previously enshrined in Article 2370 Civil Code, amounted to a significant economic impediment on institutional investor attendance, since it seriously restricted the ability of investors to freely trade their shares for a not insignificant number of days ahead of the meeting.[129] Thus, the shift toward the mandatory record date system (*See* Article 83-*sexies* CLF) has greatly reduced the main economic disincentive associated with participating in the meeting and has indeed proven to be crucial in boosting institutional investor voting, especially with regards to foreign institutions.[130] As the evidence available quite clearly shows, after introducing the record date regime in 2010, institutional investors' participation in the shareholders meetings has virtually doubled at non-controlled Italian listed companies, and has remarkably increased even at de jure controlled companies, in spite of the fact that control over voting outcomes is still secured to the controlling blockholders.[131]

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[129] *See* B. Espen Eckbo & Giulia Paone, *Reforming Share-Voting Systems: The Case of Italy* 7-8 (Tuck School of Bus. Working Paper No. 2011-93), https://ssrn.com/abstract=1822287.

[130] Belcredi & Enriques, *supra* note 63, at 21.

[131] *See* Mario Notari, *Diritti di voice degli azionisti e tutela delle minoranze* [Shareholders' voice and protections of minority shareholders], *in* IL TESTO UNICO DELLA FINANZA. UN BILANCIO DOPO 15 ANNI [CONSOLIDATED LAW ON FINANCE AT 15] 247, 256-257. (Filippo Annunziata ed., Egea 2015) (It.).

D. *SHAREHOLDER ENGAGEMENT*

As illustrated above,[132] various actions have been taken in order to support, facilitate and incentivize institutional investor participation and voting at shareholders meetings. However, other forms of engagement that usually take place outside the general meeting exist which remain substantially unregulated, despite their increasing relevance within the practice of engagement.[133]

Article 124-*quinquies* CLF (almost literally transposing Article 3g(1)(a) SRD II) now requires—if only on a comply or explain basis—that institutional investors publish their engagement policy yearly to illustrate, among other things, the ways in which "investors monitor investee companies on important issues, including strategy, financial and non-financial results as well as risks, capital structure, social and environmental impact and corporate governance, interact with investee companies, . . . cooperate with other shareholders, and communicate with the relevant stakeholders of the investee companies."[134] In line with the principles set by virtually any stewardship code, whether national or international, Article 124-*quinquies* CLF makes it clear that engagement is more than just voting and includes "investment decision-making, monitoring assets and service providers, engaging with issuers and holding them to account on material issues, collaborating with others, and exercising rights and responsibilities."[135]

The importance of shareholders' engagement is clearly recognized also by the Italian Corporate Governance Code 2020

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[132] *See supra* Part III.A-C.

[133] *See generally* Joseph A. McCahery et al., *Behind the Scenes: The Corporate Governance Preferences of Institutional Investors*, 71 *J. Fin*. 2905, 2911–16 (2016); Giovanni Strampelli, *Knocking at the Boardroom Door: A Transatlantic Overview of Director-Institutional Investor Engagement in Law and Practice*, 12 VA. L. & BUS. REV. 187 (2018).

[134] CONSOB, Article 124-quinquies CLF.

[135] FIN. REP. COUNCIL, THE UK STEWARDSHIP CODE 2020 (Oct. 2019), 7, https://www.frc.org.uk/getattachment/5aae591d-d9d3-4cf4-814a-d14e156a1d87/Stewardship-Code_Dec-19-Final.pdf.

according to which "[t]he board of directors promotes dialogue with shareholders and other stakeholders which are relevant for the company, in the most appropriate way."[136] To that end, the Code recommends "the board of directors adopts and describes in the corporate governance report a policy for managing dialogue with the generality of shareholders, taking into account the engagement policies adopted by institutional investors and asset managers."[137]

Some engagements may best be conducted privately by a single investor, and many take place behind closed doors.[138] However, there are forms of public engagement which have proven quite effective in the Italian context. In particular, Italian experience with director elections through the slate voting system suggests coordinated engagements by institutional investors can have a positive impact on investee companies, especially with regard to corporate governance issues. Closely following EFAMA,[139] the Italian Stewardship Principles acknowledge that the collective one "may be the most effective method of engagement."[140] Over the years, Assogestioni has been increasingly taking on an active role in providing operational support to its affiliates,[141] thus developing a peculiar pathway for collective engagement and showing that investor associations can play a proactive role within the framework for stewardship, as they can catalyze investors' stewardship efforts by favoring the redistribution of the engagement costs among the

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[136] CORP. GOVERNANCE COMM., *supra* note 47, at 5.

[137] *Id.*, at 6.

[138] *See supra* note 133. *See also* Elroy Dimson et al., Coordinated Engagements 9 (July 1, 2020) (Working Paper) (on file with SSRN), https://ssrn.com/id=3209072.

[139] *See* EUR. FUND AND ASSET MANAG'NT. ASS'N, *supra* note **Error! Bookmark not defined.**, at 4 (recommending that asset managers "should consider acting with other investors, where appropriate." Guidance to Principle 4 further emphasizes that shareholder collaboration may sometimes be "the most effective manner in which to engage.").

[140] Assogestioni, *supra* note 63, at 17-18.

[141] *See generally* Strampelli, *supra* note 126, at 134-35.

institutional investors that carry out engagement activities collectively.[142]

Individual and collective engagements might further be facilitated by the new rules on shareholder identification set by Article 83-duodecies CLF, as amended following the SRD II.

1. *Director (and Statutory Auditor) Elections Through Slate Voting*

The most distinctive feature of the Italian corporate governance framework is the right to board representation that is granted to minority shareholders through the slate voting system (*voto di lista*), which is mandatory for corporate elections at all listed companies. It proved to be crucial to empower institutional investors insofar as minorities enjoy the right to elect at least one member of the board of directors and one member of the board of statutory auditors. Under slate voting, corporate boards are elected from competing slates of nominees, which are usually submitted by sponsoring shareholders. The majority of directors are elected from the slate receiving the largest number of votes at the shareholders meeting (so-called "majority slate"), but at least one director must be picked from the slate that obtains the largest number of votes after the majority slate (so-called "minority slate")[143] and that is not linked in

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[142] With the aim of favoring the sharing of engagement-related benefits and costs among investors, costs are allocated in proportion of the "size" of associated asset managers: *see* ASSOGESTIONI, *Bylaws* 34 (2016), http://www.assogestioni.it/index.cfm/3,813,11301/statuto-marzo-2016.pdf (stating that each member must pay a fee comprised of a fixed amount and a variable amount, which is established by dividing the remaining portion of the budget amongst all members in proportion with the assets collected and/or managed at the end of the previous year). *See also* Balp & Strampelli, *supra* note **Error! Bookmark not defined.**, at 45-48.

143 *See* Art. 147-ter (3) (1998) (under which "the member elected from the minority slate must satisfy the integrity, experience and independence requirements established pursuant to Articles 148(3) and 148(4). Failure to satisfy the requirements shall result in disqualification from the position."). *See generally* Guido Ferrarini et al., *Corporate Boards in Italy*, *in* CORPORATE BOARDS IN LAW AND PRACTICE 367, 392–393 (Paul Davies et al. eds., 2013).

any way, either directly or indirectly, to the majority slate that won the most votes.[144] In particular, under Article 147-ter CLF, shareholders holding a minimum threshold of shares—set by Consob and currently varying between 0.5% and 4.5%[145]—are entitled to present lists of candidates for election to the board of directors. The same applies to elections to the board of statutory auditors according to Article 148 CLF, under which the chair of the board must be picked from the statutory auditors elected from the minority slate. Mandatory slate voting was first introduced in 1998, limited however to elections to the board of statutory auditors.[146] In 2005, ensuing the financial scandal around Parmalat, slate voting was extended to elections to the board of directors as well.[147]

Minority shareholders willing to submit a slate of director nominees and ready to bear the (non-negligible) costs associated are thus offered a way of gaining access to the boardroom and having a direct insight into the company's affairs. Arguably, cost considerations are part of an explanation for the crucial role that Assogestioni has been playing in the process of selecting director

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144 Article 144 (6) of Consob Regulation no. 11971 clearly states "[a] shareholder may not submit or vote for more than one list, including through nominees or trust companies. Shareholders belonging to the same group and shareholders participating in a shareholder agreement involving the shares of the issuer may not submit or vote for more than one list, including through nominees or trust companies. A candidate may only be present in one list, under penalty of ineligibility." Massimo Belcredi & Guido Ferrarini et al., *Board Elections and Shareholder Activism: The Italian Experiment*, *in* BOARDS AND SHAREHOLDERS IN EUROPEAN LISTED COMPANIES: FACTS, CONTEXT AND POST-CRISIS REFORMS 378–83 (Massimo Belcredi & Guido Ferrarini eds., 2013). *See* Belcredi & Enriques, *supra* note 63**Error! Bookmark not defined.**, at 8–9.

145 *See* 11971 Consob Regulation Art. 144-quater (1999). The minimum threshold set by Consob varies depending on the company's capitalization. Shareholders are not, however, prevented from setting a lower shareholding threshold in the articles of association.

146 *See* Belcredi & Ferrarini, et al., *supra* note 144, at 367.

147 *Id.*

nominees and submitting minority slates ever since the introduction of slate voting. If it is considered that, under the Italian Stewardship Principles, "[t]he presentation of candidates for election as independent minority members of boards of investee companies, also through the [Assogestioni] Investment Managers' Committee, represents a continuous and constructive method of engaging with investee companies,"[148] submitting slates of director nominees has indeed grown into an increasingly significant tool for exerting investor active ownership.[149] More so, slate voting, combined with the proactive role played by Assogestioni as an enabling entity, has proven to be a fundamental lever by which to support (non-activist) institutional investors' collective action as a viable and cost-effective pathway for engaging investee companies.

Assogestioni does not promote shareholder collaboration loosely, but indeed provides institutionalized support for collective engagement by leveraging the national regulatory framework for corporate elections at listed companies. Based on a formalized procedure, candidates for election as minority representatives to corporate boards are selected in accordance with the "principles for the selection of candidates for corporate bodies of listed companies" drawn up by the Assogestioni Corporate Governance Committee.[150] The Investment Managers' Committee is in charge of selecting candidates with the assistance of an independent advisor. The independent advisor is charged with maintaining a database of possible candidates and submitting to the Investment Managers' Committee a short list of those that appear to best meet the

[148] Assogestioni, *supra* note 63, at 17.

[149] *See infra* Part IV.2.

150 Such committee is composed of members of Assogestioni's board and representatives of member companies. *See* Assogestioni, PROTOCOL OF DUTIES AND RESPONSIBILITIES OF THE CORPORATE GOVERNANCE COMMITTEE AND THE INVESTMENT MANAGERS' COMMITTEE 20–21 (2017) (such committee is composed of members of Assogestioni's board and representatives of member companies).

requirements for each corporate office.[151] Further still, candidates must have adequate professionalism, integrity, and independence;[152] to avoid possible conflicts of interest, legal representatives of investment management companies and, unless at least one year has elapsed since the relevant appointments were relinquished, anyone who has served in a senior management or an executive role at an investment management company may not be selected as a candidate.[153] In addition, to ensure that candidates be independent vis-à-vis the company for which they are nominated, "[m]embers of governing or supervisory bodies and senior managers of institutions and companies that have significant business ties with the company for which they are nominated may be selected as candidates provided that at least one year has elapsed since the end of these appointments."[154] If elected, candidates are required not to accept any senior management position or corporate appointment at the same company or at any other company belonging to the same corporate group for at least one year after the end of their term, unless they are nominated once again as candidates by the Investment Managers' Committee.[155]

Ever since its adoption, slate voting has been conceived of as a lever to secure minority board representation and subsidize active

151 *Id.,* at 24-26 (specifying that "[e]ven when minority slates are presented for elections to boards, the Committee members undertake no obligation in regard to the exercise of voting rights during general meetings.") The Investment Managers' Committee is composed solely of representatives of member investment management companies or other Italian or foreign institutional investors, who communicate each time to the Committee's secretariat their interest in participating in the submission of the individual slates for minority candidates' election to the boards of Italian investee listed issuers).

152 *Id.*, at 26.

153 *Id.*, at 28–29 (also stating that persons who hold a senior management or executive role in investment management companies may not be selected as candidates for company boards).

154 *Id.*, at 29.

155 *Id.*, at 30.

shareholder monitoring.[156] Noticeably however, chiefly on account of the ownership structures of Italian listed companies, such systems for board elections can sometimes lead to unexpected and, to some extent, counterintuitive situations. Specifically, at so-called de facto controlled companies, where controllers hold less than 50% of the voting rights, institutional investors collectively may actually own the majority of the votes or, at any rate, a proportion of the votes larger than that of the controlling stockholders.[157] Hence, it is increasingly the case—especially at larger corporations where de facto controllers hold a relatively small stake—that the list submitted by institutional investors under the coordination of Assogestioni actually receives more votes than that submitted by (de facto) controlling shareholders, and sometimes even an absolute majority of the votes.[158] If it is considered that, based on the engagement strategy adopted by Assogestioni, affiliated institutions only present so-called short lists of director nominees in order to avoid taking control of the company by electing a majority of the board,[159] where minority-submitted lists receive the majority of the votes cast, a majority of the shareholders ends up appointing a minority of the directors, whilst a minority (as the de facto controlling shareholder) appoints a majority. Paradoxical as it may appear, such outcome is in line with the approach to investor

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[156] *See* Strampelli, *supra* note 126, at 135–36.

[157] ORG. FOR ECON. CO-OPERATION & DEV., CAPITAL MARKET REVIEW OF ITALY 2018: MAPPING REPORT 53-54 (2018)), www.oecd.org/corporate/OECD-Capital-Market-Review-Italy-Mapping-Report-2018.pdf.

[158] Mario Stella Jr. Richter & Federico Ferdinandi, *The Evolving Role of the Board: Board Nomination and the Management of Dissenting Opinions*, 4 ITALIAN L.J. 611, 613 (2018).

[159] *See* Assogestioni, *supra* note 150, at 23. Interestingly, also hedge funds most often take advantage of short-slate rules, since the submission of a short slate can encourage them "to seek board representation with the possible objective of putting the company up for sale, but without themselves acquiring control. Because hedge funds are not typically strategic bidders and traditionally did not want control (which carried some risk of liability), this rule well served their needs". *See* John C. Coffee Jr. & Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance*, 41 J. CORP. L. 545, 560 (2016).

stewardship adopted by the Italian Stewardship Principles, according to which the appointment of some independent directors only "serve[s] as a method of monitoring."[160] Consistent with such approach, engagement promoted by Assogestioni is primarily aimed at minimizing "the agency costs arising from the presence of a controlling shareholder by sharing management decisions, and thus by exercising closer monitoring,"[161] and not—in contrast to the usual approach of hedge funds—at influencing firms' strategic and financial decision-making, also by replacing management.[162]

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[160] Assogestioni, *supra* note 63, at 16; in fact, the regulatory framework for acquisition of major holdings or control in European listed companies applicable to traditional UCITS funds —but not to alternative funds reserved to professional investors (AIFs, such as hedge funds)— prevents mutual UCITS funds from acquiring or exercising control (or significant influence) over investee companies in order to limit risk concentration. *See* Simone Alvaro & Filippo *Annunziata, Shareholdings of Alternative Investment Funds in Listed Companies and in Banks: A Legal Perspective*, 14 (Consob Legal Research Paper No. 17, 2018), http://www.consob.it/documents/46180/46181/lp17.pdf/2ca235bc-17a1-4bda-9efb-569d9ff361b8. This, in turn, helps explain why hedge funds may submit long, or even full, slates of director nominees to a shareholder vote. *See also* Coffee & Palia, *supra* note 159, at 560 (noting that "[t]he goal of the short slate rule also was to encourage 'constructive engagement' through minority board representation-without a confrontational battle between activists and the issuer.").

[161] Matteo Erede, *Governing Corporations with Concentrated Ownership Structure: An Empirical Analysis of Hedge Fund Activism in Italy and Germany, and Its Evolution*, 10 EUR. CO. & FIN. L. REV. 328, 371 (2013). *See also* Belcredi & Ferrarini et al., *supra* note 144, at 414; Luigi Zingales, *Italy Leads in Protecting Minority Investors*, FIN. TIMES (Apr. 13, 2008), https://www.ft.com/content/357c40c4-094d-11dd-81bf-0000779fd2ac (considering that a vote for a minority list sponsored by Assogestioni is not "a vote against the management but a vote to ensure truly independent board members and avoid the representation of other opportunistic minority shareholders, who might have other goals in mind").

[162] Erede, *supra* note 161, at 370.

2. *Shareholder Identification as a Tool for favoring Collective Shareholder Initiatives*

With a view to promoting institutional investors' active ownership, Article 83-duodecies CLF, last amended in 2019 to transpose SRD II, explicitly conceives of shareholder identification as a means by which to "facilitate issuers' communication with shareholders as well as the exercise of shareholder rights, *including in a coordinated manner*."[163]

Issuers are entitled to require intermediaries along the investment chain to identify the shareholders, however limited to those holding more than 0.5% of the voting rights;[164] the costs associated with the process of identifying the shareholders are borne by the issuer (see Article 83-duodecies (1)). Importantly, Article 83-duodecies (3) CLF imposes an obligation on the company to start the identification process upon request of minority shareholders, whereas the minimum threshold required for the shareholders to make such request is the same set for submitting a slate of director nominees under Article 147-ter CLF. Hence, the threshold shareholders are required to meet to initiate the process varies between 0.5% and 4.5% of the share capital depending on the size

[163] *See* Article 83-duodecies (1) CLF (emphasis added).

[164] Noticeably, under the previous version of Article 83-duodecies CLF companies (or shareholders holding a certain stake) were allowed to request shareholder identification only where such right was actually set out in the articles of association; in turn, no restriction applied as regards the shareholders to be identified, since the request was not restricted to shareholders holding more than a certain percentage of shares or voting rights. According to the draft explanatory report, setting the minimum threshold to exercise the right to request the identification above 0.5% of the share capital was needed in order to avoid that shareholder identification be used as a defensive measure by directors or controlling shareholders against smaller shareholders aiming at building up more relevant stakes. It should be noticed, however, that setting such threshold entails that companies will not be able, as a matter of fact, to (also) identify their retail shareholder base, if they wished so. As a result, an issuer's interest in reaching out to its retail shareholders may diminish at companies where the shareholder base includes a significant proportion of retail investors.

of the company and its ownership structure. Where the process is started upon shareholder request, the costs are shared between the issuer and the requesting shareholders based on criteria set by Consob in such way as to oblige the need that shareholder requests be in line with the aim of facilitating shareholder coordination.[165] In any case, data concerning shareholder identification are made available to shareholders "on a commonly-used electronic storage device free of charge,"[166] irrespective of whether the process was initiated by the issuers or the shareholders.

As is apparent, shareholder identification, alongside the rules on top-down and bottom-up transmission of information relevant to the exercise of shareholders' rights along the investment chain (see Article 83-novies (1)(g-bis), Article 82 (4-bis) CLF, and implementing regulations), are clearly intended to support the exercise of shareholder rights as a policy goal. Shareholder identification encourages engagement between a company's investor relations department and its shareholders since it can improve communication with the shareholder base and allows the company to develop more targeted communication programs; the right granted to minorities to activate the identification process adds to shareholder active ownership since it favors non-activist institutional investor collective action—whether through voting, convening a general meeting, putting a new item on a meeting's agenda, asking questions, etc., or simply by facilitating sharing views on agenda items, corporate action and governance, or gauging

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[165] *See* Article 133-bis of Consob regulation No. 11971 (providing that cost allocation be regulated by each issuer in the articles of association; if the articles of association fail to do so, the costs of shareholder identification will be borne entirely by the issuer. However, if the shareholders make a request for shareholder identification in the six months following the end of the fiscal year, and in any case prior to the annual general meeting, and no identification request is made directly by the issuer in the same period of time, the company will fully incur the costs for disclosure of the shareholder identification data and the number of shares registered on the securities accounts).

[166] *See* Article 83-duodecies (4) CLF.

preferences, e.g. in view of an important and uncertain vote, and up to challenging the board or controlling shareholders.

IV. THE PRACTICE OF SHAREHOLDER VOTING AND ENGAGEMENT IN ITALY

This section briefly follows up on the analysis above by reporting some evidence regarding the practice of shareholder voting and engagement in Italy. We focus on say-on-pay and director elections through slate voting since these tools have proven to catalyze institutional investors' preferences in the Italian context.

A. SAY-ON-PAY VOTES

Alongside enhanced attendance rates at shareholders meetings,[167] increased institutional investor engagement with companies publicly listed in Italy can be quite clearly inferred from data concerning say-on-pay votes ever since first-time application of Article 123-ter (6) CLF in 2012, whose outcomes seem in line with those characterizing other Member States: altogether, for-votes prevail over against and withhold votes, with investors mostly tending to side with directors.[168] However, against votes are all but

[167] *See supra* Part II.

[168] See Georgeson et al., FTSE MIB Proxy Season 2013, 34-41 (2013), https://archivioceradi.luiss.it/files/2011/10/FTSE-MIB-2013-Evoluzione-degli-assetti-proprietari-ed-attivismo-delle-minoranze.pdf, according to whom for say-on-pay votes averaged 88% of the voting capital in 2012 and 90% in 2013. See also Belcredi et al., supra note **Error! Bookmark not defined.**, at 9, according to whom against and withhold votes averaged 5% in 2012. Such divergent findings are arguably attributable to the different width of sample issuers examined in the analyses (limited to FTSE MIB issuers in the first case; including all 226 publicly listed companies in the second case). Hence, higher dissent levels found in the first study emphasize that non-national institutions tend to concentrate investments in blue chips. In both cases, consensus over remuneration policies was found to be only slightly higher than that observed in the United States and the UK, and in line with that found in other countries with higher levels of ownership concentration, such as Germany.

irrelevant, more so if ownership concentration is considered.[169] Where major stakeholder votes are left aside, consensus over remuneration at larger issuers averaged 57% of the votes in 2012 and 67% in 2013. Interestingly enough, against votes nonetheless accounted for more than 50% in 10 out of 32 FTSE MIB companies in 2013, chiefly as a consequence of foreign institutional investor votes.[170] In fact, over the first years of say-on-pay application, increased attendance at shareholders meetings by foreign institutions has been found to positively correlate with both the size of investee firms and higher rates of against votes, with foreign institutions also seeming to drive the votes of domestic institutions.[171] Hence, institutional investor scrutiny appears to be stronger at larger firms.[172] In turn, the fact that dissent over remuneration policies negatively correlates with ownership concentration is generally explained by closer monitoring performed by controlling shareholders.[173]

Where against votes were found to be a majority, this occurred under particular circumstances and within complex contexts, typically in situations where the firm was facing financial distress, suits were brought against corporate directors, or all directors resigned in the context of control contests.[174] Out of such circumstances, higher dissent rates were typically found to be associated with unsatisfactory information in the remuneration policy proposed by the board, exceedingly generous compensation

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[169] *See* Belcredi & Enriques, *supra* note 63, at 18-19.

[170] *See* Georgeson et al., *supra* note 168168, at 35.

[171] *See* Belcredi et al., *supra* note **Error! Bookmark not defined.**, at 28-29, 32 (according to whom non-national institutions perform a dissent-aggregation function vis-à-vis domestic investors).

[172] *Id.*at 25, 26, 28.

[173] *Id.* at 27-28.

[174] *Id*. at 22.

levels, especially in regard to CEO severance contracts or performance-based vesting conditions in equity grants.[175]

Against and withhold say-on-pay votes by institutional investors have increased in 2018 to about 8% of the share capital and 41% of the total number of shares held by them.[176] Interestingly, since 2017, dissent has grown markedly at Italian blue chips, reversing the decreasing trend for FTSE MIB companies over the 2012-2016 period.

Altogether, relative average say-on-pay consensus in Italy has been interpreted not as a measure of institutional investors' unawareness and conformity in opinions, but as a confirmation of the efficacy of say-on-pay as a lever by which to promote higher levels of transparency concerning remuneration policies, as well as a signal for enhanced transparency[177] achieved as a response to

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[175] *See id.* at 27; *see also* Georgeson et al., *supra* note 168, at 41 (stating that such findings are in line with those referred to the UK, where non-binding say-on-pay was introduced in 2002); *see* Fabrizio Ferri & David A. Maber, *Say on Pay Votes and CEO Compensation: Evidence from the UK*, 17 REV. FIN. 527, 529 (2013) (indicating that these very same reasons motivate negative voting recommendations issued by proxy advisors as well); *see, e.g.*, Frontis Governance, *Studio sulle remunerazioni nelle società quotate in Italia. Esercizio 2011* [A Study on 2011 Remunerations at Publicly Listed Companies in Italy] 29 (2012), http://www.frontisgovernance.com.

[176] Consob, *supra* note 42, at 35 (noticing that institutional investors' dissent appears to be lower at widely held companies and when institutional investors hold a major stake).

[177] *See* Frontis Governance, *Studio sulle remunerazioni nelle società quotate in Italia. Esercizio 2012* [A Study on 2012 Remunerations at Publicly Listed Companies in Italy] 6 (2013), http://www.frontisgovernance.com/attachments/article/315/Studio%20Remunerazioni%202012%20-%20Abstract.pdf. (discussing the key role played by transparency in regard to the value of say-on-pay votes); *see* Guido Ferrarini et al., *Understanding Directors' Pay in Europe: A Comparative and Empirical Analysis* 14-15 (EGCI Law Working Paper 126/2009, 2009), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1418463.

increased shareholder oversight.[178] Interestingly, proxy advisors have been found to have a remarkable impact on the outcome of say-on-pay proposals, and a clear correlation has been found between negative proxy advisor recommendations and lower vote results. In the 2019 proxy season, for instance, "in the FTSE MIB, the five remuneration reports with the lowest level of support all received a negative recommendation from the majority of the [most significant] proxy advisors."[179]

Further still, the (previously) non-binding nature of say-on-pay votes has not been found to reduce investors' oversight incentive. Rather, precatory say-on-pay, even if well below a majority vote, has seemed to exert a disciplining effect on the remuneration committees within the board of directors, given that shareholder resolutions adopted with relatively high against and withhold votes signal lack of trust with the directors and expose the board to adverse reputational effects.[180] Therefore, say-on-pay can also serve to support fruitful shareholder-director dialogue as a form of engagement, quite the same way as so-called withhold or vote-no campaigns have proven to do in the United States.[181] It remains to be seen whether, and if so how, the transition towards binding say-on-pay votes will change investors' attitude on investee companies' compensation practices.[182] When looking at binding say-on-pay

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[178] *See* Ferri & Maber, *supra* note 175, at 530 (finding that say-on-pay can have a disciplining effect in that it induces ex-ante changes in remuneration policies aimed at limiting votes: all in all) ("UK investors perceived say on pay to be a value enhancing monitoring mechanism and were successful in using say on pay votes to pressure firms to remove controversial pay practices and increase the sensitivity of pay to poor performance").

[179] Georgeson, Georgeson's 2019 Proxy Season Review 97 (2019), https://www.georgeson.com/it/2019-season-review.

[180] *See* Ferrarini et al., *supra* note 177, at 17-18.

[181] *See* Ferri & Maber, *supra* note 175, at 531.

[182] Based on Article 7(2)(b) of Legislative Decree no 49/2019 (transposing SRD II into national law), the updated version of Article 123-ter CLF which includes binding say-on-pay on remuneration policies applies only starting from the 2020 proxy season. *See* D.L. 49/2019 (It.).

that was already in place at publicly listed banks and insurance companies, it should be noticed that comparatively lower levels of dissent have been regarded as motivating more responsible shareholder voting.[183]

B. SLATE VOTING

Beyond say-on-pay, director elections have become the main target of institutional investors, both domestic and foreign, at Italian listed companies.[184] This is chiefly a consequence of the enactment of slate voting, on the one hand, and the record date regime for shareholder voting on the other. Crucially, director elections at publicly listed companies feature a substantive convergence of foreign and domestic institutional investor votes on the slates submitted by Italian asset managers through Assogestioni, with institutional investors' votes often coming quite close to the votes cast by the major stakeholders in the company.

Even though slate voting was introduced earlier,[185] until 2010, institutional investors were only able to appoint corporate board members within a small group of listed companies.[186] As a matter of fact, Italian institutions concentrated the submission of slates of director nominees on a limited number of major issuers featuring better relative performance and better corporate governance, as well

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[183] *See* Belcredi et al., *supra* note **Error! Bookmark not defined.**, at 32.

[184] *See* Massimo Belcredi & Guido Ferrarini, *The European Corporate Governance Framework: Issues and Perspectives* 47 (ECGI Law Working Paper no. 214/2013, 2013), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2264990. Such finding is in line with the wider European context. *See* Mallin, *supra* note **Error! Bookmark not defined.**, at 192 (reporting that resolutions in most EU countries show "a clear emphasis being placed on board composition and the appointment of directors to the board").

[185] *See supra* Part III.C.3.

[186] Belcredi & Enriques, *supra* note 63, at 19–20.

as on longer-term investee companies.[187] However, since 2010, following the introduction of the record date system,[188] participation by institutional investors in voting at board elections has increased significantly and, over the years, a growing number of directors and statutory auditors have been elected by institutional investors.[189] Moreover, several bylaws, especially at larger corporations, have actually made room for two or three minority-appointed directors, and the average number of directors appointed by minorities is approximately two.[190] Currently, 100 out of 232 listed companies' boards include at least one minority-appointed director.[191] Minority-appointed directors represent, on average, 17% of the members of the boards where they are present.[192] At the same time, the boards of statutory auditors at 112 listed companies include at least one minority-appointed member.[193]

As mentioned above, owing to the enabling role played by Assogestioni in the process of selecting director nominees, a significant proportion of minority-elected directors have been picked from the lists coordinated by the Association. In 2019, sixty-four slates of director nominees were submitted to the vote by minority institutions, appointing seventy-six candidates in forty-

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[187] Such finding further suggested that institutions might have wished to concentrate engagement efforts on a small number of major firms also due to "political" and lobbying intents. *See* Belcredi & Enriques, *supra* note 63, at 20 and 30; Belcredi et al., *supra* note 144, at 414.

[188] *See supra* Part III.C.5.

[189] Belcredi & Enriques, *supra* note 63, at 21.

[190] Piergaetano Marchetti et al., *Dissenting Directors*, 18 EUR. BUS. ORG. L. REV. 659 (2017).

[191] Assonime, *La Corporate Governance in Italia: Autodisciplina, Remunerazioni e Comply-or-Explain*' [Corporate governance in Italy: Soft law, remunerations and comply-or-explain] 37 (2019), http://www.assonime.it/attivita-editoriale/studi/Pagine/note-e-studi-1-2019.aspx; CONSOB REPORT 2019, *supra* note 17, at 17.

[192] CONSOB REPORT 2019, *supra* note 17, at 17.

[193] *Id.*

nine listed companies.[194] It should be noticed that, although the shareholdings of the Italian institutional investors that formally submit the lists do not exceed, on average, 3.5% of the votes cast, the lists promoted by Assogestioni are able to catalyze the votes of a sizeable number of Italian and foreign fellow institutional investors, so that minority slates frequently end up receiving more than 30%—and sometimes around 50%—of the votes cast.[195] Given the decreasing weight of Italian mutual funds in the Italian stock market, the support of foreign institutional investors has proven to be essential in this respect.

Altogether, collective engagement promoted by Assogestioni with a view to board elections can be seen as a fairly effective tool for monitoring investee companies; minority-appointed independent directors within the board can favor some form of oversight within the board itself, given that such directors are primarily expected to protect minority interests, also by enhancing board disclosure.[196]

V. HEDGE FUND-DRIVEN ACTIVISM AND ENGAGEMENT

While the Italian corporate governance framework is mainly meant to empower non-activist institutional investors, one noticeable factor that has been shaping institutional investor ownership in Italy over the very last few years is the growing relevance of activist hedge fund intervention. Interestingly, after the United States, activism among large economies is "relatively most frequent in Italy, the Netherlands, Germany and Switzerland (in declining order), none of which are typically labeled as having

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[194] ASSOGESTIONI, STAGIONE ASSEMBLEARE 2019 [2019 Proxy Season Review] 10 (2019), http://www.assogestioni.it/index.cfm/3,161,12799/stagione-assembleare-2019.pdf.

[195] *Id.*

[196] *See, e.g.*, Moscariello et al., *supra* note 127, at 165 (finding a positive relationship between the proportion of independent minority directors and firm value); Piergaetano Marchetti et al., *supra* note 190, at 659 (finding that minority-appointed directors are more likely to dissent than directors appointed with a majority of the votes).

active markets for corporate control."[197] Further still, in relative terms, activism is "less frequent [in the United States and the UK] after adjusting for the number of listed companies than in Italy or Germany."[198] In Italy, indeed, hedge funds have "taken position in a great variety of listed companies regardless of the presence of controlling shareholders."[199] Such findings may be surprising at first sight, given that controlled companies predominate within the Italian corporate landscape. The truth is, however, that minority-empowering shareholder rights, particularly the right to appoint directors on the board, coupled with mainstream institutional voting support to activist proposals,[200] can be the drivers of activist intervention at controlled companies which feature a significant proportion of institutional investors in the shareholder base, especially where de facto control is in place, as they indeed have proven to be in the Italian context. The presence of U.S. institutional investors in the shareholder base seems to provide further support

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[197] Marco Becht et al., *Returns to Hedge Fund Activism: An International Study*, 30 REV. FIN. STUD. 2933, 2940 (2017).

[198] *Id.*

[199] Erede, supra note 161, at 354 (further noting that "differences in the ownership structure of the target companies also seem to have had no impact on activists' investment choices": Ibid 358). See also Belcredi & Enriques, supra note 63, at 20–22, 31 (noticing the rise, in recent years, of hedge funds successfully resorting to legal tools and remedies made available by reforms in the last two decades to aggressively target listed companies engaging in controversial transactions); Elisabetta Bellini, Hedge Fund Activism in Italy, 9 J. Corp. L. Stud. 201, 231, 233 (2009).

[200] See, e.g., J.P. Morgan, The activist revolution. Understanding and navigating a new world of heightened investor scrutiny 8 (2015), https://www.jpmorgan.com/jpmpdf/1320693986586.pdf, (emphasizing that "[n]o other factor has had as significant an impact on the success of shareholder activism as the changing attitude and behavior of traditional long-only investors: public pension funds, institutional investors and money managers.").

for activism. In effect, U.S. institutional investors exert significant influence on the level of activism in non-U.S. countries.[201]

Against this backdrop, while the increase in the presence of activist investors on the Italian capital markets can further incentivize mainstream institutions' active conduct, it may also, to some extent, influence the role played by non-activist institutional investors in Italy. Due to their different incentive structures, activist investors are more willing than mainstream institutions to engage in costly, and often confrontational, initiatives aimed at bringing about a change in the target company's policies or management. Hence, even non-activist institutional investors might be willing to support activist intervention in spite of the collaborative and constructivist stance for shareholder engagement adopted by Italian legislature and soft law principles. Put differently, the rise in activists' interventions could lead to the diffusion of an engagement approach quite different from that which EU and Italian law aims to stimulate.

One illustrative example concerns the 2018 battle for control of Telecom Italia between Vivendi and Elliott Advisors, showing that this form of "cooperation" between activist and mainstream institutional investors can enhance the relevance of activist-driven initiatives and lead to a more confrontational model of engagement in Italy. In the Telecom Italia case, indeed, the majority of mainstream institutional investors decided to side with Elliott Advisors and the cooperation between activist and non-activist institutional investors helped Elliott Advisors to appoint ten out of fifteen members on the board at Telecom Italia.[202] In effect,

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201 See Becht et al., supra note 197, at 2968–69 (noticing that "[t]he increase and spread of U.S. foreign institutional holdings has significantly contributed to hedge fund activism becoming a global phenomenon").

202 Whether the diffusion of such initiatives can be beneficial for the Italian capital markets is difficult to predict, as the potential effects of increased shareholder activism also depend, to a certain extent, on the ownership structure of target companies. See Gaia Balp, Activist Shareholders at De Facto Controlled Companies, in 13 Brooklyn J. Corp. Fin. & Com. L. 348 (2019) (noting that, as far as de facto controlled companies are concerned, "an activist's power to exert substantial

enhanced institutional investor participation at shareholders meetings renders voting outcomes more difficult to predict, even in contexts of concentrated ownership. This in turn can increase the potential for successful activist intervention. At de facto controlled companies, where corporate control is contestable, this might especially be the case where shareholder slates are submitted to be voted on at director elections, proxy fights occur, or the general meeting is to vote on material related party transactions.

VI. CONCLUSION

The case of Italy quite clearly shows that institutional investors can play a major role within contexts of concentrated corporate ownership, and that legislature can greatly contribute to favoring institutions' active ownership by creating a friendly regulatory environment. Indeed, despite high levels of ownership concentration of publicly listed companies, institutional investors have grown into prominent players on the Italian corporate governance scene. Different factors, both economic and regulatory, contributed to bringing about such outcome. Within a context dominated by the principal-principal agency problem, regulatory action taken over time has been one strongly shaped around empowering minority shareholders, whether by enhancing minority shareholder rights or supporting minorities' actual ability and willingness to exercise shareholder rights. Moreover, intermediaries' regulation has focused on institutional investors and asset managers as owners and has enhanced their oversight role, especially as to voting obligations. Coupled with support provided by self-regulation, particularly the Italian Stewardship Principles, these factors have driven institutional investors to become more active owners and more engaged stewards at Italian listed companies.

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influence over the company's management premised on a small equity stake, coupled with the presence of a much larger, but (theoretically) disempowered, blockholder is likely to cause instability at the corporate-governance level").

Particularly, say-on-pay votes, enhanced shareholder oversight of related party transactions, and slate voting for director elections, alongside the pivotal effect of the record date regime on boosting institutions' participation in the shareholders meeting, have proven most successful at driving increased institutional investor engagement with Italian listed companies. Moreover, say-on-pay votes, related party transaction oversight, and slate voting have proven to mutually combine in the Italian practice of shareholder engagement. First, say-on-pay is a tool complimentary for minority representation on the board of directors to foster institutional investor stewardship. In fact, the presence of minority-elected directors within the board's remuneration committee has been found to positively correlate with increased institutional investor participation in the shareholder meetings, and higher levels of transparency concerning the remuneration policies were quite often achieved as a response to relevant against and withhold say-on-pay votes. Second, minority board representation ensured by slate voting can improve self-dealing oversight since ex ante independent scrutiny of related party transactions is required. Additionally, at Italian listed companies, the presence of minority elected directors has actually had a positive impact on the adequacy of internal procedures for addressing related-party transactions.

On the other hand, Italian experience with director elections through slate voting suggests that coordinated engagements by institutional investors can have a positive impact on investee companies. The Italian Stewardship Principles emphasize the relevance of collective engagements, and Assogestioni, the Italian non-profit asset manager association, greatly contributed to developing a peculiar pathway for collective engagements which leverages slate voting to catalyze investors' stewardship efforts. By redistributing engagement-associated costs among the affiliated investors, Assogestioni promotes shareholder collaboration within a formalized framework for the selection of candidates and the submission of short lists of director nominees as a tool for shareholder monitoring. As a matter of fact, slate voting, subsidized by the proactive role played by Assogestioni as an enabling entity and combined with the incentivizing effect of the record date system, has proven to be a fundamental lever by which to support mainstream institutional investors' collective action as a viable and cost-effective pathway for engaging and monitoring investee

companies in Italy. An ever-growing number of directors and statutory auditors are actually elected by institutional investors.

ALL THE GUCCI IN CHINA: PARALLEL IMPORTATION RULES FOR BRINGING TRADEMARKED GOODS TO CHINA

*Yumei Xia**

I. INTRODUCTION 65

II. TRADEMARK EXHAUSTION DOCTRINE AND PARALLEL IMPORTATION 68
  A. STYLIZED FACTS ON TRADEMARK EXHAUSTION DOCTRINE 68
  B. PARALLEL IMPORTATION *71*
    1. Definition 71
    2. Price Discrimination 72
  C. PARALLEL IMPORTS AND TRADEMARK EXHAUSTION DOCTRINE *76*

III. TRADEMARK PARALLEL IMPORTATION IN CHINA 79
  A. BACKGROUND AND RELATED STATUTES 80
  B. TRADEMARK PARALLEL IMPORTATION CASES 83
    1. 1999 to 2013 — Avoiding the Issue 85
    2. 2013 to 2016 — Heightened Controversy 91
    3. 2017 to Present — Emerging Consensus 97

IV. HOW TRADEMARK EXHAUSTION WORKS IN MOST COUNTRIES 102
  A. TRADEMARK EXHAUSTION IN THE UNITED STATES 102
  B. TRADEMARK EXHAUSTION IN THE EUROPEAN UNION 107

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V. DAIGOU PREVALENCE IN CHINA — DERIVED FROM PARALLEL IMPORTATION 114

VI. PROBLEMS WITH CHINA'S CURRENT APPROACH AND PROPOSAL TO CLARIFY THE FUTURE TRADEMARK EXHAUSTION 122

VII. CONCLUSION 127

Parallel importation refers to importing intellectual property goods into a market and sold without authorization of the intellectual property owners in that market. It is an international trade phenomenon, and it is also a significant international trade issue related to intellectual property rights. It has close relations with the intellectual property exhaustion doctrine. In trademark law, most of the world's large economies have clear exhaustion doctrine. Surprisingly, however, China does not have clear law and policy on parallel importation — despite being the world's second-largest economy and a nation known worldwide for being central to the international trade system. The parallel importation disputes are increasingly common in Chinese courts, especially after the establishment of the Free Trade Zones. What's more, in practice, Chinese courts allow and hold in favor of parallel importation. Apart from the rising trade in trademarked goods, the Chinese government takes note of a vast and growing practice of Chinese tourists financing their trips abroad by reselling the goods they bring back in their suitcases — the "daigou" phenomenon. This daigou phenomenon raises both parallel importation and tax issues because these tourists are arguably smuggling goods without paying tariffs. All of these activities reflect or promote intellectual property trade development and make it impossible for China to neglect this issue any longer. This Article explains why parallel importation laws are necessary and outlines the crucial features of such a law to guide legislators who could react to it.

I. INTRODUCTION

Intellectual property plays an essential role in the global trade integration process. Parallel importation is an international trade phenomenon, and it is also a significant international trade issue related to intellectual property rights. "Parallel importation" refers to the importation of intellectual property goods into a market and sold without the authorization of the intellectual property owners in that market. Whether a country permits the parallel importation or not depends on which type of exhaustion doctrine it adopts.

The "exhaustion doctrine" is one of the limits on intellectual property rights. It means once a product protected by intellectual property rights has been launched on the market with the intellectual property owners' consent, the intellectual property owners cannot control the further distribution or resale of the given product.[1] Thus, if X sells an intellectual property protected product to Y, the exhaustion doctrine lets Y distribute the product further without X's permission. Despite its importance, there is no international consensus on a uniform exhaustion doctrine. Article 6 of The Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) leaves the details of the exhaustion doctrine for signatory members to determine.[2] Different nations adopt different exhaustion regimes, and thus have different stances on parallel importation.

Most of the world's large economies have clear exhaustion doctrine: the EU adopts the regional exhaustion approach, and the U.S. takes the international exhaustion approach. Surprisingly,

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[1] *See Interface Between Exhaustion of Intellectual Property Rights and Competition Law,* COMM. ON DEV. AND INTELLECTUAL PROP. (CDIP), World Intellectual Property Organization, Annex, Page 3, Eighth Session (Nov. 14-18, 2011). This document was prepared as an integral component of the Thematic Project on Intellectual Property and Competition Policy, as revised and approved at the fourth session of the CDIP, held in Geneva, on Nov. 16-20, 2009, https://www.wipo.int/edocs/mdocs/mdocs/en/cdip_8/cdip_8_inf_5_rev.pdf (last visited Jun. 16, 2020).

[2] Agreement on Trade-Related Aspects of Intellectual Property Rights, Apr. 15, 1994 [hereinafter TRIPS]; TRIPS Agreement, Art. 6.

however, China does not have clear law and policy on parallel importation—despite being the world's second-largest economy and a nation known worldwide for being central to the international trade system.

One reason for this silence is that China didn't need an answer. Parallel importation usually happens *into* prosperous countries *from* less developed countries because importers depend on price differences to survive. Until recently, China was plainly in the latter category. However, in China, as a fast-growing economic entity, the international intellectual property imports have proliferated in recent years based on the 2019 World Intellectual Property Report.[3] International intellectual property trade is essential to China. Since 2013, China established several China Pilot Free Trade Zones to explore new paths and models for China's opening to the outside world, as well as promote the transformation of economic growth patterns and optimize economic structures.[4] Further, China strengthened the construction of its intellectual property protection environment, amended intellectual property laws, and increased law enforcement. And, as anyone who has visited a high-end fashion retailer in America or Europe can attest, Chinese visitors are avid buyers of trademarked goods (which they often resell back home to the consternation of the intellectual property owners). All of these activities reflect or promote intellectual property trade development and make it impossible for China to neglect this issue any longer at the same time.

What's more, parallel importation disputes are increasingly common in Chinese courts, especially in the trademark area. Since the first reported case involving trademark parallel importation in

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[3] *See The Geography of Innovation: Local Hotspots, Global Networks*, WORLD INTELLECTUAL PROPERTY ORGANIZATION, World Intellectual Property Report 2019, at 8, https://www.wipo.int/edocs/pubdocs/en/wipo_pub_944_2019.pdf (last visited Aug. 2, 2020).

[4] *See* The World Bank in China, WORLD BANK, 2020, https://www.worldbank.org/en/country/china/overview.

1999,[5] more and more international trademark owners filed lawsuits in China concerning the trademark exhaustion and parallel importation issue, especially after the establishment of the Free Trade Zones. Yet these disputes do nothing to establish the law because China is a civil law country, and most cases decided by courts in China do not have precedential value.[6] Trademark owners, consumers, and the courts need an explicit statute to deal with the trademark parallel importation issue.

Although China previously clarified its law on a related form of parallel importation (patented goods),[7] reform efforts petered out before a resolution could be found for trademark law. That being said, there is reason to believe a clarifying statute will finally be enacted in the near future. Apart from the rising trade of trademarked goods, Chinese officials have taken note of the vast and growing practice of Chinese tourists financing their trips abroad by reselling the goods they bring back in their suitcases. This *daigou* phenomenon raises both parallel importation issues and tax issues because these tourists are arguably smuggling goods without paying tariffs. *Daigou* thrives in part because of an absence of clear trademark exhaustion statutes and no specific parallel importation policy. The solution is for China to answer the legal questions and define the trademark exhaustion doctrine through legislation. This Article explains why new laws are necessary and outlines the crucial features of such laws to guide legislators who could enact it.

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[5] *See* Wu Jianchuang, *Viewing the Legal Issues of Parallel Imports from the Shanghai Lihua Trademark Case*, LAW STAR (Oct. 8, 2007), http://service.law-star.com/cacnew/200710/50008774.htm.

[6] The exceptions are cases adjudicated by the Supreme People's Court, but there are no such cases on this topic.

[7] *See* Order of the President of the People's Republic of China No.8 (promulgated by the Standing Comm. Nat'l People's Cong., Dec. 27, 2008, effective Oct. 1, 2009), art. 69, "[t]he following shall not be deemed to be patent right infringement: (1) After a patented product or a product directly obtained by using the patented method is sold by the patentee or sold by any unit or individual with the permission of the patentee, any other person uses, offers to sell, sells or imports that product…" at 13-14, https://www.wipo.int/edocs/lexdocs/laws/en/cn/cn028en.pdf.

This Article proceeds as follows: Section II introduced the trademark exhaustion doctrine and parallel importation; Section III elaborates on the current trademark exhaustion approach in China. This section is divided into three parts to show the "practice beforehand"—how the courts reach to the current international trademark exhaustion doctrine in practice; Section IV presents how trademark exhaustion works in other countries, using the United States and the European Union (EU) as examples; Section V discusses the parallel importation variation in China, referred to as *daigou* fever, to show why China needs to change their laws immediately. Section VI discusses two problems with the current parallel importation regime and explains how to clarify the law in a future trademark exhaustion statute. Section VII concludes the Article.

II. TRADEMARK EXHAUSTION DOCTRINE AND PARALLEL IMPORTATION

A. STYLIZED FACTS ON TRADEMARK EXHAUSTION DOCTRINE

Trademark exhaustion, which can also be referred to as the trademark first sale rule, states the right of a trademark owner "to control the distribution of its trademarked product does not extend beyond the first sale of the product."[8] Additionally, "[r]esale by the first purchaser of the original article under the producer's trademark is neither trademark infringement nor unfair competition."[9]

Trademarks have different functions compared to copyrights and patents. Trademarks possess the ability to indicate the source of goods. Trademarks grant trademark owners the ability to prevent third parties from using similar or identical marks on similar or

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[8] Sebastian Int'l, Inc. v. Longs Drug Stores Corp., 53 F.3d 1073, 1074 (9th Cir. 1995); David W. Barnes, *Free-Riders and Trademark Law's First Sale Rule*, 27 SANTA CLARA HIGH TECH. L.J. 457, 461 (2011), https://digitalcommons.law.scu.edu/cgi/viewcontent.cgi?article=1522&context=chtlj.

[9] Sebastian Int'l, Inc., 53 F.3d at 1073, 1074.

identical products to avoid consumer confusion.[10] Trademarks also represent and guarantee the quality of products.[11] The exhaustion doctrine helps to determine the boundaries of the extent to which trademark owners can "constrain the behavior of other people to use things in their rightful possession."[12] The principle of trademark exhaustion finds its rationale in the assumption that "trademarks must not be used as a tool to control market distribution or as a means of market division contrary to their function as indicators of commercial origin and product quality."[13]

Cross-border transactions have become increasingly prevalent in the wake of economic globalization and trade integration. The trade of intellectual property products is an essential and indispensable part of it.[14] TRIPS plays an essential role in establishing the international law of intellectual property rights. However, there is a blank space in the TRIPS Agreement which pertain to the exhaustion doctrine. Article 6 of TRIPS provides that "nothing in the Agreement shall be used to address the issue of the

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[10] *See* Nicholas S. Economides, *The Economics of Trademarks,* 78 TRADEMARK REP. 523, 526 (1988); William P. Kratzke, *Normative Economic Analysis of Trademark Law*, 21 MEM. ST. U. L. REV. 199, 205 (1991); Irene Calboli, *Market Integration and (The Limits Of) The First Sale Rule in North American and European Trademark Law*, 51 SANTA CLARA L. REV. 1241, 1248-49 (2011).

[11] *See id.*

[12] Molly Shaffer Van Houweling, *Exhaustion and The Limits of Remote-Control Property*, 93 DENV. L. REV. 951 (2016); *See* Molly Shaffer Van Houweling, *Exhaustion and Personal Property Servitudes, in* RESEARCH HANDBOOK ON INTELLECTUAL PROPERTY EXHAUSTION AND PARALLEL IMPORTS (Irene Calboli & Edward Lee ed., 2016).

[13] Calboli, *supra* note 10, at 1250; Shubha Ghosh & Irene Calboli, *Trademark Exhaustion Across Selected Jurisdictions*, EXHAUSTING INTELLECTUAL PROPERTY RIGHTS: A COMPARATIVE LAW AND POLICY ANALYSIS 66 (Cambridge University Press, 2018).

[14] *Agreement on Trade-Related Aspects of Intellectual Property Rights*, April 15, 1994; *Marrakesh Agreement Establishing the World Trade Organization*, Annex 1C, 1869 U.N.T.S. 299 [hereinafter TRIPS Agreement]. TRIPS was negotiated at the end of the Uruguay Round of the General Agreement on Tariffs and Trade (GATT) in 1994 and is administered by the WTO.

exhaustion of intellectual property rights."[15] TRIPS does not imply, prescribe, or prohibit a regime of exhaustion and leaves the autonomous right to all the World Trade Organization (WTO) member nations.

There are three versions of exhaustion doctrine based on the geographical scope: national exhaustion, international exhaustion, and regional exhaustion. According to national exhaustion, intellectual property rights to a particular good are exhausted only if the good is manufactured or sold within the country's domestic market. The acceptance of the principle of the exhaustion doctrine has rarely been questioned for the unauthorized sale of genuine goods originating within national markets.[16] This is because courts and trademark theorists reached a consensus on the rights of a trademarked products' proprietor, agreeing that proprietors "should remain free to enjoy the specific privileges of traditional ownership," and more specifically "should be free to resell or otherwise dispose of his property."[17]

At the other extreme, international exhaustion doctrine does not care about the manufacturing and first distribution location. It allows all authorized goods to be freely resold in the country's domestic market. A nation that endorses international exhaustion has mainly opted for worldwide exhaustion concerning the item sold. The U.S. adopted the international exhaustion doctrine in trademark law a long time ago, and China also reaches to consensus

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[15] TRIPS Agreement, art. 6.

[16] Calboli, *supra* note 10, at 1252.

[17] *See id.*; *see* Herman Cohen Jehoram, *International Exhaustion versus Importation Right: A Murky Area of Intellectual Property Law*, 4 G. R. U. R. INT'L 280 (1996). Trademark owners want to use trademark exclusive rights to control the downstream market, and trademark exhaustion defeats this market division strategy. However, trademark owners can still impose restrictions on further distribution through contract system. They can't enforce those restrictions through trademark law, however, the contract law, even the antitrust law still works if there are anti-competitive terms and conditions in contracts. This article will not discuss further in detail about how contract and antitrust laws work.

through legal practices and takes international exhaustion in the trademark area.

In between these two extremes, regional exhaustion applies to goods initially put on a specific group of countries' markets. Usually, this specific group of countries is a treaty-based trading group, like the European Union (EU). Within the EU or European Economic Community (EEC) scope, there is no reason to prevent the free circulation of genuine goods across the Member States after the first sale within this region. The principle behind regional exhaustion is the integration of the internal market and the free movement of products across the EU and the EEC. Which type of exhaustion regime that each country applies will significantly impact intellectual property rights owners.

B. PARALLEL IMPORTATION

1. Definition

Parallel importation, also known as gray market goods, are genuine goods purchased in one country and then brought into a second country for resale without the intellectual property rights owners' authorization.[18] Parallel imports have a close relation to the exhaustion doctrine. Whether such trade is legally permitted depends on which type of exhaustion doctrine a country chooses. When a state chooses the national exhaustion doctrine, parallel importation is prohibited. When a state chooses the international exhaustion doctrine, it permits parallel importation. Hence, intellectual property rights are exhausted upon the first sale anywhere outside the domestic market, and parallel importation can occur despite opposition from intellectual property owners. The regional exhaustion doctrine permits parallel importation within a

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[18] *See* Quality King Distributors, Inc. v. L'anza Research Int'l., Inc., 523 U.S. 135, 153 (1998) (citing K Mart Corp. v. Cartier, Inc., 486 U.S. 281 (1988), "parallel importation refers to the importation of foreign-manufactured goods bearing a valid United States trademark without the consent of the trademark holder."). *See also* Kirtsaeng v. John Wiley & Sons, Inc., 133 S.Ct. 1351 (2013), at 1379, n.9 ("[T]he term gray market good refers to a good that is imported outside the distribution channels that have been contractually negotiated by the intellectual property owner.").

specific geographic area. Regional exhaustion doctrine will be illustrated in Section IV with a discussion of EU trademark exhaustion.

As stated above, TRIPS gives full latitude to WTO member nations to choose their exhaustion regimes, so different countries implement different exhaustion regimes in each intellectual property field. Because there is no global consensus on the exhaustion doctrine, the type of regime each country chooses depends on the actual condition of each country.

The main reason that gave rise to parallel importation is price discrimination. Price discrimination is ubiquitous in the current market. Producers will likely charge a higher price where the demand is high or when consumers have a better ability to pay, or charge a lower price where the demand is low or when consumers cannot afford the product. For example, with global price discrimination, intellectual property owners can charge different prices in different countries' markets according to the supply-demand curve. It also gave intellectual property owners more power to control the price and the subsequent downstream distribution. National exhaustion doctrine allows intellectual property owners to implement global price discrimination without worrying about the low-priced products in other markets flooding and ruining the domestic market. It seems that price discrimination is a desirable tool for intellectual property owners to get further control over the distribution of goods. However, parallel importation is a form of arbitrage as to price discrimination, and it defeats many market segmentation schemes. Under international trade integration, many multinational companies set up the international commerce chain, primarily driven by intellectual property technology, making choices on parallel imports more controversial.

2. *Price Discrimination*

According to Carl Shapiro and Hal R. Varian, within the broader domain of price discrimination, there is a commonly

accepted classification dating to the 1920s.[19] There are three degrees of price discrimination. The first degree, also called personalized pricing, is sold to each user at a different price.[20] With the first degree price discrimination, the producers can charge the maximum possible price for each unit that allows producers to capture all the available consumer surplus for themselves; this is why it is also known as perfect price discrimination. Nevertheless, in practice, first-degree discrimination is very rare because each consumer's preference is private and very hard to identify accurately.[21] The second degree is called versioning, which is offering information products in different versions for different market segments.[22] Sellers will identify different dimensions of a product that some customers highly value while others assign little value; therefore, it constitutes a useful tool of self-selection to appeal to customers with different willingness to pay.[23] For example, booksellers offer hardcover books and paperback books, movie producers will first lease their productions in theaters and then move to online or digital video disk, and airlines have different classes of tickets. So, when sellers implement second degree price discrimination, high-value customers who desire a higher quality product, are impatient to wait for movies to launch online, or prefer more comfortable seats, will not mind paying a higher price to receive better products or services. The third degree of price discrimination, also known as group pricing, is when sellers will offer the same product to different groups of consumers for different prices.[24] For example, students and seniors will often get discounts when buying a movie ticket. While these three types are not mutually exclusive, sellers will use them together in building a

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[19] Carl Shapiro & Hal R. Varian, INFORMATION RULES: A STRATEGIC GUIDE TO THE NETWORK ECONOMY 39 (Harvard Business School Press) (1999).

[20] *Id.*

[21] *See* Guy A. Rub, *Contracting Around Copyright: The Uneasy Case for Unbundling of Rights in Creative Works*, 78 U. CHI. L. REV. 257, 262 (2011).

[22] *See* Shapiro & Varian, *supra* note 19, at 54.

[23] *Id.*

[24] *Id.* at 39.

product distribution line. So, implementing geographic price discrimination on intellectual property related products is associated with the second and third degree.

Price discrimination occurs when there is a variation in demand for a product across countries, and sellers set different prices in different countries to serve buyers with varying willingness to pay. In the parallel importation context, people who support the national exhaustion regime will often cite the benefits of implementing international price discrimination and argue that parallel imports should be prohibited. The main arguments in favor of geographic price discrimination are divided into two parts. The first aspect is that it increases both output and access.[25] Proponents of international price discrimination argue that parallel imports permit goods in lower-priced markets to flow back to the higher-priced market and force prices in the higher-priced market to go down. Suppliers will not allow the arbitrageurs to bear fruit over time, so they will either raise the price in lower-priced markets to a global uniform price or abandon those markets altogether to reduce the harm.[26] By imposing price discrimination schemes, people in lower-income areas will still get the chance to buy the products at a lower price; therefore, compared to the uniform price, geographic price discrimination increases the output and access of the good.

The second aspect is that the price discrimination scheme will increase the total surplus, reduce the deadweight loss, encourage investment in the research and development section,[27] and

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[25] *See* David A. Malueg & Marius Schwartz, *Parallel Imports, Demand Dispersion, and International Price Discrimination*, 37 J. Int'l Econ. 167 (1994).

[26] *See* Guy A. Rub, *The Economics of Kirtsaeng v. John Wiley & Sons, Inc.: The Efficiency of a Balanced Approach to the First Sale Doctrine*, 81 FORDHAM L. REV. RES GESTAE 41, 47 (2013); S. Zubin Gautam, *The Murky Waters of First Sale: Price Discrimination and Downstream Control in the Wake of Kirtsaeng v. John Wiley & Sons, Inc.*, 29 BERKELEY TECH. L. J. 717, 733 (2014); Malueg & Schwartz, *supra* note 25, at 190.

[27] *See* Ariel Katz, *The First Sale Doctrine and the Economics of Post-Sale Restraints*, 2014 B.Y.U. L. Rev. 55, 78 (2014).

contribute to dynamic efficiency.[28] The increased output may contribute to the total surplus increase. Compared to lower-income market abandonment, price discrimination increases access to the secondary market and reduces social deadweight loss.[29] Moreover, regarding the research and development section, there is an argument against legalizing parallel trade that parallel imports will reduce the profits that the manufacturer earned, leading the investment to the product decreases initially.[30] This is an important claim in the pharmaceutical sector, and the pharmaceutical industry is often brought up by national exhaustion proponents to argue against parallel imports. This Article, however, does not address the pharmaceutical problem.

Based on the above two aspects, price discrimination is a socially desirable tool. From here, it is tempting to mistakenly infer that obstacles to price discrimination are bad. If price discrimination is desirable, then parallel importation is arbitrage and will defeat price discrimination, then it is bad, and international exhaustion

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[28] *Id.*

[29] Guy A. Rub, *Rebalancing Copyright Exhaustion*, 64 EMORY L. J. 741, 767-773 (2015). Author states, "the overall effect of price discrimination on the deadweight loss and on the access to the work is usually expected to be modest." (Author states that implementing price discrimination in a low-elasticity market, the price is expected to increase. The price's change increases the producer's surplus but also decrease in quantities, so the deadweight loss increases and the social surplus decreases; however, in high-elasticity market, sellers who implement price discrimination typically choose to reduce prices and increase quantities, then because of the corresponding increase in quantities, so the deadweight loss decreases and increases total surplus. But the total deadweight loss, taking all markets into account, is inconclusive. In most cases, these two effects cancel each other out. But overall, Professor Guy A. Rub think price discrimination is socially desirable).

[30] *See* Keith E. Maskus, *Economics Perspectives on Exhaustion and Parallel Imports,* RESEARCH HANDBOOK ON INTELLECTUAL PROPERTY EXHAUSTION AND PARALLEL IMPORTS (Irene Calboli & Edward Lee eds., 2016).

doctrine allows parallel importation, so it is also bad.[31] Therefore, nations should theoretically choose the national exhaustion doctrine. However, there is a mismatch between prohibiting arbitrage with the solution of the national exhaustion doctrine. Even within the same market, price differentiation can exist on the same commodity. This is arbitrage within a nation's geographic territory. And national exhaustion allows the domestic arbitrage. If arbitrage is the problem that new intellectual property laws should regulate, national exhaustion and international exhaustion are just different types of arbitrage. It seems strange to prohibit just one type of arbitrage (cross-border) and permit another type (domestic).[32] Therefore, taking a reflexive recourse to national exhaustion is unjustified because it is overinclusive. Moreover, even though implementing national exhaustion doctrine supports global price discrimination, investing in different prices and marketing schemes increases cost. Hence, any praise for national exhaustion must be measured against price discrimination investment costs.

C. Parallel Imports and Trademark Exhaustion Doctrine

Even though international price discrimination is a useful tool to segment the global market, parallel importation is already a global phenomenon, especially under the global trade integration environment. Parallel imports will take up a significant share of trade in the intellectual property rights related goods if permitted within nations.[33] In the trademark area, the conflict between parallel

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[31] *See* Ariel Katz, *The Economic Rationale for Exhaustion: Distribution and Post-Sale Restraints*, RESEARCH HANDBOOK ON INTELLECTUAL PROPERTY EXHAUSTION AND PARALLEL IMPORTS 23, 32-34 (Irene Calboli & Edward Lee eds., 2016).

[32] *Id.*

[33] *See* Nancy T. Gallini & Aidan Hollis, *A Contractual Approach to the Gray Market*, INT'L REV. OF L. AND ECON. 2, 19 (1999) (There are some statistic data cited in the paper, for example, a 1988 estimate of the size of the gray market in the United States was $7 to $10 billion per year;

importation and trademark exhaustion has been solved in many major markets. Most of them implement international exhaustion and permit parallel imports in general. However, to address concerns related to parallel importation (including low product quality, lower-priced products flooding the domestic market, and trademark owners' exclusive right protection), nations have adopted differing mechanisms to protect trademark owners' rights and to balance the consumers' benefit with the trademark owners' benefit. In China, the parallel importation issue appeared rather late, but China is solving the issue and balancing the benefits.

In our daily life, individuals buy luxury products (such as paintings, a Hermès Birkin bag, or a car) in a state with a lower price, and then bring it to a state with a higher price and sell it without catching any attention. So, the individual-level or retail-level parallel imports will not catch the attention of the intellectual property rights owners and producers, and the sellers make a considerable profit from the deal. This kind of behavior is also the starting symptom of *daigou* fever in China.[34] Consumers want to have more shopping choices, and so they will do comparison shopping to choose the lower price tag. In China, the primary categories of *daigou* focus on luxurious products (high-end jewelry and watches, bags, limited-edition products, etc.), clothing, cosmetic products, and daily necessities (diapers, milk powder, etc.). The high tariffs imposed on those products lead to high prices in the Chinese market. To take advantage of this, some will purchase goods abroad (while studying abroad or for work) and sell them back home for a profit. It all starts with price discrimination. *Daigou* is a variation of parallel importation in China. There are

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The U.S. gray market in luxury automobiles grew 2000% between 1981 and 1986 on the tail of considerable dollar appreciation; And as the Japanese yen appreciated at the end of the 1980s, gray imports achieved greater penetration in Japan; Some 60,000 gray market cars were imported from Europe in 1985; Gray market car sales in Germany in 1996 are estimated at over 300,000, implying a minimum of $6 billion in sales.)

[34] *See* Huifeng, He, *"China's Band of Daigou Shoppers Turn to Domestic Sales After Coronavirus Halts Overseas Trips for Luxury Goods"*, Yahoo! News (November 13, 2020).

other issues related to *daigou* behavior, which Section V will address.

With parallel importation, large volumes of parallel import goods are usually organized by parallel import firms which operate at the distributor level. In order to profit from gray market goods, parallel importers need to find a stable supply channel and a reasonable shipping line. They also need to consider the transportation costs, customs costs, and other expenditures needed for importation. The price difference between the two markets has to be big enough, or it will not offset all overhead expenses. Based on these facts, it seems meaningless to argue over the choice between national exhaustion and international exhaustion for less developed countries because parallel importation depends on the existence of considerable price differentials. So, parallel importation usually happens between developed, prosperous countries and less developed countries, like in the *Kirtsaeng* case,[35] which is a textbook parallel importation case between Thailand and the U.S.

The development of economic globalization has bonded various economies increasingly closer, with worldwide free trade being the ultimate goal. The international exhaustion principle increases access to intellectual goods in the market. It provides more shopping choices to consumers so many developing countries are

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[35] Kirtsaeng v. John Wiley & Sons, Inc., 568 U.S. 519 (2013) (stating how the Thailand student, Kirtsaeng, moved to the United States for college and stayed through the completion of a Ph.D. program. While living in the U.S., Kirtsaeng had his friends and family in Thailand purchase English version textbooks legally sold in Asian areas and ship those textbooks to him. Kirtsaeng then sold the books at a lower price than the U.S. editions. John Wiley Corp. published academic textbooks in the U.S. and abroad, and books printed in Asia area were licensed to a foreign subsidiary and then manufactured and sold throughout Asia with a copyright notice that limited authorized sale in specific areas, not including the U.S. Then Wiley sued the Kirtsaeng for copyright infringement based on Wiley's exclusive right to distribute the copyright-protected products. This case finally decided by the Supreme Court, held the copyright first sale rule does not contain a geographical limit, and the copyright exhaustion doctrine goes international since this case).

willing to accept international exhaustion, especially in patent areas. In China, intellectual property law is incomplete and parallel importation is a relatively new phenomenon. With the development of the national economy and the intellectual property industry, parallel importation cases have increased, especially for trademarked goods. This phenomenon has been catching people's attention. China implemented the international exhaustion doctrine in the patent area and codified it in the Patent Law, and the international exhaustion doctrine acquiesced in the trademark area through judicial applications. The next section will elaborate on parallel importation of trademarked goods in China.

III. TRADEMARK PARALLEL IMPORTATION IN CHINA

China is a leading nation in exports, one of the biggest manufacturing hubs in the world, and its factory output is used as a key indicator of its global demand. China is known to this day as "the world's factory." Everyone knows the phrase, "Made in China." Many historical changes have taken place in China since the initiation of economic reform and opening up to global trade in 1978. To bring in foreign capital and advanced technologies, China created numerous open door policies. With low labor costs, increased foreign investments and technologies imported from foreign countries, China's economy grew rapidly. However, in the intellectual property industry, compared to the United States and other developed nations and communities, China is lagging behind, and it is an intellectual property importation country.

China is a civil law country. After China became a member of the WTO in 2001, China made efforts to review and revise relevant laws and regulations, even departmental rules at the central government level. While China has been criticized internationally for its lack of intellectual property protections, it has been improving its intellectual property laws and regulating market behavior to respect and protect the rights of intellectual property owners. The principle legislation regarding intellectual property in China is the Trademark Law of the People's Republic of China (PRC), which was adopted at the 24th Session of the Standing Committee of the Fifth National People's Congress on August 23, 1982. The Trademark Law has been amended four times as of 2019. Each amendment revised some statutes and regulations to complete its registration system, enhanced the statutes' enforceability, and

clarified infringement situations.[36] For example, the 2019 revisions clarified the relations between a mark's use in commerce and their registration to prevent malicious trademark registration. However, there is no explicit provision covering trademark exhaustion doctrine or the parallel importation issue.

A. BACKGROUND AND RELATED STATUTES

To date, there is no explicit provision about parallel importation in the Trademark Law to identify the trademark exhaustion doctrine or regulate the parallel importation of trademarked goods, although gray market goods have long existed in China. Since 2013, China has established several Pilot Free Trade Zones. These free trade zones are multi-functional special economic zones that implement special customs supervision policies and favorable tax treatment. In principle, it means that products in these zones are imported, manufactured, and re-exported without intervention by customs.[37] The purpose behind these Free Trade Zones is to adapt to global trade liberalization and integration, promote China's economy and foreign commerce development, encourage exports, and to explore the international market. By 2019, China established eighteen free trade zones. After the first free trade zone was established in Shanghai, China launched a policy concerning parallel importation

[36] *See* 中华人民共和国商标法 [*Trademark Law of the People's Republic of China*], PEOPLE.CN (Nov. 6, 2019), http://ip.people.com.cn/n1/2019/0704/c192427-31214379.html (China); *see also* 中华人民共和国商标法[*Trademark Law of the People's Republic of China*], STATE ADMINISTRATION OF MARKET REGULATION (Apr. 20, 2020), http://gkml.samr.gov.cn/nsjg/tssps/202004/t20200420_314426.html (China).

[37] 中国自贸区指的是什么 自贸区有哪些及其有什么作用 [*What are China's Free Trade Zones?*], XINHUA SILK ROAD, https://www.imsilkroad.com/news/p/109994.html (China) (last visited Jun. 10, 2020).

of foreign cars.[38] On October 23, 2014, the General Office of the State Council issued an official statement providing suggestions for boosting the nation's imports. In the statement, the government suggested all parties involved in importation optimize import management and "accelerate the trial program for parallel car imports in the Shanghai Pilot Free Trade Zone."[39] The phrase "parallel importation" appeared in this government statement, marking the first official acknowledgment of the issue. Then, the parallel import plan later extended it to other free trade zones, including Guangdong, Tianjin, Fujian.

Through the parallel import program supported by government policy, Chinese consumers enjoy easy access to foreign luxury vehicle brands like Porsche and Land Rover, and their enthusiasm sparked sales amid softening sales in the broader market in 2017.[40] In the first eight months of 2017, auto parallel imports bought from other markets for sale in China surged 47.2% year-over-year to 110,000 units, which is a sharp increase from 16.3% growth in 2016.[41] The goal of this parallel importation car program in the free trade zones is to exploit large price differences between the luxury cars sold in countries like the U.S. and Germany, and those marketed in China.[42] The selling price of luxury cars in the aforementioned countries are cheaper than in the mainland China.[43] These numbers suggest that more and more Chinese consumers enjoy the advantage of parallel imports. Starting from the policy of allowing parallel imported cars, the trademark judicial practices in the People's Courts in China acquiescence in adopting the international

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[38] *State Council Issues Opinions on Boosting Imports*, THE STATE COUNCIL OF THE PEOPLE'S REPUBLIC OF CHINA (Nov. 6, 2014), http://english.www.gov.cn/policies/infographics/2014/11/06/content_281475006256178.htm.

[39] *Id*.

[40] *Parallel Imports Boost Chinese Auto Market*, CHINADAILY.COM.CN, http://www.chinadaily.com.cn/business/motoring/2017-09/25/content_32454382.htm (last visited June 10, 2020).

[41] *Id.*

[42] *Id.*

[43] *Id.*

exhaustion on parallel imported trademarked products, even though there is no specific statute to regulate it.

In the early 2000s, the traditional parallel importation issue was not important in China because trademark parallel importation cases rarely appeared and people barely knew about parallel imports.[44] Over time, consumers began to pay more attention to the authenticity of the products.[45] China values intellectual property and pays more attention on the development of intellectual property. With various economic policies issued and implemented, the economic situation in China is changing rapidly. Now, it is significantly more expensive to buy goods from particular industries in China, due to the high tax levied on imported goods.[46] Thus, the parallel importation issue has become important. More and more international trademark owners have brought lawsuits in China regarding parallel importation.[47] Due to these economic changes, China needs to modify the Trademark Law, define the trademark exhaustion doctrine and explicit parallel importation on trademarked goods, fill in the gaps through trademark legislation, and further develop the Chinese intellectual property system.

When courts come across parallel importation issues, they typically use Section 57 of the Trademark Law to decide the case. Otherwise, they look to other laws like the Chinese Anti-Unfair Competition Law.[48]

> Section 57 provides that: "Any of the following constitutes an infringement of the exclusive right to use a registered trademark: (1) Using a trademark that is identical with a registered trademark in connection with the same goods without the authorization of the owner of the registered trademark; … (3) Selling goods that violate the exclusive right to use a registered

[44] *Id.*
[45] *Id.*
[46] *Id.*
[47] *Id.*
[48] *Id.*

> trademark; … (5) Altering another party's registered trademark without authorization and selling goods bearing such an altered trademark; … (7) Otherwise causing prejudice to another party's exclusive right to use its registered trademark."[49]

This provision does not mention the right to prevent the importation of trademarked goods, nor does it indicate any trademark exhaustion doctrine.[50] It does not include the relative words, like the trademark owner's exclusive right.[51] However, this statute is important because almost all decisions related to trademark parallel importation cases are adjudicated relative to this statute.

B. TRADEMARK PARALLEL IMPORTATION CASES

There are not many reported[52] trademark parallel importation cases to date. This section will elaborate on some reported cases

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[49] CHINA TRADEMARKS (中国与商标) [Trademark Law] P.R.C. Laws, Sec. 57.

[50] Daniel Chow, *Exhaustion of Trademarks and Parallel Imports in China*, 51 SANTA CLARA L. REV. 1283 (2011) (discussing provisions in Section 57, which was formerly Section 52, of the Chinese Trademark Law remain the same, and do not mention the right to prevent the importation of trademarked goods or trademark exhaustion direction).

[51] *Id*.

[52] There is no official system of case reports in China, therefore many cases have no official records published. What's more, courts do not issue full opinions and rationales containing the reasoning used in decisions, and instead of using simple sentences illustrate main points in the judgment. The facts, rationales of cases used and cited in this article are either come from the reported cases judgments, or known because of short articles written by lawyers, judges, legal scholars, and legal workers work in the intellectual property area. However, there is an official website that people can search cases decisions issued by the Supreme People's Court, and the website is http://www.court.gov.cn/wenshu.html. Because there is

focusing on how courts adopt the international exhaustion doctrine in the trademark area. However, one premise that needs to be clear is the cases decided by lower levels of the People's Court are not binding cases: only cases decided by the Supreme People's Court are binding.[53] However, there is no such case yet. Even though the cases discussed in this Article are not binding cases, they can manifest a trend of the probable direction the Supreme People's Court may take on trademark parallel importation cases. By following these cases, the courts' attitude towards the parallel importation in trademark area becomes clear and consistent, especially after the year 2016. This section is divided into three parts: the first part is cases from 1999 to 2013, the second is cases from 2013 to 2016, and the last part is cases from 2016 to present.

After China became a member of the WTO, China opened more to the world.[54] Many multinational companies chose to establish a subsidiary or an affiliate as manufacturing facilities in China to produce and sell goods in the Chinese market; these companies were enticed by the low labor cost and attractive foreign investment economic policies.[55] A typical situation involving parallel importation may involve a multinational company with a brand owner who has already registered its trademark in China, and the company also established a facility for manufacturing in China, which is wholly owned by the company or as a joint venture with a Chinese partner.[56] Then, the brand and trademark owner licenses its trademark to its joint venture, subsidiary or affiliate in China to produce its trademarked goods for sale either in China or export them to foreign countries.[57] The trademarked goods are then manufactured in China, exported from China, and purchased by a

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no trademark parallel importation case adjudicated by the Supreme People's Court to date, and there are only some guidance comments issued by the Supreme People's Court on the already decided cases, controlling as to why there is no reported case published on this website.

[53] *Id*.

[54] *Id*.

[55] *Id*.

[56] Chow, *supra* note 50, at 1283.

[57] *Id*.

third party in a foreign country who attempts to import them back.[58] Another situation involving parallel importation concerns a Chinese company signing an exclusive license agreement with the trademark owner to use the trademark, produce goods and sell them in China; meanwhile, the trademark owner also signs a license agreement with a third country (for instance, Singapore) and then a third party buys the authorized trademarked goods in the third country and subsequently imports them into China. In these situations, the trademark owner or the exclusive licensee will claim the parallel importation of trademark goods without their consent constitutes an infringement of the trademark owner's exclusive rights because there is no clear statute to regulate this behavior.

The first reported case involving trademark parallel importation was the *Lux* case in 1999. The following section uses cases to show that China's attitude towards parallel importation of trademarked goods has been acquiescent, implicitly applying the international exhaustion regime.

1. 1999 to 2013 — Avoiding the Issue

Lux[59] is the first reported case in China related to parallel imports. The plaintiff, Shanghai Lihua Co., Ltd., was a joint venture between a Netherlands company, Unilever Co., Ltd., and a local Chinese business entity.[60] Unilever registered its "Lux" trademark and its Chinese transliteration trademark "Lishi" (力士) in China. In 1997, Unilever signed a trademark licensing agreement with Shanghai Lihua for the use of its trademark "Lux" and "Lux力士,"

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[58] *Id.*

[59] *Shanghai Unilever Co. Ltd v. Commercial Imp. and Exp. Trading Co. of Guangzhou Econ. and Tech. Developing Dist.*, Hui Zhong Fa Zhi Chu Zi, No. 82, Guangzhou Intermediate People's Court, (1999) [hereinafter *Lux*], http://pkulaw.cn/fulltext_form.aspx?Db=art&Gid=df7e46676f6e0e3ba627d91534159397bdfb&keyword=&EncodingName=&Search_Mode=&Search_IsTitle=1.

[60] *Id.*; Andrea Zappalaglio, *The Exhaustion of Trademarks in The PRC Compared with the US and EU Experience: A Dilemma That Still Needs an Answer*, EURO INTELL. PROP. REV (2016).

and manufactured consumer products and sold them under those two trademarks in China. On October 5, 1998, Unilever entered into a revised agreement with Shanghai Lihua to change the licensing method to exclusive license and also granted the licensee the right to take legal action, including litigation, or any other action the receiving party considers appropriate against any infringement of such right.[61] On June 7, 1999, the Customs Office in Foshan, Guangdong Province discovered and seized 895 boxes of soap bearing the "Lux" trademark that were manufactured in Thailand and imported into China by the defendant, the Guangdong Commercial Import and Export Trading Company, without the plaintiff's consent.[62] The plaintiff brought an action in the Guangzhou Intermediate People's Court seeking an order to stop the defendant importing and selling the goods which infringed on the exclusively licensed right of the plaintiff to use the trademark.[63] After hearing the case, the Court held that the defendant imported the soap without authorization from the plaintiff, and infringed the trademark right and the exclusively licensed right of the plaintiff to use the "Lux" trademark.[64] The defendant argued that the soaps were authorized genuine products, not knock-off goods. The defendant also stated that the soaps were ordered by one Hong Kong company, and that Hong Kong company bought them from BN Marketing Company, which bought them from Supamitl.V. Company, which claimed it is the distributor for the Unilever Thai Holding Company.[65] This case is a typical parallel importation case. However, when this issue appeared in front of the court, the court chose not to face the main issue; instead, the court held that the defendant failed to prove that it had imported the original Lux products and failed to prove that it had made the Lux products under the authorization of Unilever.[66]

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[61] *See Lux*, *supra* note 59.
[62] *Id.*
[63] *Id.*
[64] *Id.*
[65] *Id.*
[66] *See Lux, supra* note 59.

In simple terms, the court bypassed the main issue—parallel importation—and chose to decide on whether the defendant gave enough evidence to show those "Lux" trademarked soaps were authorized products. It's hard to explain why the court chose to circumvent the main issue. Maybe, at that time, the court did not realize the *Lux* case was a parallel importation case; it's also possible the court did not feel confident to decide a case with a novel issue because there was no statute and no prior cases. In sum, the court missed the first chance to clarify the parallel importation issue and felt reluctant to deal with it.

The next case related to parallel importation is the *AN'GE*[67] case. An'ge Co., Ltd. France is the owner of the "An'ge" trademark. On October 30, 2000, the plaintiff, Beijing Fahuayilin Commercial Company, signed a contract to obtain an exclusive license for the use of the An'ge trademark on clothing.[68] According to the license agreement, the plaintiff has the exclusive right to use the trademark and sell clothing with the An'ge trademark in the cities of Beijing, Shanxi, Chongqing, Zhejiang, and several other cities and provinces.[69] In April 2001, the defendant opened a counter in Taipingyang Department Store in Chongqing and sold An'ge trademarked clothing. The defendant stated the clothing was imported from Hong Kong Ruijin Company, and Ruijin Company is the "An'ge" authorized distributor in Hong Kong.[70] On August 8, 2001, the plaintiff sued the defendants claiming that the defendants infringed on the plaintiff's exclusive right of selling clothing with the An'ge trademark, and requested the court to stop the unfair competition and compensate the plaintiff for economic losses.[71] The Beijing Basic People's Court held that the plaintiff had acquired the exclusive right, but this exclusive right could not exclude a third party from selling clothing with the same An'ge

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[67] *Fahuayilin Inc. v. Shijihengyuan Inc. & Taipingyang Dep't Store*, Beijing No. 2, Intermediate People's Court (2003), http://www.chinaipmagazine.com/journal-show.asp?779.html.

[68] *See id.*

[69] *See id.*

[70] *See id.*

[71] *See id.*

trademark in the same market.[72] The plaintiff appealed and instead argued under Article 5 of the Anti-Unfair Competition Law based on the same facts.[73] The Beijing Intermediate People's Court followed the lower court in affirming the plaintiff's rights while nevertheless vindicating the defendant. On one hand, the court affirmed that the appellant had acquired the exclusive right to use the An'ge trademark. On the other hand, the court held that the appellee legally bought the clothing, imported it from Hong Kong, and sold it in Chongqing.[74] The court stated that the An'ge clothing sold by the appellee did not cause consumers' confusion regarding the source of the goods and it did not affect the reputation of the An'ge trademark.[75] However, this case was not decided under trademark law because the An'ge French Company did not register its trademark according to the Chinese Trademark Law. So, the plaintiff brought this case under the Anti-Unfair Competition Law because unregistered trademarks are not entitled to protection under the Trademark Law. Finally, the court decided that the appellant's claim was short of legal and factual evidence under the Anti-Unfair Competition Law and affirmed the Basic People's Court decision.[76]

The *An'ge* case was another opportunity for the Chinese court to rule on the issue of parallel importation. The claim under the Anti-Unfair Competition Law was based on business concepts and not on trademark rights, so the court was unable to rule on whether

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[72] *See id.*

[73] *See Anti Unfair Competition Law of the People's Republic of China* (promulgated by the Ministry of Commerce P.R.C. Laws, Sept. 2, 1993, effective Dec. 1, 1993), art. 5 P.R.C. LAWS ("Managers should not use the following unfair methods in their business transactions which can damage other competitors: … (2) to use the specific name, package, decoration of the famous or noted commodities, or use a similar name, package, decoration of the famous or noted commodities, which may confuse consumers distinguishing the commodities to the famous or noted commodities… ").

[74] *See* Fahuayilin Inc. v. Shijihengyuan Inc. & Taipingyang Department Store, Beijing No. 2, (Intermediate People's Ct. 2003) (China), http://www.chinaipmagazine.com/journal-show.asp?779.html.

[75] *See id.*

[76] *See id.*

the trademark owner's rights were exhausted. Even though this case was not decided on the parallel importation issue, this case mentioned the imported clothing that was authorized for sale in another market did not cause consumer confusion, and the defendant's sale in Chongqing was not unfair competition. Based on this case, to regulate gray market goods, the courts should hold that the reason why imported clothing are not infringed goods is because the trademark owner exhausted the exclusive rights after the first sale; however, the trademarks need to be registered in China at first. Maybe around the time this case was decided, parallel importation was not a thorny problem in China and there were not many parallel importation cases; also, the plaintiff, in this case, filed the lawsuit under the Anti-Unfair Competition Law.

Before 2013, there was another case reported about parallel importation—the *Michelin Tires* case.[77] In this case the plaintiff was Michelin, a famous French multi-national company that manufactured tires and had already registered its "MICHELIN" series trademarks in China, which included the "MICHELIN" trademark and its Michelin tires figure that the company used on all its products.[78] Michelin's China affiliate manufactured Michelin branded tires and sold its products in China; however, Michelin also entered into a licensing agreement with a Japanese licensee that authorized the licensee to manufacture and sell the Michelin tires in Japan.[79] In April 2008, the plaintiff found out that the two

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[77] *See* Compagie Generale des Etablissements Michelin v. Tan Guoqiang & Ou Can, (Chang Zhong Min San Chu Zi No. 0073 Civil Written Judgment), (Changsha (Hunan Province) Intermediate People's Ct., 2009) (China), https://www.fahejia.com/view?id=7cd2acfc02de42f2b4f93e00acff467c&userid=3cde0acb16a04cc2bba315ead7e7d846&type=2. [hereinafter Michelin v. Tan Guoqiang & Ou Can].

[78] *See id.*

[79] Huang Hui Huang Yibiao (黄晖 黄义彪), *On Trademark Infringement Related to Parallel Import* (略论与平行进口有关的商标侵权行为), (Mar. 12, 2020, 12:22 PM), https://www.fahejia.com/view?id=7cd2acfc02de42f2b4f93e00acff467c&userid=3cde0acb16a04cc2bba315ead7e7d846&type=2.

defendants, Tan Guoqiang and Ou Can, sold Michelin tires that Michelin China did not authorize, which infringed the plaintiff's exclusive trademark rights.[80] The defendants stated they bought the authorized Michelin tires in Japan, which are cheaper than the locally manufactured tires in China, and then imported the tires to sell in China.[81] The plaintiff sued the defendants in Changsha Intermediate People's Court for an order to prohibit the defendants from importing the gray market tires, to pay compensation for the economic loss, and to make a public apology in the national media to dispel the impact of the infringement.[82] The plaintiff had a registered trademark in China, while the defendants bought the genuine authorized products at a cheaper price and then imported them into China without the plaintiff's consent; this is a typical parallel importation case.[83] However, the court decided the case from an alternative point: the gray market tires had not obtained a Chinese Compulsory Product Certification (the so-called "3C" Certificate).[84] The 3C Certification is a mandatory product certificate regulation issued by government departments implementing unified standards and assessment procedures, unified logo and charges on all products included in the Catalog, and requirements to meet the national safety standard.[85] Tires are included in the Catalog.[86] The court held that, even if the tires were Michelin authorized tires manufactured in Japan, the tires sold by defendants in the Chinese market had not acquired the 3C Certification, which meant that those tires may not have met the Chinese national standard and may have quality and safety issues.[87] If those issues appeared in the process of using the tires, consumers would attribute the problems to Michelin Company, which would

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[80] *Id.*
[81] *Id.*
[82] *Id.*
[83] *See id.*
[84] *Id.*
[85] *CCC Mandatory Products*, MPR CHINA CERTIFICATION, https://www.china-certification.com/en/list-of-ccc-mandatory-products/.
[86] *See id.*
[87] Yibiao, *supra* note 79.

jeopardize Michelin's goodwill in China.[88] Therefore, the court held that the importation of those gray market tires would cause prejudice to the exclusive right of the owner of a registered trademark based on §§ 52(2) and (5)—now §§ 57(2) and (5)—of the Trademark Law.[89]

In the *Michelin* case, the court bypassed the crucial point and decided based on a sub-prime issue. However, if the defendants got the mandatory 3C Certification and sold the imported gray market tires, could we consider those tires to have not infringed the trademark owner's exclusive rights? Some Chinese scholars think this *Michelin* case indicated that, as long as those Michelin tires satisfied the Chinese national safety standard, they did not cause consumer confusion and did not cause prejudice to the goodwill of the company; thus, parallel importation is allowed in China. This leads to the next case, the *Victoria's Secret* case, and next era of parallel importation law, from 2013 to 2016.

2. *2013 to 2016 — Heightened Controversy*

It seems that the number of parallel importation cases heard in the courts have been increasing since 2013. The attitude towards the trademark exhaustion regime is becoming clearer, but there is still confusion in legal practice. *Victoria's Secret* is an example case for this period.[90] In this case, the plaintiff Victoria's Secret registered many trademarks related to its brand under many classes, including "Victoria's Secret" and its transliteration into Chinese, "Victoria's Secret Pink."[91] The plaintiff did not open retail

[88] *Id.*

[89] *See id.*

[90] Weiduoliyade MiMi Shangdian Pinpai Guanli Youxian Gongsi Yu Shanghai JinTian Fushi Youxian Gongsi Shangbiaoquan Ji Buzhengdangjingzheng Jiufen An (维多利亚的秘密商店品牌管理有限公司与上海锦天服饰有限公司侵害商标权及不正当竞争纠纷案) [Victoria's Secret Stores Brand Management, Inc. v. Shanghai Jintian Clothing, LLC.], (2012) Hu Er Zhong Min Wu (Zhi) Chu Zi No. 86 (Shanghai No.2 Intermediate People's Court 2012) (China).

[91] *Id.*

businesses in China at that time, and the plaintiff found out the defendant, Shanghai Jintian Clothing LLC, was selling products online under those marks.[92] The plaintiff sued the defendant for infringing its exclusive trademark right and stated the defendant's business behavior constituted unfair competition and false advertisement, so the plaintiff requested an order to stop the defendant's infringing behavior and compensate the plaintiff's economic loss.[93] The defendant argued that all the products were bought from the Victoria's Secret parent company, Limited Brands, Inc. (LBI), and all the products were genuine products that were authorized to use the Victoria's Secret series of trademarks.[94] The court held that even though the wholesale method that the defendant used to sell through the Internet violated the contract with LBI, the sales of goods were authentic goods that were parallel imported after being purchased from the authorized company.[95] However, the complaint did not include a breach of contract claim. Therefore, the court held that the defendant's actions did not constitute an infringement on the plaintiff's exclusive trademark rights.[96] The court upheld the unfair competition and false advertisement claims because the way that the defendant advertised caused consumers' confusion to believe the defendant was the only designated general distributor of the Victoria's Secret brand.[97]

From the parallel importation aspect, the court decided in favor of the parallel importer in this case. In comparison to the plaintiff in *Michelin*, Victoria's Secret does not need to apply for certification to prove the quality of their products. As long as the gray market goods are genuine products, there is no consumer confusion and no damage to trademark goodwill, and there are no material differences between the gray market goods and other authorized products that sell in the domestic country, the parallel imported goods are allowed in China. To be honest, it seems the attitude towards the trademark

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[92] *Id.*
[93] *Id.*
[94] *Id.*
[95] *Id.*
[96] *Id.*
[97] *Id.*

parallel importation in the *Michelin* case is the same as in the *Victoria's Secret* case besides the certification requirement. Because there is no statute to clarify the approach, the court felt there is not enough standing to rule on this issue. All the cases were not decided by the Supreme People's Court, so there is no binding effect. Furthermore, there is no judicial interpretation issued by the Supreme People's Court with regard to parallel importation cases. Therefore, the courts in different provinces accidentally choose to hear the case from side issues.

Following the *Victoria's Secret* case there are several other cases about parallel importation. The *J.P. CHENET* case[98] is about parallel imported wine that the defendant, Monte International Trade (Tianjin) Co. Ltd., bought from an English company, Castillon International Ltd., which got the authorized genuine products from the plaintiff's authorized English distribution company.[99] The plaintiff, the French company Les Grand Chais De France S.A.S., registered its trademark, J.P. CHENET, in China and authorized Dynasty (Tianjin) Co. as the exclusive distributor in China to sell its products.[100] The plaintiff claimed that the defendant's imported wine was different in many aspects from the wine authorized to sell in the Chinese market, including the wine's quality grade, composition, expiration date, price, and after-sale service.[101] So, the plaintiff brought a lawsuit against the defendant for infringing its exclusive right to the trademark and requested an order to stop the defendant from importing and selling J.P. CHENET wine and to stop using J.P. CHENET trademark or any other similar marks on any product packaging, advertisement, and any other promotional materials.[102] The court found that it was the brand owner's right to produce different quality levels, different series,

[98] 法国大酒库股份公司诉慕醍国际贸易（天津）有限公司侵害商标权纠纷案—平行进口中的商标侵权判定 [Les Grand Chais De Fr. S.A.S. v. Monte Int'l Trade (Tianjin) Co., Ltd.], 2012, (Tianjin Interm. People's Ct. Nov. 3, 2015) (China).

[99] *Id.*

[100] *Id.*

[101] *Id.*

[102] *Id.*

and different types products, and the brand owner's right to sell to different markets with the same or different marks.[103] The defendant's imported wine was an authorized genuine product in England, and the defendant declared the wine at customs in China.[104] Moreover, the court stated that there was no consumer confusion, and it was the consumers' choice to buy which kind of J.P. CHENET wine.[105] Therefore, there was no trademark infringement. The Tianjin Intermediate People's Court allowed the parallel imported wine.

In sum, even though there were differences between the imported products and the products authorized to sell in the domestic market, the courts upheld the parallel importer. Those small differences were not material enough to cause consumer confusion and affect the trademark's goodwill.

During this period, there are several other parallel importation cases, such as Gucci *v. Shanghai Milan Outlet* (2013), *Prada v. Xinjiang Shenshi Trading Co.* (2015), and *Fendi v. Shanghai Yilang Co.* (2016). The fact patterns in these three cases are similar.[106] To summarize, the facts are the following: Gucci, Prada, and Fendi are well-known world-famous brand names and trademarks; the defendants in those three cases respectively sell authentic gray market products in different stores without the trademark owners' authorization.[107] In the *Gucci* case, the defendant highlighted the brand name "GUCCI" and "OUTLET GUCCI" in the store's signboard and inside decorations without any other identification to

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[103] *Id.*
[104] *Id.*
[105] *Id.*
[106] Li Jieqian (李婕茜), *An Shui "Quanmin Hai Tao" Shengkuang Xia Pingxingjinkou Faluwenti Ji Zhuyishixiang* (案说"全民海淘"盛况下平行进口法律问题及注意事项 [*The Case Says Parallel Import Legal Issues and Precautions Under the Prosperous Situation of "All-People Overseas Shopping"*], ZHICHANLI (知产力), Apr. 23, 2018, http://news.zhichanli.cn/article/6210.html.
[107] *See generally id.*

differentiate the source of goods.[108] While in the *Fendi* case, which was also in Shanghai, the defendant's store operated in a Shanghai outlet shopping mall, and the defendant used "FENDI" in the store's signboard to indicate that the store was selling Fendi products.[109] The plaintiffs in both cases sued defendants for exclusive trademark rights infringement and unfair competition.[110] Although both cases were in Shanghai, the cases were in different District People's Courts with different results.[111] In the *Gucci* case, the court decided that the defendant infringed the plaintiff's exclusive trademark rights because the defendant highlighted the plaintiff's trademarks without any identification to explain the source of goods.[112] Thus, the defendant mislead consumers to believe that the defendant's store is an authorized business or that the plaintiff invested in the defendant's business.[113] In contrast, the defendant in the *Fendi* case did not infringe on the plaintiff's trademark because the way that the defendant used the Fendi trademark belongs to nominative use, which reasonably indicates that authentic Fendi products are sold in the store, and because the defendant clearly marked its company's information, name, and contact method.[114] The defendant also stated that its business included other brands' products.[115] Furthermore, the *Prada* case's result is similar to the *Gucci* case's result.[116] This is because the defendant's use of the Prada trademark mislead consumers as to the source of the goods and caused customers to misunderstand whether or not there was a business authorization between Prada and the defendant.[117]

The reason why these three cases appear in this section is because the judicial practice regarding parallel importation from

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[108] *Id.*
[109] *Id.*
[110] *Id.*
[111] *See id.*
[112] *Id.*
[113] *Id.*
[114] *Id.*
[115] *Id.*
[116] *See id.*
[117] *Id.*

2013 to 2016 is controversial and unclear. In the three cases above, all of the plaintiffs brought the unfair competition claim with the trademark exclusive right infringement claim.[118] According to Article 6(2) of the latest Anti-Unfair Competition Law of the PRC, unfair competition occurs when one party overuses and takes advantage of a trade name in business without authorization and misleads consumers to believe that there is a connection between the two parties.[119] With the unfair competition claim in the three cases above, all the courts decided that the defendants' business behavior constituted unfair competition, even though they sold genuine gray market products.[120] Since there is no statute on trademark exhaustion, the courts emphasized the unfair competition and tried to use Anti-Unfair Competition Law to regulate the parallel import phenomenon.[121]

In 2016, the Beijing Superior People's Court issued a legal document to clarify some intellectual property legal issues.[122]

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[118] *Id.*

[119] Zhonghua Renmin Gongheguo Fanbuzhengdang Jingzheng Fa (中华人民共和国反不正当竞争法) [ANTI-UNFAIR COMPETITION LAW] (promulgated by the Standing Comm. Of National People's Cong., Nov. 4, 2017, effective Jan. 1, 2018), art. 6, § 2, http://gkml.samr.gov.cn/nsjg/fgs/201906/t20190625_302771.html (China) ("Business operators shall not carry out the following confusing acts to lead people to mistakenly believe that they are products of others or have specific connections with others … Unauthorized use of the names of enterprises (including abbreviations, font sizes, etc.), names of social organizations (including abbreviations, etc.), names (including pen names, stage names, translated names, etc.) that have a certain influence by others").

[120] Jieqian, *supra* note 106.

[121] *See id.*

[122] *See generally* Dangqian Zhishichanquan Shenpan Zhong Xuyao Zhuyi De Ruogan Falv Wenti (当前知识产权审判中需要注意的若干法律问题) [*Several Legal Issues that Need to be Paid Attention to In the*

Trademark parallel importation was one of the included legal issues.[123] The legal document stated that trademark law is not created for trademark owners to monopolize the goods' circulation.[124] The trademark exhaustion doctrine is one of the basic rules of market competition and needs to be designed to promote the free movement of goods.[125] Based on this, if the accused infringing products come from the trademark owner or under his authorization, the trademark owner has already received the commercial value of the trademarked goods from the first sale.[126] The trademark owner cannot prevent others from secondary sales or other reasonable commercial marketing.[127]

3. 2017 to Present — Emerging Consensus

From 2017 to present day, the controversy on trademark parallel importation is calming down, and the growing consensus in the academic and legal community is that trademark parallel importation is not an infringement behavior. They think parallel importers are retailers of legitimate goods. As long as genuine products are not altered in any form, the connection between the trademarked goods and trademark owners is not isolated. Therefore, the resale of legitimate parallel imported goods should be permitted. The *Daio Paper GOO.N* case is a strong example of these principles.

In 2017, Daio Paper Corporation and Dawang (Nantong) Living Supplies Company, Ltd. filed several civil lawsuits in Tianjin and Hangzhou City, which were all based on the parallel imported

Current IP Trial], ZHONGGUO GUOJIMAOYI CUJIN WEIYUANHUI ZHUANLI SHANGBIAO SHIWUSUO (中国国际贸易促进委员会专利商标事务所) [CCPIT PATENT AND TRADEMARK LAW OFFICE], at Zhishichanquan Xinwen (知识产权新闻) [INTELLECTUAL PROPERTY NEWS], May 7, 2016, https://www.ccpit-patent.com.cn/zh-hans/node/3197.

[123] *Id.*

[124] *Id.*

[125] *Id.*

[126] *Id.*

[127] *Id.*

"GOO.N" diapers.[128] Daio Paper Corp. (Daio) registered its GOO.N trademark in China under class 16 for facial tissue, toilet paper, diapers, etc.[129] In 2015, Daio signed a trademark licensing contract with Dawang (Nantong) Living Supplies Company, Ltd (Dawang) and licensed Dawang to exclusively use the GOO.N trademark in Mainland China.[130] That same year, the plaintiffs Daio and Dawang discovered that the defendants sold GOO.N diapers online on websites "Tmall.com" and "Taobao.com."[131] The plaintiffs then filed several lawsuits in two cities, Tianjin and Hangzhou, all including the same claim that the parallel imported diapers are materially different from the diapers sold in Japan and it infringed the plaintiffs' trademark exclusive rights based on Section 57 of the Trademark Law.[132] The material differences in the claim mainly include the diapers' permeability index and the after-sale service.[133] However, the Tianjin No. 2 Intermediate People's Court and the Zhejiang Superior People's Court decided that there was no essential difference between the parallel imported diapers and the domestic diapers sold in Japan, including the trademark logo, diapers packaging, and the quality of the products.[134] As to the difference of the permeability index, the courts held that this index

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[128] *Daio Paper Co. v. Tianjin Senmiao Import&Export Co., Ltd.*, (2017) Jin 02 Min Zhong No. 2036; *Daio Paper Co. v. Hangzhou Jun'ao Trading Co. Ltd.*, (2017) Zhe Min Shen No. 1714. The Civil Written Judgment come from the China Judgement Online websites: https://wenshu.court.gov.cn/website/wenshu/181107ANFZ0BXSK4/index.html?docId=5d8961f58abb43dd9c8da7a600e5f35f; and https://wenshu.court.gov.cn/website/wenshu/181107ANFZ0BXSK4/index.html?docId=1e1a2214c3564dca8bf0a8db009e398b.

[129] *Id.*

[130] *Id.*

[131] Taobao.com is a Chinese online shopping website, headquartered in Hangzhou, and owned by Alibaba. It is analogous to eBay.com or Amazon.com in the U.S. Taobao Marketplace facilitate consumer-to-consumer retail by providing a platform for small business and individual entrepreneurs to open online stores that mainly cater to consumers in China and abroad, which is made payable by online cellphone accounts.

[132] *See Parallel Imports Boost Chinese Auto Market, supra* note 40.

[133] *See supra* note 128.

[134] *Id.*

belongs to diapers permeability quality index and is only one of the other several quality indexes of diapers, and the most important thing is the parallel imported diapers' index on permeability meets the Chinese standard on diapers.[135] So, parallel imported diapers are qualified products. Moreover, as to the after-sale service, the plaintiffs claimed that they have a whole system of after-sale service that the parallel importers cannot supply, and it is going to affect the trademark goodwill if the consumers have issues after they bought the parallel imported diapers.[136] On this point, the courts held that even if the after-sale service is different, the consumers have the expectations for after-sale service when they choose to buy the parallel imported diapers, which means the consumers knew the products are parallel imported, so it will not derogate the trademark value.[137] In conclusion, the courts held that the parallel imported legitimate goods meet the products quality management standards in China, and it provides more shopping choices to domestic consumers.[138] Plus, the parallel importers did not alter the goods, so it will not cause consumers' confusion, and it will not damage the trademark's function of indicating the source of goods and the trademark's goodwill.[139]

With more and more gray market goods appearing in the Chinese market, the parallel importation phenomenon is a known trend and consumers are already familiar with parallel imported products. Consumers have more choices than ever. For instance, they can shop around to find the cheapest price, and they can also get a product that has not been put on the shelf in the Chinese market. The latter example is derived from parallel importation called *daigou* (shopping agents) or *haitao* (overseas online shopping) that will be elaborated on in the last section of this article. It's a parallel importation variation. As previously stated, the parallel importation issue is still in the embryonic stage of

[135] *Id.*
[136] *Id.*
[137] *Id.*
[138] *Id.*
[139] *Id.*

development in China.[140] Still, the booming international intellectual property trade and the great attention to intellectual property development devoted by the Chinese government require a clear, definite, and transparent statute on parallel importation.[141] If not, it will affect the intellectual property transaction environment, destroy market order, cause consumers' confusion, and damage trademarks.[142] The *daigou* fever discussed in Section V will explain this in further detail.

Before we conclude the discussion of trademark parallel importation, there is one last case. This is the case decided by the Nansha District People's Court within the Guangdong Free Trade Zone.[143] The first time the term "parallel importation" officially appeared in the government documents is when the country began to establish Free Trade Zones.[144] In August 2019, Nansha District People's Court in the Guangdong Free Trade Zone announced its first instance judgment on the initial group of cases on parallel-import-related trademark infringement and unfair competition.[145] The plaintiff in this case, OBD Bettermann (Shenzhen), a wholly-owned subsidiary of the German company, was authorized to exclusively use the two "OBO" trademarks (in different series numbers) in China that were registered in 2006 and 2011 respectively.[146] The plaintiff was also authorized to protect the trademark rights in its name.[147] OBD Shenzhen claimed that all of its lightning protectors were imported from Germany and sold either by itself or by authorized dealers.[148] In December 2017, the

[140] *See infra* Section VI.

[141] *See infra* Section VI.

[142] *See infra* Section VI.

[143] The First Batch of Trademark Infringement and Unfair Competition Cases Involving Parallel Imports in Guangdong Free Trade Zone Were Publicly Judged, PEOPLE'S DAILY ONLINE (July 30, 2019, 9:35 AM), http://ip.people.com.cn/n1/2019/0730/c179663-31264186.html.

[144] *See id.*

[145] *See id.*

[146] *See id.*

[147] *See id.*

[148] *See id.*

company found that the lightning protectors labeled with the OBO series trademarks were sold by the defendant, Guangdong Shifu Electric Industry Co. Ltd., and used in a large construction project and neither itself nor its dealers were part of the transaction.[149] The plaintiff claimed that the defendant infringed on its exclusive trademark rights and constituted unfair competition.[150] The defendant argued that the products were produced by the enterprises authorized by the OBO Germany and imported from Singapore dealers after clearing customs formalities.[151] They argued further that the products were genuine and authorized to be sold by the trademark owner in Singapore.[152] After the hearing, the court held that the imported products were genuine products and the defendant's importation did not violate any public policy and legal restriction in China, so it should not be assessed negatively.[153] The court also held that the parallel imports did not damage or distort the choices of market players and consumers, thus there was no unfair competition.[154] In conclusion, the court ruled in favor of parallel importers and the plaintiff in this case appealed.[155]

Based on the above case study, China recognizes the legal status of parallel imports by adopting the international trademark exhaustion in judicial practice.[156] Trademark owners' claims may not be upheld by courts to prohibit parallel imports as long as those parallel imports are authorized products sold in other markets and have not been altered or modified.[157] However, as a civil law country, there are many other details that need to be defined on the trademark parallel importation issue in China, like the products' material differences, repackaging issues, Chinese product national

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[149] *See id.*
[150] *See id.*
[151] *See id.*
[152] *See id.*
[153] *See id.*
[154] *See id.*
[155] *See id.*
[156] *See id.*
[157] *See id.*

standard issues, damages, relief issues, etc.[158] The trademark exhaustion statute needs to clarify the general international exhaustion approach adopted by Chinese trademark law and extend to further details of the rule. For example, to what degree can the material differences be accepted on parallel imports? What categories of parallel imports need to meet Chinese national product quality standards, if any? Before we proceed to the proposed trademark exhaustion statute, I will discuss how the trademark exhaustion doctrine works in other countries, as it seems Chinese courts took on some approaches from other countries.

IV. HOW TRADEMARK EXHAUSTION WORKS IN MOST COUNTRIES

A. TRADEMARK EXHAUSTION IN THE UNITED STATES

Historically, the exhaustion doctrine "dates back to the late nineteenth century, when the unprecedented economic change led to a rise in product manufacturing and the growing availability of commercial goods."[159] Trademark owners attempted to use exclusive trademark rights to further control downstream commercial sales after the initial sale.[160] To counter this attempt, North America and Europe reached, at first, the conclusion that manufacturers could not use trademark rights to further control purchasers' rights on subsequent sales activities.[161] After the initial sale, the purchasers are free to dispose of their property.

The limitation of trademark owners' rights is imposed upon trademark owners by the principle of trademark first sale or trademark exhaustion. The trademark exhaustion principle "preserves an area for competition by limiting the producer's power to control the resale of its product."[162] After the first sale, the

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[158] *See id.*
[159] Calboli, *supra* note 10, at 1251.
[160] *See id*. at 1251-52.
[161] *See id*.
[162] *Sebastian Int'l, Inc. v. Longs Drug Stores Cor*p., 53 F. 3d 1073, 1075 (9th Cir. 1995).

trademark owners gain rewards and goodwill associated with the quality of their products. The consumers get what they bargained for—the genuine product—and they will not be confused about the products' identification.[163] The case is going to be different if the third party altered the quality of the marked product without the trademark owner's consent after the first sale.[164]

In the U.S., importation of genuine goods with U.S. protected trademarks is generally permitted as long as there is no consumer confusion about the origin or quality of the imported goods. The U.S. adopts the international exhaustion regime in trademark law. In *K Mart Corp. v. Cartier,* the Supreme Court held that a U.S. Customs Service regulation, promulgated by the Secretary of the Treasury, "permit[s] the importation of certain gray-market goods where (1) both the foreign and U.S. trademarks are owned by the same person or business entity, or (2) the foreign and domestic trademark owners are a parent and subsidiary companies or are otherwise subject to common ownership or control, or (3) the trademark is applied by an independent foreign manufacturer under the authorization of the U.S. owner."[165] Moreover, Sections 32, 43, and 42 of the U.S. Lanham Trademark Act (Lanham Act) provide the provisions that regulate trademark infringement and importation of trademarked goods. Section 32 allows civil action for the U.S. registered trademarks;[166] Section 43(a) mainly stipulated civil action for the unregistered trademarks;[167] Section 43(b) is about importation—it gives the trademark owners the right to block importation or refuse entry when any goods marked or labeled in contravention of the provisions of this section and the goods are likely to confuse consumers or infringe or dilute the registered or unregistered trademarks.[168] Section 42 authorizes the U.S. Customs and Border Protection (CBP) to prevent importation of goods that

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[163] *See id.*; *see also* Calboli, *supra* note 10, at 51.

[164] *Id.*

[165] K Mart Corp. v. Cartier, 486 U.S. 281, at 289 (1988); 19 CFR 133.21 (c)(1)-(3).

[166] 15 U.S.C.A. § 1114.

[167] 15 U.S.C.A. § 1125(a).

[168] 15 U.S.C.A. § 1125(b).

infringe on the registered or unregistered U.S. trademarks.[169] Additionally, the "Lever-rule," which comes from the case *Lever Bros. C. v. United States,*[170] also helps trim the edges of importation and exhaustion rules. The Court's conclusion allowed the trademark owners to bar the importation of gray market products when the products "differ materially" from the goods authorized for sale domestically in the U.S., "regardless of the trademark's genuine character abroad or affiliation between the producing firms."[171]

But what triggers the material difference doctrine which blocks parallel importation? The U.S. courts held that even "subtle differences" are enough because there is a "low threshold of materiality."[172] Any higher threshold would endanger a manufacturer's investment in product goodwill and unduly subject consumers to potential confusion by splitting the connection between the trademark and its associated product characteristics.[173] This also violates the original intention of trademark law. The courts said there is no mechanical way to determine the point at which a difference becomes "material," and it's like "separating the wheat from chaff," which "must be done on a case-by-case basis."[174] For example, material differences have been found in cases including chocolates with different shapes;[175] minor differences in

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[169] 15 U.S.C.A. §1124 (1999).

[170] Lever Bros. Co. v. United States, 877 F.2d 101 (DC Cir. 1989); Lever Bros. Co. v. United States, 981 F.2d 1330 (DC Cir. 1993).

[171] *Lever Bros*., 981 F.2d at 1339.

[172] Zino Davidoff SA v. CVS Corp., 571 F.3d 238, 246 (2d Cir. 2009) ("In the context of gray-market goods, in comparing the trademark holder's product with the gray-market product, we apply a low threshold of materiality, requiring no more than a slight difference which consumers would likely deem relevant when considering a purchase of the product."); Mary LaFrance, *Wag The Dog: Using Incidental Intellectual Property Rights To Block Parallel Imports*, 20 MICH. TELECOMM. & TECH. L. REV. 45, 53 (2013).

[173] *See* Societe Des Produits Nestle, S.A. v. Casa Helvetia, Inc., 982 F. 2d 633, 641 (1st Cir. 1992).

[174] *Id*.

[175] *Id.*; *see* LaFrance, *supra* note 172, at 53.

ingredients and packaging between versions of deodorant soap,[176] different packaging and labeling,[177] different advertising participation and marketing methods,[178] quality control differences,[179] and even dolls with Spanish adoption papers.[180] Therefore, to protect the domestic trademarks' goodwill and reputation, identify the products' bloodline, and avoid the consumers' confusion, the U.S. courts will consider "subtle differences" in trademarked goods as material in gray-market goods importation.

Section 42 of the Lanham Act allows the trademark owner to block parallel importation goods with the help of Customs and Border Protection by using the "Lever-rule" strategy. According to Title 19 Customs Rules, trademark owners need to apply in writing for protection with the Customs and Border Protection by proving that the products are physically and materially different from those authorized for domestic sale. Moreover, trademark owners who assert physical and material differences exist must state the basis for such a claim with particularity, and must provide competent evidence and summaries of physical and material differences for publication.[181] In addition to case law and the Lanham Act provisions, Section 526 of the 1930 Tariff Act also regulates the

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[176] *Id*. (citing *Lever Bros*, 877 F.2d at 108).

[177] *Id*. (citing Ferrero U.S.A., Inc. v. Ozak Trading, Inc., 753 F. Supp. 1240, 1247-1249 (D.N.J. 1991)).

[178] *Id*. (citing PepsiCo, Inc. v. Giraud, 7 U.S.P.Q. 2D (BNA) 1371, at 1373, (D.P.R. Mar. 14, 1988)).

[179] Iberia Foods Corp. v. Romeo, 150 F.3d 298, 304 (3d Cir. 1998).; *see* LaFrance, *supra* note 172, at 53.

[180] *Id*. (citing Original Appalachian Artworks, Inc. v. Granada Elecs., Inc., 816 F.2d 68 (2d Cir. 1987)).

[181] 19 C.F.R. §133.2(e) (1999). "CBP determination of physical and material differences may include, but is not limited to, (1) specific composition of both the authorized and gray market products(including chemical composition); (2) formulation, product construction, structure, or composite product components, of both the authorized and gray market product; (3) performance and/or operational characteristics; (4) differences resulting from legal or regulatory requirements, certification, etc.; (5) other distinguishing and explicitly defined factors that would likely result in consumer deception or confusion as proscribed under applicable law."

importation of trademarked goods. Section 526(a) prohibits the importation of authorized goods without the written consent of the trademark owner, even without showing material differences or likelihood of confusion, but the trademarks are the registered trademarks owned by U.S. citizens, corporations, or associations. However, the regulation furnishes a "common-control" exception from the ban, permitting the entry of gray-market goods manufactured abroad by the trademark owner or its affiliates.[182] What's more, unlike the Lanham Act, Section 526 applies to the importation of foreign manufactures,[183] which means goods that are manufactured outside the U.S. The original purpose of Section 526 was to protect domestic companies, because the trademark holder usually sold to the foreign manufacturer an exclusive right to use the trademark in a particular location with the condition that the foreign manufacturer would promise not to import its trademarked goods bearing the identical trademark back to the United States.[184] This provision, together with Section 42 of the Lanham Act, does not apply to the importation of articles accompanying any person arriving in the U.S. when such articles are for personal use and not for sale.[185] The major disadvantage of using the Tariff Act as a remedy against parallel imports is the requirement that the U.S. trademark owner cannot also own the trademark (directly or through an affiliate) in the country of the manufacturer, because of the "common-control" exception.[186] So, most U.S. trademark owners would find it disadvantageous to assign foreign rights in a valuable mark.[187]

Even though trademark law adopts the international exhaustion regime, and it seems that the U.S. permits parallel importation of

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[182] K Mart Corp. v. Cartier, Inc., 486 U.S. 281, 288 (1988).

[183] 19 U.S.C. §1526(a) (2012).

[184] K Mart Corp. v. Cartier, Inc., 486 U.S. 281, 287 (1988). *See* Mary LaFrance, *Using Trademark Law to Override Copyright's First Sale Rule for Imported Copies in the United States*, RESEARCH HANDBOOK ON INTELLECTUAL PROPERTY EXHAUSTION AND PARALLEL IMPORTS (Irene Calboli & Edward Lee eds., 2016).

[185] 19 U.S.C. §1526(d)(1) (2012).

[186] *See* LaFrance, *supra* note 184.

[187] *Id*.

genuine trademarked goods. There are still many bars that impede gray-market goods access to the U.S. market. The "material difference" exception is commonly used by trademark owners. However, parallel importers can overcome the "materially difference" bar by attaching a proper label with a prominent disclaimer.[188] According to the Customs and Border Protection Rule §133.23, the material differences can be cured by a proper label stating: "[t]his product is not a product authorized by the United States trademark owner for importation and is physically and materially different from the authorized product."[189] The disclaimer must be "conspicuous and legible" and must remain on the product "in close proximity to the trademark as it appears in its most prominent location on the article itself or the retail package or container" until "the first point of sale to a retail consumer in the United States."[190] It seems that proper labeling helps eliminate consumers' confusion and fits the trademark law's function of indicating the source of goods.

The law (case law and statute provisions) on trademark parallel importation is explicit, and there is no controversy about this issue in the United States. The formation of this rule (international trademark exhaustion in general with "materially difference" as an exception) relied on the trademarks' functions. The premise is that trademarks indicate the original source of products, avoids consumers' confusion, and guarantees the products' quality. Therefore, as long as consumers are not confused about the trademarked product and its original source, and the trademarked product has not been altered, the parallel imports are generally permitted.

B. TRADEMARK EXHAUSTION IN THE EUROPEAN UNION

This section describes the use of trademark exhaustion doctrine in the European Union as a whole, not of any individual member

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[188] 19 C.F.R. §133.23(b).
[189] *Id.*
[190] *Id.*

state within the EU or European Economic Area (E.E.A.).[191] The trademark exhaustion doctrine adopted within the EU and E.E.A. is regional exhaustion. This territorial trademark exhaustion has been harmonized and qualified through the EU Member States or E.E.A. market. Trademark exhaustion will be triggered after the initial sale within the EU and E.E.A. In 1957, six European nations signed the treaty establishing the European Economic Community (EEC). One of the provisions in this treaty is Article 85,[192] which prohibits "any agreements between enterprises that are likely to restrict competition within the common market."[193] The underlying economic policy was the creation of an internal European market, as well as the protection and integration of this internal market "without internal frontiers in which the free movement of goods, persons, services and capital is ensured in accordance with the

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[191] European Economic Area (EEA) was established via the *Agreement on the European Economic Area*, an international agreement which enables the extension of the European Union's single market to member states of the European Free Trade Association (EFTA). The EEA links the EU member states and three EFTA states (Iceland, Liechtenstein, and Norway) into an internal market governed by the same basic rules. *See European Economic Area*, WIKIPEDIA, https://en.wikipedia.org/wiki/European_Economic_Area.

[192] Article 85 of the Treaty Establishing the European Economic Community, Article 85(1), "The following shall be deemed to be incompatible with the Common Market and shall thereby be prohibited: any agreements between enterprises, any decisions by associations of enterprises and any concerted practices which are likely to affect trade between the Member States and which have as their object or result the prevention, restriction or distortion of competition within the Common Market, in particular those consisting in: (a) the direct or indirect fixing of purchase or selling prices or of any other trading conditions; (b) the limitation or control of production, markets, technical development or investment; (c) market-sharing or the sharing of sources of supply;…" Mar. 25, 1957.

[193] Treaty Establishing the European Economic Community, Mar. 25, 1957, 298 U.N.T.S. 3; *See* Kaoru Takamatsu, *Parallel Importation of Trademarked Goods: A Comparative Analysis*, 57 WASH. L. REV. 433, at 447 (1982).

provision of the Treaties."[194] This economic policy summarizes the relevant EU treaties and EU competition law. The exhaustion doctrine is further mandated by EU primary law forbidding the partitioning of the internal market, particularly Article 34 and 36 of the Treaty on the Functioning of the European Union (TFEU), which is a goal shared by EU competition law.[195]

The free movement of goods is a cornerstone of the internal market's effectiveness, and it was held to be an overarching policy promoted by European competition law.[196] In the early stage of this competition policy development, the European Court of Justice (E.C.J.) was adamant that a national trademark owner could not prevent the importation of goods bearing an identical mark that was lawfully marketed in the country of origin by virtue of its exclusive right.[197] Additionally, the exhaustion doctrine was meant to eradicate any possible restraints on the free flow of trade and competition raised by the exercise of national intellectual property rights, prioritizing an effective regional market with an undistorted competition system first.[198]

Before trademark law harmonization in Europe, trademark rights were territorial and individual Member States adopted their own trademark registration methods and exhaustion regimes. Before adopting the First Council Directive 89/104/EEC relating to trademarks in 1988, the E.C.J. used the competition law provisions of the TFEU, then the Treaty Establishing the European Economic

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[194] Consolidated Versions of the Treaty on European Union and the Treaty on the Functioning of the European Union, Official Journal C 326, 26/10/2012 P. 0001-0390, Article 26 (Ex Article 14 TEC), https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A12012E%2FTXT.

[195] *See id.*; Apostolos G. Chronopoulos & Spyros M. Maniatis, *Trademark Exhaustion and Its Interface with EU Competition Law*, RESEARCH HANDBOOK ON INTELLECTUAL PROPERTY EXHAUSTION AND PARALLEL IMPORTS (Irene Calboli & Edward Lee eds., 2016).

[196] *See* Chronopoulos & Maniatis, *supra* note 195, at 344.

[197] *See id.*; Case 192/73, Van Zuylen Frères v. Hag AG, [1974] E.C.R. 731, 744, https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A61973CJ0192#SM.

[198] *See id.*

Community (EEC Treaty), to decide trademark cases.[199] So, before the harmonization, parallel imports were not allowed due to the national frontiers. However, the free movement of goods, the competition policy, and the further integration of the EU market were the primary objective, so this required the courts to reconcile conflicting rules and find the balance between policymaking and interpretation of the law.[200] Gradually, in parallel with the growth and strengthening of the common market, the approach of the court shifted towards the core of each intellectual property right, and E.C.J. took the trademark function jurisprudence by reference to the essential function.[201] The essential function is "to indicate the origin of the [marked] product."[202] Furthermore, "the proprietor of the trademark has the right to use that trademark for the purpose of putting a product into circulation for the first time and therefore to protect him against competitors wishing to take advantage of the status and reputation of the trademark by selling products illegally bearing that mark."[203] At this stage, "trademark exhaustion becomes subjected to a 'rule of reason' analysis directed at balancing all the interests involved in cases of parallel importation, much like a theory of unfair competition."[204] In the case *Hoffmann-La Roche & Co. A.G. v. Centrafarm*, the E.C.J. decided, based on Article 36 of TFEU, to recognize that "a trademark proprietor is entitled to prevent an importer of a trademarked product, following repackaging of that product, from affixing the trademark to the new

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[199] 2012 O.J. (L 101). *See* Ghosh & Calboli, *supra* note 13, at 70.

[200] *See* Spyros M. Maniatis, *Whither European Trade Mark Law? Arsenal and Davidoff: The Creative Disorder Stage*, 7 INTELL. PROP. L. REV. 99, 100 (2003).

[201] *See id.*

[202] *Id. See also* Van Zuylen Frères v. Hag AG, *supra* note 197, at 735.

[203] Case C-10/89, SA CNL-SUCAL NV v. HAG GF AG, 1990 E.C.R. I-03711. *See* Maniatis, *supra* note 200, at 100; Chronopoulos & Maniatis, *supra* note 195, at 345.

[204] Chronopoulos & Maniatis, *supra* note 195, at 347.

packing without the authorization of the proprietor."[205] However, the trademark proprietors' right to block imported repackaged trademarked products should never "constitute a means of arbitrary discrimination or a disguised restriction on trade between the Member States," according to Article 36 of TFEU.[206] Moreover, Article 34 of TFEU prohibits "quantitative restrictions on imports and all measures having equivalent effect" between the Member States.[207] Therefore, in promoting free movement of goods, parallel imported genuine trademarked products were permitted in general among Member States, unless the imported products did not share a common origin, or the imported products had been repackaged or altered without trademark proprietor's authorization.[208] However, this rule was not a strict rule. The E.C.J. also developed a more nuanced rule based on it, which is a "Member State may not in principle prohibit the sale in its territory of a product lawfully produced and marketed in another Member State even if the product is produced according to technical or quality requirements which differ from those imposed on its domestic products."[209] The rule further states that "[t]he proper functioning of the common market

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[205] Case 102/77, Hoffmann-La Roche & Co. AG v. Centrafarm Vertriebsgesellschaft Pharmazeutischer Erzeugnisse mbH, 1978 E.C.R. 01139, Document 61977J0102, https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A61977CJ0102.

[206] Treaty on the Functioning of the European Union, art. 36.

[207] Treaty on the Functioning of the European Union, art. 34.

[208] Van Zuylen Freres v. Hag AG, *supra* note 197; Hoffmann-La Roche & Co. AG v. Centrafarm Vertriebsgesellschaft Pharmazeutischer Erzeugnisse mbH, *supra* note 205. *See* Ghosh & Calboli, *supra* note 13, at 71.

[209]*See* Case T-120/78 Rewe-Zentral AG v. Bundesmonopolverwaltung für Branntwein, 1979 E.C.R. 00649, https://eur-lex.europa.eu/legal-content/en/ALL/?uri=CELEX%3A61978CJ0120; *See also* 1980 O.J. (C 256) 2, at 2-3; *See* Ghosh & Calboli, *supra* note 13, at 71.; *See* Case 120/78 Rewe-Zentral AG v. Bundesmonopolverwaltung fur Branntwein, [1979] E.C.R. 00649, Document 61978CJ0120, available on the website: https://eur-lex.europa.eu/legal-content/en/ALL/?uri=CELEX%3A61978CJ0120. *See also* OFFICIAL JOURNAL OF THE EUROPEAN COMMUNITIES, No. C 256/2, 3. 10. 1980, at 2-3.

demands that each Member State also consider the legitimate requirements of the other Member State."[210] The gist of establishing and promoting the integrated European market does not change, so in order to achieve this goal, the harmonious development must go fast and effectively.

Trademark law has been harmonized throughout the EU Member States since the adoption of the First Council Directive 89/104/EEC, then repealed by Directive 2008/95/EC, and recently repealed and replaced by the Directive 2015/2436.[211] The First Council Directive 89/104/EEC established the community-wide exhaustion doctrine. In the course of legal development, the exhaustion rule was codified in European Trademark Directive 2008/95/EC as Article 7 and now replaced by the effective Article 15 of Directive 2015/2436. The exhaustion rule states: "A trademark shall not entitle the proprietor to prohibit its use in relation to goods which have been put on the market in the Union under that trademark by the proprietor or with the proprietor's consent."[212] Also, "the E.C.J. clarified that Community-wide exhaustion was the only applicable criterion and that national rules providing different exhaustion regimes needed to be amended."[213] However, Article 15(2) states the trademark owners' rights are not exhausted after the first sale if the imported goods are altered, changed, or impaired.[214] Still, the nuanced rule stated in the last

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[210] *Id*.

[211] *See* Ghosh & Calboli, *supra* note 13, at 70.

[212] Directive 2015/2436 of the European Parliament and of the Council of 16 December 2015 (approximating the laws of the Member States relating to trademarks (Text with EEA relevance), O.J. L336/1, Article 15(1) – Exhaustion of the rights conferred by a trademark. Article 15(2) states: "Paragraph 1 shall not apply where there exist legitimate reasons for the proprietor to oppose further commercialization of the goods, especially where the condition of the goods is changed or impaired after they have been put on the market").

[213] *See* Shubha Ghosh & Irene Calboli, *supra* note 13, at 72.

[214] Joined Cases C-427/93, Bristol-Myers Squibb v. Paranova A/S; C-429/93 C.H. Boehringer Sohn, Boehringer Ingelheim KG & Boehringer

paragraph about the exhaustion doctrine still applies: if the imported products are repackaged products but they are the result of trademark owners' marketing strategy, and it is necessary in order to market the products in the Member State of importation, and the importers have not changed or modified the products, the regional exhaustion still works.[215] This is the "mutual recognition" principle and Member States subject to it.[216]

In the *Hoffmann-La Roche* case, the court held that the trademark owner may rely on his rights as the owner to prevent an importer from marketing a product put on the market in another Member State by the owner or with his consent, or where that importer has repackaged the product in new packaging to which the trademark has been reaffixed, unless "(1) it is established that the use of the trademark right by the [owner], having regard to the marketing system which he has adopted, will contribute to the artificial partitioning of the markets between the Member States; (2) it is shown that the repacking cannot adversely affect the original condition of the product; (3) the owner of the mark receives prior notice before the repackaged product is put on sale; and (4) it is stated on the new packaging by whom the product has been

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Ingelheim A/S v. Paranova A/S; and C-436/93 Bayer Aktiengesellschaft and Bayer Danmark A/S v. Paranova A/S, 1996 E.C.R. I-3457, I-3527 (Disscussing the "legitimate reasons" in Article 7(2) of European Trade Mark Directive – replaced by Article 15(2) of the 2015 Trade Mark Directive); Council Directive 2015/2436, art. 15(2), 2015 O.J. (L 336) 13. *See* Shubha Ghosh & Irene Calboli, *supra* note 13, at 72.

[215] *See id.*; Case C-349/95, Frits Loendersloot, trading as F. Loendersloot Internationale Expeditie v. George Ballantine & Son Ltd and Others, 1997 E.C.R. I-06227, https://eur-lex.europa.eu/legal-content/GA/TXT/?uri=CELEX%3A61995CJ0349. ("The Court hold… that the possibility for the owner of trade mark rights to oppose the marketing or repackaged products under his trade mark should be limited only in so far as the repackaging undertaken by the importer is necessary in order to market the product in the Member State of importation. It need not be established, on the other hand, that the trade mark owner has deliberately sought to partition the markets between Member States").

[216] COUNCIL OF THE EUROPEAN UNION, 2000 O.J. C (141) 2, https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32000Y0519%2802%29.

repackaged."[217] In sum, the EU's trademark exhaustion is regional exhaustion with the primary objective of the internal market integration and free movement of goods within the EU region.

Based on the above analysis of the trademark exhaustion in the U.S. and EU, the U.S. takes international exhaustion, and EU takes regional exhaustion in the trademark area. Concerning each Member State within the EU/E.E.A., the regional exhaustion is a "quasi-international exhaustion" regime but within the limited geographic area. The U.S. and EU share some commonalities. Firstly, the parallel importation is permitted in the trademark area in general. Secondly, in order to protect trademark owners' rights, the trademark owners still hold the right to oppose imported products if there are differences between the imported goods and other authorized goods. Lastly, they both have correspondent measures as to those imported trademarked products' differences, the U.S. use "proper labeling" to cure the "materially differences," and the EU asserted mutual recognition and the harmonization method to achieve the primary objective.

V. DAIGOU PREVALENCE IN CHINA — DERIVED FROM PARALLEL IMPORTATION

As set forth in the prior sections, parallel importation involves the sale of genuine goods outside of authorized distribution channels in the gray market, and it is a global phenomenon. In recent decades, global economic integration is a growing trend. In the past few years, accompanied by the growth of global business, gray markets' marketing channels are further boosted at the operational level.[218] The rise of e-commerce has been particularly apparent in China over

[217] *See* Case 102/77, Hoffmann-La Roche & Co. A.G. v. Centrafarm Vertriebsgesellschaft Pharmazeutischer Erzeugnisse mbH, 1978 E.C.R. 01139, https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A61977CJ0102; Bristol-Myers Squibb v. Paranova A/S, *supra* note 214, at I-3533-3534. *See also* Ghosh & Calboli, *supra* note 13, at 72-73.

[218] Hai Li et al., *Parallel Importation in a Supply Chain: The Impact Of Gray Market Structure*, 114 TRANSP. RES. Part E: Logistics & TRANSP. REV., 220, 220 (2018).

the past few years. Parallel importation did not only appear on the authorized retailers' level. In fact, third-party parallel importation is also very common in the gray market.[219] For instance, *daigou* (shopping agents), or *haitao* (overseas online shopping) are classic examples of third-party parallel importation. These terms refer to the Chinese nationals who take advantage of their stay or travel overseas to buy goods for their clients in China.

At first, this behavior only existed between friends and families. People asked their friends or other family members to help them buy specific products and bring them back, due to the cheaper prices in foreign countries. Eventually, people saw the potential business opportunity and started businesses reliant on this overseas shopping behavior. They started to travel abroad often, and took advantage of international jobs (e.g., an international airline stewardess), or worked with a friend who is studying or living abroad. They would buy products that are either popular in domestic market or according to their client's needs at a relatively lower price. The main product categories these businesses would import include cosmetic products, luxury goods, clothing, health care products, and baby products. To bring these products home, they either packed the products as their personal luggage or mailed them back through personally mailed parcels. The radical revolution of the Internet promotes electronic commerce. Shopping agents bring products back, add a little bit more on the price but are still cheaper than the domestic market price, and then sell them online. More and more consumers start to shop online because it is very efficient and cost-saving, and they also promote the development of e-commerce.

The main reason for parallel importation is the price difference. Many products imported into China are levied on high tariffs, in addition to the value-added tax and consumption tax that apply, according to the domestic regulations. Besides tax, other fees are also added onto imported goods, such as the freight fees, site or mall rental fees, personnel wages, marketing expenses, and profits. All those fees together constitute high prices of imported products in China. What's more, if a brand's business operation process includes multi-layers commercial agents, whether based on different

[219] *Id.*

markets or different districts in the same markets, the costs and fees added by the different layers in between will result in an even higher price because every link in the business operation process wants to gain more profit. One typical example is Louis Vuitton's classic Neverfull midsize handbag, which sells for $1390 ($1480-$1510 after tax, depending on different tax rates in different states) in U.S. dollars in the United States, 10,900 RMB in China ($1589), 1,040 euros in France ($1154), and 1,710,000 won in Korea ($1472).[220] The fluctuations in price of this Louis Vuitton Neverfull bag is small all over the world, but China still has the highest price. These higher prices are common with the other luxury products in the Chinese market. That is because the overall tax rate is high in China, and the market is not competitive enough, containing many information asymmetry loopholes. Many world-famous brands take advantage of this weakness and tend to fix a high-price strategy in China when first imported into the Chinese market. Moreover, the extraordinary enthusiasm of domestic consumers for foreign brands leads to even bigger price differences. These huge price gaps force Chinese consumers to shop overseas, which then leads to *daigou* fever.

All commodities imported into China need to pay three types of duty and taxes: customs duties, value-added tax, and consumption tax. The valuation method is cost, insurance and freight (CIF), which means the import duty and taxes payable are calculated on the complete shipping value that includes the cost of the imported goods. According to China's 2020 Customs Tariff Implementation Plan ("2020 China Tariff Schedule") the import and export taxable items remain the same with the 2019 version (8549 items).[221] Customs duties are computed either on an *ad valorem* basis or quantity basis.[222] The former is calculated based on the actual

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[220] *Midsize monogram "Neverfull" price*, LOUIS VUITTON, https://us.louisvuitton.com/eng-us/products/neverfull-mm-monogram-007653 (last visited October 25, 2020).

[221] *See* Xinhua, *China Releases Tariff Schedule for 2020*, ENGLISH.GOV.CN, http://english.www.gov.cn/statecouncil/ministries/201912/30/content_WS5e09fa9ac6d07ec821d3e92d.html (last updated Dec. 30, 2019).

[222] Yan Qi, *Import Duties Relating To Cross-Border E-Commerce In A Chinese Context*, 33 ARIZ. J. INT'L & COMP. L., 263, 266 (2016).

transacted price or value of the imported goods, with certain required adjustments.[223] In 2018, nation's value-added tax reformed to three-tier rate of 16%, 10% and 6% for certain goods.[224] According to the Interim Regulations on Consumption Tax, certain imported goods are subject to consumption tax, which include luxury products like diamond jewelry, high-end watches, yachts, high-end products such as passenger cars and motorcycles, and non-renewable petroleum products like diesel oil.[225] Due to the amount involved in paying the addition of customs duties and the value-added tax, imported goods will normally incur import duties equaling 25-30% of its overseas-transacted price.[226] For example, the consumption tax on imported cosmetics is 30%, so it's not a surprise to see an imported cosmetics product sold in China for double, or even triple, its selling price in its origin country.[227] Due to the large price gap, and with the help of an online shopping environment, the e-commerce trading group gets bigger and bigger.

Due to the growth of cross-border e-commerce trade and the shopping agents, the *daigou* phenomenon is developing rapidly in China, and some problems arise with emerging industry. The first big problem is tax evasion. Those shopping agents, whether they are individuals or small companies, make a living by selling "tax-free" genuine foreign products at a lower price. However, the reason that they can sell those products at a lower price but earn profits at

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[223] *Id.*

[224] The original value-added tax (VAT) was 17% or 13%. Then in 2017, the 13% rate was abolished and led to a structure of VAT with 17%, 11%, and 6%. Then in 2018, with the VAT reform further pressed ahead, the original 17% and 11% tax rates were adjusted to 16% and 10% respectively to form the current three-tier VAT rate schedule of 16%, 10%, and 6%. *See Status of the Value Added Tax Reform in the People's Republic of China*, ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, http://www.oecd.org/ctp/consumption/status-of-the-vat-reform-in-the-peoples-republic-of-china-2018.pdf (last visited Oct. 25, 2020).

[225] *See* Interim Regulations on Consumption Tax of the People's Republic of China, Promulgation Number 539 (2009), State Council of the PRC; Qi *supra* note 222, at 266.

[226] *See* Qi, *supra* note 222, at 266.

[227] *See id.*

the same time is because they circumvent the customs authorities and do not go through the customs declaration process. This behavior is considered smuggling: they bring a large number of products from foreign nations then import them into the domestic market for sale, but in the name of personal use by carrying them in their luggage or by mailing the products directly to the clients without a customs declaration. It is impossible for customs authorities to check every single parcel to catch smugglers.[228] These smugglers often sell these products online through taobao.com, other shopping websites, or their WeChat[229] social media account. WeChat is very convenient for smugglers because they can start by selling within a small circle of friends, and then ask for a recommendation to other users. As the time passes by, the friends' circle grows bigger and bigger, so the small *daigou* business starts to become a large retail business. The *daigou* business becomes more and more popular because people see others make profits in the end. As the business grows, the product categories diversify and expand. The shopping representatives eventually stop importing based on their clients' requests, and instead import popular products according to the sales volume in domestic shopping malls, fashion trends, etc.

The reason this *daigou* phenomenon grows derives from the parallel importation concept, which is that parallel imports are genuine products with lower prices than the domestic authorized-to-sell goods. *Daigou* business builds upon trust and friendship between people, but it gradually becomes a social issue because of the associated tax evasion. But for the exhaustion doctrine it would have been an intellectual property issue. The shopping agents make a big profit at the expense of government tax. Furthermore, some unscrupulous merchants only see the profits in this *daigou* process that cause a lot of problems, including using shoddy, knock-off, and low-quality goods instead of genuine products, false advertising,

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[228] *See id.*

[229] WeChat is a Chinese multi-purpose messaging, social media, and mobile payment App; it is developed by Tencent Holdings, Ltd. It is analogous to Facebook, Instagram, etc. in the U.S.

and fraudulent transactions. The primary reason is because there is no explicit trademark exhaustion statute.

As *daigou* fever spread, the Chinese government became aware of the problem and wanted to stop its spread, as well as regulate the e-commerce activities associated with this practice. China enacted its E-Commerce Law, which came into effect on January 1, 2019 to "safeguard the legitimate rights and interests of all subjects involved in electronic commerce, regulate e-commerce practices, maintain the sound market order," and foster the development of the e-commerce industry in a sustainable and healthy manner.[230] However, it missed the point.

Before the E-Commerce Law was enacted in 2012, a former stewardess, together with others, took goods from the airport without declaring that they carried cosmetics and other goods into the country, and evaded customs tax on imported goods for more than 80,000 RMB (≈$11,429 in U.S. dollars).[231] The prosecutors filed public charges against the stewardess and the two others, accusing them of smuggling common goods.[232] The stewardess was initially sentenced to eleven years in jail at trial, but she filed an appeal in 2013. After a hearing in October 2013, she and her friends were each sentenced to two or three year sentences for evading taxes of over 80,000 RMB (≈$11,429 in U.S. dollars).[233] For the cross-border e-commerce import tax, there are two circumstances that can apply to cross-border e-commerce import: goods purchased from merchants registered in China's cross-border e-commerce network, or goods purchased from any overseas merchant and shipped by a courier company who is able to present three required documents (commercial invoice, airway bill, and proof of payment), and who can take legal responsibility for the import. Personal imports of these types, with a customs value up to 5,000 RMB (≈$715 in U.S.

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[230] E-Commerce Law of the P.R.C., Article 1.

[231] Reports on The Cent. People's Gov't of the P.R.C., *Former Stewardess Smuggling Case Retrial−Term of Imprisonment from 11 years to 3 years*, http://www.gov.cn/jrzg/2013-12/17/content_2549426.htm.

[232] *Id.*

[233] *Id.*

dollars), and where the accumulated transaction value has not surpassed the personal annual limit of 26,000 RMB (≈$3715 in U.S. dollars) are exempt from import duty; imports which exceed these limits will be subject to all duties and taxes.

After the E-Commerce Law came into effect, the regulated e-commerce business activities and the e-commerce business environment became more formal and legitimate. The law also includes some key provisions about intellectual property rights protection in Articles 41, 42, 43, and 45. However, these provisions emphasize intellectual property rights protection, infringement action, and how and what e-commerce platform business operators should do to protect intellectual property rights.[234] There are no clear provisions about regulating (or prohibiting) the *daigou* behavior; all the intellectual property related provisions focus on the intellectual property infringements and standardize the e-commerce shopping environment. Since the enactment of the E-Commerce Law, the supervision system of online-shopping platforms has become more complete and stronger. Platforms like Tmall.com, Taobao.com, JD.com, etc., are under more regularized management—at least when the *daigou* incident happens, people have related laws to rely on because it is not fully unregulated anymore. However, there are no specific provisions about parallel imports, and some wording of the E-Commerce Law is rather broad, like "necessary measures," which is unclear about the definition and scope of "necessary." What's more, even though e-commerce platforms like Taobao.com, etc., are under strict supervision, WeChat is a loophole. Because WeChat is a social network software, it is very difficult to supervise. At least for now, WeChat is still the fairyland for *daigou*. There is no doubt the E-Commerce Law makes progress on regulating e-commerce trade; however, the main issue is still there.

The above statement is the current situation about *daigou* behavior. We can see that the legislation department and governmental administration department tried to regulate this behavior and want to provide a healthy, positive, and clear e-commerce environment for people. However, the *daigou* behavior

[234] *See* E-Commerce Law of the P.R.C., Article 41-43, 45.

is derived from parallel importation. Intellectual property trade is very important to China. In China, parallel importation is more like a trade problem, rather than an intellectual property issue. Like the U.S., China needs an explicit statute on implementation of the international exhaustion. The highest priority is to enact trademark exhaustion statutes and parallel importation provisions and regulations to fill the missing adequate legal basis on the trademark parallel imports issue. If the legal basis is added, the parallel importation market will be regulated and parallel imports' quality will be more guaranteed, then the *daigou* phenomenon will not need to be worried about in the future.

Two main issues exist in *daigou* activities. The first is tax circumvention. The second is the product quality will not be guaranteed, meaning there are knock-off goods mixed in the authentic products. Unscrupulous merchants use *daigou* as a cover and use free-trade zones' preferential tax policy as a channel, pretending to export those knock-off goods then bring them back sold in the domestic market eventually. Free-trade zones are part of the territory. However, any goods entering this part will be subject to import tariffs, so it is regarded as outside the customs border. The explicit international trademark exhaustion will remedy the *daigou* situation.

The reason for the rise of *daigou* is price differences. After taking the international exhaustion, parallel imports are explicitly permitted. More parallel imported goods will emerge in the Chinese market, and those gray market goods' prices usually will be lower than the authorized products sold in the domestic market. The consumers will have more shopping choices, and they will not need to worry about the authenticity of the goods because parallel imported products are genuine products. Moreover, parallel importers will go through the Customs declaration process, so there will be no product-smuggling risk, and the tax evasion issue will be settled. Imported products sell at a high price in the Chinese market because of the high tax rate. However, China is reforming itself to integrate the world, plus intellectual property trade is very important to China. Many preferential policies implemented in those free-trade zones are to stimulate trade development and encourage exports. Maybe China will lower its high tariff rate and high tax rate again, and then the Chinese market price will decrease. With parallel imports at a lower price and quality guarantee, the domestic product price may be lower in the future, plus the cost of doing

daigou business; therefore, the price gap will be reduced, and profit margins will be cut. When the little profit cannot offset all the costs, this *daigou* phenomenon will disappear.

VI. PROBLEMS WITH CHINA'S CURRENT APPROACH AND PROPOSAL TO CLARIFY THE FUTURE TRADEMARK EXHAUSTION

Based on the background information provided and the parallel importation cases involving trademark law discussed above, China's current approach to parallel importation is evidently problematic.

The first and most fundamental issue is there is no statute in trademark exhaustion or in trademark parallel importation in the Trademark Law. As the trademark parallel importation issue developed to this current situation, China must revise and amend the Trademark Law to fill this gap. Because only rely on those scattered non-binding case decisions, the trademark owners, consumers, and the parallel importers are not clear about the general rule or the exceptions on parallel importation. We need to regulate this phenomenon rather than taking a laissez-faire attitude, or it will cause an adverse effect on the market transactions environment.

From reading the above case history, we can see that a general consensus has been reached, which is trademarked parallel imports are permitted as a principle and prohibited as an exception. However, the above parallel importation cases indicate that there are two hurdles that need to be overcome before suing for infringement of exclusive trademark rights.

The first hurdle is that parallel imported goods are genuine goods, which are authorized to sell in other markets. It seems that the courts will first check whether the imported goods are authentic products imported by parallel importers after clearing customs formalities. The courts think this is the premise to rule on a legitimate trademark parallel importation case. In academia and the legal practice field, there is a phrase called "legitimate parallel

imports."[235] These entities think the legitimate parallel imports will not destroy the trademarks' identification function, nor the trademarks' goodwill.[236] However, there is a misunderstanding about parallel importation. By definition, parallel imports are genuine products that authorized to sell in one country market, which are authorized to be sold in the market of one country and subsequently imported to another country to be sold in that market, all without the consent of the trademark owner or licensee. Parallel imports are not knock-off goods, so courts cannot mix the parallel imports goods with counterfeit products. Therefore, parallel imports are legitimate products. Nevertheless, it is understood why China pays more attention to imported goods' authenticity. China is very sensitive to the perception that it does not respect foreign intellectual property rights, skills, and technologies. There are always voices in the international community criticizing the intellectual property protection in China, so China has been under international pressure to alleviate serious counterfeiting and commercial piracy problems. It is possible that opening the gate and allowing parallel imports into the domestic market will lead to more severe counterfeit and substandard products issue. Under the trademark international exhaustion doctrine, some counterfeiters deliberately use this open gate to manufacture some knock-off goods with the same or similar foreign trademarks in some Southeast Asian countries then import them into China and deceive consumers that the products are parallel imports and not counterfeits. By definition, parallel imports are genuine products. However, based on the current condition of Chinese market, what needs to be clearer is how to verify and prove the legal source of parallel imports—like with license contracts, sales contracts, invoice notes, delivery documents, and so on. This is another aspect that needs to be made clear through legislation. The parallel importation issue is new to China, so it makes sense that Chinese courts will check the authenticity of parallel imports before ruling on other aspects.

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[235] *See* Han Jinwen & Xu Anbi, *A Review of Trademark Infringement In Parallel Imports*, BEIJING ANJIE LAW FIRM, http://news.zhichanli.cn/article/7162.html. (last visited Oct. 11, 2018).

[236] *Id*.

The second hurdle is that the trademark must be registered under the Trademark Law of China, or else litigants cannot sue based on the parallel importation issue. For unregistered trademarks, the Anti-Unfair Competition Law will come into play. As the intellectual property system becomes more complete and as more parallel importation cases arise in China, foreign trademark owners have already registered their trademarks when it comes to trademark infringement cases. Furthermore, the trademark owners will always take the unfair competition claim with the trademark exclusive right infringement claim and try to seek another layer of protection under the no clear trademark exhaustion statute situation.

After the two hurdles have been settled, the trademark parallel imports cases are decided on the following aspects: (1) whether the parallel importer altered the products' packaging or repackaged, changed the original trademark, or used Chinese transliteration of the foreign trademarks on the products without permission (e.g., the J.P. CHENET case); (2) whether the parallel imports met the requirements of products standard[237] in China (e.g., the GOO.N case); (3) whether the parallel imports violate the quality certification required by the mandatory administrative regulations (e.g., the Michelin case); and (4) whether the parallel importers used the trademark more than normative use in business operation process (e.g., the Fendi, Prada, and Gucci cases). It is not limited within those above aspects in reality. The starting point of allowing parallel importation is it will give domestic consumers more

[237] Article 8 of the Product Quality Law of the PRC, "Industrial products constituting possible threats to the health or safety of human life and property must be in compliance with the national standards and trade standards safeguarding the health or safety of human life and property…"; and Article 15 "All marks on the products or the packages thereof shall meet the following requirements: (1) with certification showing that the product has passed quality inspection; … (3) with corresponding indications regarding the specifications, grade of the product, the main ingredients and their quantities contained in the product, where such particulars are to be indicated according to the special nature and instructions for use of the product; [and] (5) with warning marks or warning statements in Chinese for products which, if improperly used, may cause damage to the products per se or may endanger the safety of human like or property…"

shopping choices, and consumers will get a genuine product and benefit from the relatively low price. However, it can be noticed that the methods the courts use to rule on the trademark parallel importation issue is probably inspired by the material differences standard established by the leading case *Lever Bros* of the U.S., and the trademark harmonization standard on parallel importation in the EU area. For now, China is beginning to focus more on the products' authenticity and the differences between the parallel imports and authorized goods sold in Chinese domestic market. If China decides to use the material differences standard, it needs to define the limit of differences and define the word "material."

As the economic policies change rapidly, and with more Free Trade Zones set up, it can be predicted that parallel importation cases will continue to proliferate in the near future. This is because the establishment of the Free Trade Zones officially bring the parallel importation into the legal practice (government issued policy about parallel imported cars). Further, the establishment of the Free Trade Zones is an adaptation to the world trade rules, and it also meets the needs of China's own reforms and development. Thus, it's the right time to revise and amend trademark law to provide a clear way to solve parallel import cases in the future.

With the proliferation of international commerce in China, the parallel importation situation will increase the risk of intellectual property market's instability, if the situation continues. When the parallel importation issue first appeared in the Chinese market, this issue was relatively new. The courts tried to avoid the issue at first and decided the case from another aspect, like the unfair competition. The trademark area takes the international exhaustion direction through the judicial process, but there is no explicit statute yet. The Trademark Law of China needs to be amended and add one or more provisions about the trademark exhaustion regime and parallel importation regulation. Statutes are the legal basis. Parallel importation is more like a trade policy issue in China, especially from the establishment of the Free Trade Zone and the *daigou* phenomenon.

Nevertheless, the root cause of the issue comes from trademark law, which lacks legal basis on trademark parallel importation. Without a legal basis, the parallel importation market will not be regulated normally. It will also increase the consumers' likelihood of confusion as to the authenticity of the trademarked goods. Over

time, it will adversely affect the market order and transaction environment.

Therefore, in proposing the trademark exhaustion doctrine, this Article raises several points that need to be clear in the statute.

First, the future trademark exhaustion statute or parallel importation proposition needs to be clear and transparent on exhaustion doctrine regime.

Second, based on the current intellectual property trade environment in China, it is necessary for courts to add one more method to check parallel imported products' authenticity, even if this is temporary. It will be improved when the intellectual property protection is stronger and more complete.

The third aspect is based on the above case history analysis. It seems courts borrow the material difference technique from the U.S. and try to use it in deciding parallel importation cases. However, the provision needs to be clear on how to judge the material difference and to what extent the differences can be accepted in the Chinese market. For example, whether repackaging counts as a material difference; whether importers add an authorized Chinese transliteration name of the trademark on the original package count as material difference; and whether the imported products need to meet the Chinese national product standard and if they do, there should be a list of product indexes on different kinds of products, and so on.

Fourth, in connection with the previous point, if the parallel imports are found to be materially different from the authorized products marketed in the Chinese market, the law needs to consider whether the proper labeling would cure the differences and dispel the consumers' confusion.

Finally, the future trademark exhaustion provision needs to clarify the relief and damages on trademark parallel importation. As a civil law country, China needs to be clear on the above four aspects in the future statutes to establish a robust legal basis on the trademark parallel importation issue. The *daigou* issue will be solved, and the healthy and regulated trading and commerce environment in the trademark area will keep rolling.

VII. CONCLUSION

This article has analyzed the evolution of the exhaustion doctrine in China's trademark law, inquiring into how parallel imports are regulated and why China needs to enact an explicit trademark exhaustion statute. China's trademark law case history demonstrates that Chinese courts tend to adopt the international exhaustion doctrine in favor of parallel imports. Surprisingly, the Trademark Law of China is still silent on this issue. However, it seems the Chinese courts are inspired by the U.S. and EU approaches in trademark exhaustion, like the material differences rule. With the prosperity of China's international trade, the increasingly accumulated cases adjudications are not enough to distill a general rule on the trademark parallel importation issue. What's more, the establishment of those Free Trade Zones accelerates trade development, and the *daigou* phenomenon thrives in part because of an absence of clear trademark exhaustion statutes and no specific parallel importation policy. Over time, it will not be conducive to market stabilization, and it will increase the risk in international trade. Therefore, the legislature needs to fill the trademark exhaustion gap, and the Trademark Law must be amended as soon as possible. Specifying the trademark exhaustion and parallel importation policy would foster legal certainty when dealing with all the trademarked goods brought to China. After the specific statutes are enacted, *daigou* fever would be regulated and parallel imports would stimulate international transactions for the sake of international trade and business.