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INTELLECTUAL PROPERTY PROTECTION AS ECONOMIC POLICY: WILL CHINA EVER ENFORCE ITS IP LAWS?

ROUNDTABLE

BEFORE THE

CONGRESSIONAL-EXECUTIVE COMMISSION ON CHINA

ONE HUNDRED NINTH CONGRESS

FIRST SESSION

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INTELLECTUAL PROPERTY PROTECTION AS ECONOMIC POLICY: WILL CHINA EVER ENFORCE ITS IP LAWS?

MONDAY, MAY 16, 2005

CONGRESSIONAL-EXECUTIVE
COMMISSION ON CHINA,
Washington, DC.

The Roundtable was convened, pursuant to notice, at 2 p.m., in room 192, Dirksen Senate Office Building, John Foarde (staff director) presiding.

Also present: Demetrios Marantis, Office of Senator Max Baucus; Susan Roosevelt Weld, general counsel; Keith Hand, senior counsel; Adam Bobrow, counsel, commercial rule of law; and William A. Farris, senior specialist on Internet and commercial rule of law.

Mr. FOARDE. Good afternoon, everyone. Let us get started. We have developed a reputation, whether deserved or undeserved, for both starting on time and ending on time, so we are going to try to keep up our three and a half years of good record this afternoon.

I would like to welcome everyone on behalf of Chairman Chuck Hagel and Co-Chairman Jim Leach of the Congressional-Executive Commission on China, and also on behalf of the legislative and executive branch members of the Commission who have been named so far.

This afternoon, our inquiry is about intellectual property and its protection, or lack thereof, in the People's Republic of China. All of our members have been interested in our trade relationship for many years, and all of them share an interest in the protection of intellectual property [IP]. They recognize, as I am sure everyone here recognizes, that America's intellectual property industries, which rely on IP protection for their revenues, significantly contribute to the U.S. economy and represent a growing proportion of our gross domestic product [GDP]. This sector includes not only the copyright industries, such as motion pictures, musical recordings, and book publishing, but also industries that rely on the value of their trademarked brands. It also includes patent industries, such as the pharmaceutical industry and many manufacturing businesses.

The health of U.S. IP industries, as well as the development of IP industries in China, may depend on whether China continues its role as the largest producer of pirated products in the world or joins the ranks of nations that protect IP.

So this afternoon we want to examine the current crisis resulting from the lack of IP enforcement in China, and looking beyond the

simple question of how much piracy and counterfeiting occurs, we hope to examine the policies that have created the current problems and assess whether they are likely to continue in the future.

Our panelists this afternoon will explain the scope of the problem, analyze its source, and assess which strategies can advance IP protection in China. We are delighted to have three extremely distinguished and knowledgeable panelists this afternoon. I will introduce them in detail before they speak.

Our procedure is as we have operated for the last three and a half years at these Issues Roundtables. Each panelist will get 10 minutes for an opening presentation. After about eight minutes, I will tell you that you have a couple of minutes left, and then that is your signal to wrap things up. Inevitably, you will not cover everything that you want to say in your initial presentation, but we will be able, we hope—and that has certainly been our experience—to pick up anything that has been left unsaid during the question and answer session, which will follow the opening presentations.

Each of the members of the staff panel here will get the opportunity to ask a question and hear the answer for about five minutes each, and then we will just continue to do rounds until 3:30 arrives, or we run out of steam or exhaust the subject, whichever comes first. On a subject this interesting and complex, I doubt we will get to the exhaustion-of-topic problem this afternoon.

So let me then recognize, with great pleasure, Mr. Daniel C.K. Chow, Robert J. Nordstrom Designated Professor of Law at Ohio State University's Michael E. Mortiz College of Law. Mr. Chow specializes in international trade law, international business transactions, international intellectual property, and legal issues concerning China. He has authored numerous books and articles, including two well-known case books, but he is probably most well-known as the author of this wonderful tome, "The Nutshell Series: The Legal System of the People's Republic of China," and we have all benefited from it. Mr. Chow is fluent in Mandarin Chinese and reads and writes Chinese at a high level. He obtained his bachelor's degree from Yale College and his J.D. from Yale Law School.

Welcome, Dan. Thank you for coming this afternoon.

STATEMENT OF DANIEL C.K. CHOW, ROBERT J. NORDSTROM DESIGNATED PROFESSOR OF LAW, OHIO STATE UNIVERSITY, MICHAEL E. MORTIZ COLLEGE OF LAW, COLUMBUS, OH

Mr. CHOW. Thank you, Mr. Foarde. Does the staff panel have a copy of the PowerPoint printout? Let me begin on page one.

My topic today is trademark counterfeiting, so I am going to focus on the counterfeiting of trademarks, products, and brands. I am not going to focus on patent infringement or on copyright piracy, but I am going to focus specifically on product counterfeiting. Let me begin, nonetheless, by saying that the counterfeiting problem in China is recognized by many as the most serious counterfeiting problem in world history. The PRC Government itself estimates that the counterfeit trade in China is between $19 and $24 billion per year, and about 8 percent of its gross national product.

U.S. industries that do business in China estimate their losses to be in the billions to tens of billions of dollars per year. In China,

15 to 20 percent of well-known brands of consumer products are counterfeit. You can find them in every large city, in every street market in China.

One thing about this that I want to emphasize is that no problem of this size and scope could exist without the direct or indirect involvement of the government, and I want to detail how that occurs in my talk. I also want to highlight an ominous development, which is that exports from China of counterfeit products, which are already serious and which make this into a global problem, are about, in my opinion, to increase significantly as a result of China's entry into the World Trade Organization [WTO]. I will discuss that in detail.

If we could go to the second page, please.

What are the origins of such a problem? Well, first, let me say that China is the world's largest recipient of foreign direct investment. It surpassed the United States as a recipient of foreign direct investment—I mean foreign capital—in the year 2002. But along with capital, foreign direct investment is the best source of technology transfer in the world today. In fact, when you look at a company such as Coca-Cola, the value to Coca-Cola of its trademark in China is worth much more to that company than the millions, tens of millions, or hundreds of millions of dollars of capital investment that Coca-Cola has put into China.

So, too, with trademarks of companies like Procter & Gamble, Johnson & Johnson, Unilever. All of these marks, all of these intellectual property rights [IPRs], are actually far more valuable to the company than the value of the capital that the company might put into China. So because it is the world's largest recipient of foreign direct investment, China now has unprecedented access to the world's most valuable intellectual property.

The second cause of this problem, I think, is that although China is the world's largest recipient of foreign direct investment, China's legal system still has many gaps, it is still weak, and it is still developing. That, in combination with the value of the product or intellectual property that has gone into China, has led to one of the world's most serious counterfeiting problems.

I will also talk about issues of political and legal reform, but let us go on now and I want to discuss the issue in detail, if we can turn to the third page. I am going to talk now about the economics of counterfeiting in China. If you look at the map here, you can divide counterfeiting really into two distinct segments. First, there is the manufacturing end of it, and second, there is the distribution end.

With respect to the manufacturing end, if you look at the map, the shaded area of the map shows the southeast region of China, Guangdong Province and Fujian Province, which were two of the areas first open to foreign direct investment, and which is where most of the manufacturing occurs. The manufacturing occurs in the south, but let me emphasize here the role of criminal organizations in counterfeiting, organized crime in Hong Kong and in Taiwan. Most of the people in Hong Kong have their ancestral home in Guangdong Province; most of the people in Taiwan have their ancestral home in Fujian Province. But criminal organizations involved in smuggling, prostitution, and narcotics have now moved

into the counterfeit trade because it is so lucrative. They supply the capital and they supply the know-how by investing in factories in Guangdong and in Fujian Province, and they use the international borders of Taiwan and Hong Kong to elude law enforcement and detection.

The second part of the counterfeiting industry that I want to point out is the distribution end. Of course, as everyone knows, it is no good just to have a counterfeit product, you must be able to deliver it to the end-use consumer. So, distribution plays a vital role in the counterfeit trade.

Here on the map are highlighted five different wholesale markets throughout the central and northern region of China. Each of these wholesale markets is located near a strategic urban location, large and densely populated urban areas such as Shanghai in the east, Beijing and Tianjin in the north, Guangzhou and Shenzhen in the south. These wholesale markets, many of them open-air or partly enclosed, serve the vital role of delivering the counterfeit product to the end-use consumer, as retailers who will come to these wholesale markets will be able to buy counterfeit goods and then take them back to street kiosks, street stalls, and small retail stores for their purchase by consumers.

I want to focus for a moment on Yiwu, which is in Zhejiang Province, that you see on the map on the east here. If I had a screen, I would point to it, but unfortunately I do not. If you see it, it is on the east coast of China. This city is well-known as the counterfeiting capital of China.

The thing to understand about these distribution centers is that many of these wholesale markets are established by local governments. Local governments, specifically the local Administrations of Industry and Commerce [AIC], invest in and protect these local markets.

In Yiwu, there are 100,000 different products, 200,000 visitors per day who purchase 2,000 tons of goods. Between 80 and 90 percent of these goods are counterfeit and infringing goods. I know this for a fact because I spent many weeks in Yiwu when I was working in China and saw personally the scope of this problem.

In 1997, the China Small Commodities Market, the largest wholesale market in Yiwu, grossed $2.4 billion in total revenue in China. That is larger than Procter & Gamble, Nike, Unilever, and Johnson & Johnson combined. That is larger than their total yearly revenues.

The role of counterfeiting in Yiwu, it is no exaggeration to say, supports the entire local economy and legitimate businesses, such as restaurants, nightclubs, warehouses, transportation companies, and hotels. All of them have grown up and they support the trade in counterfeit goods. If you shut down the trade in counterfeit goods in Yiwu, you will probably shut down the local economy. Because the government has invested in these wholesale markets, they are heavily defended at the local level.

If you skip the chart on the next page, I know I am running out of time already. I would like, now, to move to the chart on the State Administration of Industry and Commerce [SAIC] on trademark enforcement activity.

I just want to highlight for you the nature of the enforcement issue. I am just going to talk about this briefly and skip over most of this subject, but it is detailed in my written statement.

In the year 2000, there were 22,000 enforcement cases which were brought by the State Administration of Industry and Commerce. The average fine in those cases was $794. We are talking about a multi-billion dollar industry, and the fine was $794. Perhaps even more startling, if you look at criminal prosecutions, there were 45, total. That is 45 cases out of 22,000 enforcement actions that were then transferred over to the authorities for criminal prosecution. The level of enforcement, I think, in China, does not create deterrence.

Now, if we can go to the next page on exports. As I know my time is running very low, I am going to now emphasize the most significant point on this page, which is that in my opinion there is going to be a significant increase of counterfeit products from China, which already accounts for probably 80 percent of all of the counterfeit items that are exported in the world today. There is going to be a significant increase because, in 2004, China, in accordance with its WTO commitments, has eliminated the export monopoly that had been enjoyed by state trading companies. Prior to 2004, a counterfeiter had to get the cooperation and compliance of a state trading company, which had a monopoly on export rights, before they could export counterfeit product. Now, in 2004, that monopoly has been eliminated. It means that any counterfeiter now can export counterfeit product. As there are, in my view, no criminal penalties specifically directed at the exporter of counterfeit goods, I think we are going to see a significant increase. In fact, mid-year 2004 figures show a sharp jump in the amount of counterfeit product that is being seized by U.S. Customs.

Finally, if we can go to the last page, let me just talk now about future trends. The issue, as I see it, in China is that, really, counterfeiting occurs at the local level. It supports local economies. Shutting down counterfeiting will mean, in many instances, shutting down entire towns and municipalities which will cause problems of unemployment, dislocation, and social chaos, which is something that the Chinese Government fears more than anything else.

On the one hand, you have the tremendous cost of the shutdown and crackdown on counterfeiting. On the other hand, you have multinational companies in China which are very afraid of offending the Chinese Government and they do not want to do anything that might jeopardize their business interests.

So I think right now there is no political will on the part of the Chinese Government to crack down, because right now counterfeiting is not causing the Chinese Government pain. Until it does, I do not think there is going to be a significant change in the situation.

Thank you very much.

Mr. FOARDE. Thank you very much, Dan, for a sobering and very quick overview. We will come back to some of the issues that you have raised in the question and answer session. I take it they did not give you the key to the city for all the time you spent in Yiwu, right?

Mr. CHOW. No. We stayed in the best hotel, though, I must say. It was run by the counterfeiters.

[The prepared statement of Mr. Chow appears in the appendix.]

Mr. FOARDE. I would like, now, to recognize Eric Smith, who is president of the International Intellectual Property Alliance [IIPA]. IIPA is a private sector coalition of six U.S. trade associations which represents over 1,300 companies producing and distributing materials protected by copyright laws throughout the world.

Mr. Smith serves as chairman of the ITAC–15, the executive branch's Trade Advisory Committee on Intellectual Property Rights, and regularly advises the U.S. Government on negotiating strategy in the trade and intellectual property rights arena. He was formerly chairman of IFAC–3, the predecessor to ITAC–15, as well as a member of IFAC–4, which formally advised the U.S. Government on e-commerce issues. He is a former trustee of the Copyright Society of the United States, and former chairman of the D.C. Bar's Committee on Copyright. He has written numerous articles on communications and international copyright, and has lectured worldwide on many subjects related to both domestic and international copyright law, U.S. trade policy, and intellectual property and new technologies.

Eric hails from California, and holds a J.D. from the University of California at Berkeley—Boalt Hall, 1967—and obtained his bachelors degree with honors from Stanford.

Welcome, Eric Smith. Thank you for sharing your expertise with us this afternoon.

STATEMENT OF ERIC H. SMITH, PRESIDENT, INTERNATIONAL INTELLECTUAL PROPERTY ALLIANCE, WASHINGTON, DC

Mr. SMITH. Thank you, Mr. Foarde. I appreciate it. This is a terrific forum to highlight both the counterfeiting and piracy problems in China, and I really appreciate the opportunity to talk to all of you about it. Mr. Chow introduced the topic quite well. I am going to speak about copyright piracy.

Our organization represents, as you mentioned, six trade associations, 1,300 companies that account for about 6 percent of the U.S. GDP and about 4 percent of U.S. employment, and that has been growing every year since we started doing the first study in 1990.

These industries employ workers at about three times the rate of the economy as a whole. The situation globally for the copyright industries is very difficult because of the ease of copying, but China is a particular problem for us because the levels of piracy are the highest in the world. For example, in each of our industries, piracy runs about 90 percent of the market. That means 9 out of 10 copies available in China are pirated. Given the global demand and the demand in China for our products, for movies, for music, for software, these companies should be generating literally billions of dollars of revenue in the Chinese market. When you think about it, how do you make money in a market where you are competing for 10 percent of the market?

But it should not be forgotten that an additional problem in China is the lack of market access for each of these sectors. The copyright sector is probably the most closed to doing effective business in China than any other U.S. business sector, partly because

of the sensitivity of many of these industries; the Chinese Government always viewed film as a major propaganda tool. But the combination of high levels of piracy and the inability to get legitimate product into the market combines to create, in our case, a very conservative estimate of $2.5 billion in losses a year. Now that is just measuring what the market is today. If you were to look at what the market should be with market access and the ability to form anti-piracy organizations like we have in every other country in the world, and if piracy stayed at 90 percent, the losses would be many times that.

I wanted to leave you with some key thoughts. I have given in my written testimony, and I have handed you our rather comprehensive February 301 submission that we give to the Office of the U.S. Trade Representative [USTR] every year, that goes into detail about the problems in China from a copyright piracy standpoint.

The Chinese enforcement system relies almost entirely on thousands of people who run administrative raids against pirates and counterfeiters. As Mr. Chow said, the fines are the cost of doing business, basically. We did a survey in Beijing a little while ago with respect to actions taken at the request of one of our industries, the motion picture industry, and looked at the fines that were assessed in those cases. These were administrative cases brought by the Beijing Copyright Bureau, in conjunction with the Ministry of Culture and other agencies that worked together. We discovered that the fines tended to average a little bit above the cost of buying a blank tape. With this kind of penalty structure, as Mr. Chow mentioned, there is simply no disincentive to continue in this business.

In the trademark area, we understand there have been some criminal cases. I think Mr. Chow mentioned 40. In our area, we have been able to count, over the last 10 years, maybe, to our knowledge, 10 criminal cases. We know of only one criminal case that involved foreign copyrighted works. This really gets to the nubbin of the issue, I think. In every other country in which our companies do business, and that is 100 countries, all use their criminal law as a way of dealing with piracy.

The profits are so high in this business that if you are a CD factory owner—and there are now 83 factories in China, many of which churn out pirated product on a regular basis—the money is so high that, without criminal enforcement and the potential of jail terms, there is going to be no possibility of ever getting a handle on this problem. We have been, and the U.S. Government has been, asking now for 15 years, really, for the Chinese to undertake an enforcement program that has deterrent penalties, and we have yet to really see it.

In the Joint Commission on Commerce and Trade [JCCT], which convened last April when Vice Premier Wu Yi was here, the U.S. Government and the Chinese delegation met, and the Chinese delegation committed—Wu Yi committed—to significantly reducing piracy rates. A year later, during the USTR out-of-cycle review process, the formal legal process that they use to evaluate what China has been doing, there has only been a negligible change in the piracy levels in China.

I think in the recording industry, piracy rates went down approximately 5 percent, from 90 percent to 85 percent. However, on the other side of the equation, Internet piracy skyrocketed. We do not have any way of really measuring Internet piracy yet, but China is going online, and it is a very serious problem and the legal infrastructure is not there yet.

So we have a situation where piracy rates have not been significantly reduced, and during the course of that one-year period, we know of one copyright piracy case that involved the two Americans who were arrested in Shanghai.

Let me just spend a couple of minutes on that case. That case was initially prosecuted under Article 225 of the criminal law of China. That is the part of the criminal law that says it is illegal to engage in a business operation without the license allowing you to do it. It is not a piracy offense, it is illegal business operations. At the end of the day, when that case was finally decided, the prosecutor broke that down to an Article 217 case, which is, in fact, the crime of piracy. There has not been much news about that. We were happy that that happened, because it is the first time that that has happened. The problem with criminal prosecutions under Article 225, is it just sends the wrong message to Chinese society.

I would just leave you with this one fundamental point. Unless China is willing to use its criminal law procedures to deal with piracy, they are not going to be able to substantially change the situation. Now, China cannot continue to operate in the atmosphere in which they are operating now. They have to move up the value chain. They cannot continue to be a low-wage manufacturing country.

We have the examples of Korea, Taiwan, and other countries in the Asian region that have driven down piracy rates from, in the mid-1980s, 100 percent piracy in Taiwan and Korea, to—believe me—piracy rates at the latter part of the 1990s that were down to 15 percent. How did they do it? Very simple. They put pirates in jail. If it was not a jailable offense, they fined them at levels that were deterrent. Until China makes the political commitment to do that, it is not going to be able to deal with this problem.

In 1995–1996—and this goes to the point that Mr. Chow made at the end of his presentation, and this is a point about incentives—the Chinese Government was facing $2 billion worth of retaliation if they did not close their CD factories. The Minister of Propaganda finally ordered the closure of those factories. They were in the provinces.

Mr. Chow is absolutely right, it is a local issue, too. But until the Politburo and the central political leadership of China makes that kind of a decision to say "enough" and announces it into the society, nothing is going to change in China. We are working now with USTR, looking at the possibility of a WTO case. We are strongly supportive of the JCCT commitment on both the market access and the piracy side, and there is an IPR working group.

Madam Ma is going to be in town next week. So this hearing, in particular, is very timely and we hope that the Chinese delegation gets the kinds of messages from the U.S. Congress that they need to get in order to solve this problem. Thank you very much.

[The prepared statement of Mr. Smith appears in the appendix.]

Mr. FOARDE. Thank you very much, Eric Smith, for another rich presentation. We will pick up some of those issues as well in the question and answer session.

I would like to go on now and recognize an old friend, Jim Zimmerman, partner and chief representative of the Beijing office of Squire, Sanders & Dempsey, LLP. Jim concentrates his practice on foreign investment matters in China and represents multinational clients in a broad range of industries with respect to their joint venture investments, manufacturing investments, liquidation and dissolution of investments, mergers and acquisitions, regulatory compliance, customs and trade matters, and dispute resolution. Jim is the author of several books, chapters, and articles concerning Chinese law, customs regulations, and trade policy related issues, including "The China Law Deskbook," which is a publication of the American Bar Association. He is a governor and vice chair of the Board of Governors of the American Chamber of Commerce in China [AmCham], and chair of the Legal Committee for that Chamber. He is also chair emeritus of the China Law Committee of the ABA's International Law Section. He is on the panel of mediators for the U.S.-China Business Mediation Center, jointly operated by the CPR Institute of Dispute Resolution and the China Council for the Promotion of International Trade. Jim is also on the panel of arbitrators for the International Court of Arbitration of the International Chamber of Commerce [ICC] and has served as an arbitrator in ICC cases.

Welcome, Jim Zimmerman. It is great to have you here in Washington.

STATEMENT OF JAMES M. ZIMMERMAN, PARTNER AND CHIEF REPRESENTATIVE, BEIJING OFFICE, SQUIRE, SANDERS & DEMPSEY, LLP, BEIJING, CHINA

Mr. ZIMMERMAN. Thank you, Mr. Foarde. It is a pleasure to be here.

My comments will be on behalf of not just myself and my firm, but also on behalf of the American Chamber of Commerce in China. We are here in town this week as part of the Chamber's annual Washington Doorknock Program. I have prepared a written statement and I will send that by e-mail to you later today. If anyone would like a copy of that, they can ask me or send me an e-mail.

Basically, my perspective is a little different. I come from the perspective of being on the ground in China and spending a lot of time meeting with government officials, meeting with court officials, and to get their insights on IP enforcement.

But let me start by saying this. In January of this year the U.S. Ambassador to China held an IPR roundtable and I provided the comments on behalf of the U.S. industry. I made the following comment: "Since its accession to the World Trade Organization in December 2001, China has made significant improvements to its written laws governing intellectual property rights. However, there has been minimal progress in establishing a system of effective enforcement." My comments were picked up by the press in the United States and by the press in China. The press in China, in the China Daily, focused on the comment that "significant improve-

ments have been made." The press in the United States focused on the comment of "minimal progress in establishing a system of effective enforcement."

Therein lies the problem, which is a perception issue. Some people in the United States believe China has done nothing, and I do not believe that is true, as I will go into some detail later. At the same time, China believes that it has made significant improvements, not just to their written laws, but with respect to enforcement. That is not true, either. Much, much, much more work needs to be done in a lot of different areas, and China does need to be strongly encouraged to make some progress, and progress this year.

The progress that they have made is that they have spent a great deal of time re-writing their laws and amending regulations, adopting rules and standards. They have improved the court systems. They have gone from a situation where they were without a legal system 25 years ago, to one where they have an environment, at least to some degree, in which the rule of law is followed.

The IP court, specifically in Beijing and Shanghai, at least, has highly trained judges. They have retired most of the military officials, most of the Party officials, and have put in place qualified judges, for the most part.

Now, the situation in the courts right now is that there is a significant amount of litigation, but that has been filed mostly by domestic companies. At least 90 percent of the litigation in the courts is between domestic parties, and less than 10 percent may involve a foreign party. Somebody is taking advantage of the court system in China. It is not the foreigners, but the domestic companies because the issue of IPR enforcement strongly affects domestic companies. I agree 100 percent with Dan and Eric on their observations, but a big impact is on the domestic companies as well and their ability to get the benefit of their IP rights.

But progress needs to be made. Leadership needs to be shown in a number of areas. I do agree with what Eric is saying and Dan is saying about criminal prosecution. The PRC Government needs to demonstrate the political will to put people in jail and to enforce the laws.

In a meeting with the Supreme People's Court in February, the AmCham leadership discussed the judicial interpretation on IPR criminal penalties that came out in January 2004. On its face, the judicial interpretation lacks specificity. It is not detailed enough. There is much that needs to be clarified, specifically with respect to the liability of organizational end users with software, with respect to the liability of exporters, and also with respect to infringement that may be a health and safety issue.

One question we posed to the Supreme People's Court was, "Well, what if you are below the threshold?" Hence, you have a situation where you do not reach that threshold for criminal liability, but someone dies as a result of a tainted drug? The Supreme People's Court did say that a crime would be committed in that instance, but not under the judicial interpretation, but some other law. The Supreme People's Court, in no uncertain terms, told us that they will use their leadership to strongly enforce the judicial interpretation. So, it is left for observation what they will actually do. At the end of the day, what really needs to take place is that

they need to bring prosecutions. That is something that we are encouraging them to do.

Second, what needs to take place is that China must dedicate more resources to IP-related issues. As an example, the Trademark Office is significantly understaffed. In this regard, I have seen situations where we have applied or petitioned on behalf of clients to invalidate infringing trademarks and we have been told by the Trademark Office staff that they have over 20,000 cases, and they are still dealing with cases that were filed in 1999. This is the Trademark Office telling us that they are understaffed. It is unheard of that a Chinese Government official would make that kind of statement, but it is true. They are under-staffed. It is almost like a cry for help, that they need more resources. Now, one of the things that we are stressing—the American Chamber of Commerce—is that the government needs to add resources to get that backlog of cases taken care of.

Bear in mind that the 20,000 case backlog also involves domestic companies. The case that we are waiting for specifically is a U.S. company versus a Singapore company, foreigner versus foreigner. There is no political risk here. There is no political issue. The Trademark Office will not be protecting some domestic enterprise. It is a case, from our view, that should be quickly decided, but they are backlogged. So, the dedication of additional resources must be encouraged. It is very important. In addition, the Chinese Government agencies responsible for trademark and patent registration are behind because they do not have the resources.

Third, they need better agency coordination. One of the things that we have been pressing for is better communication and coordination of cases between IPR-related agencies. In China, it is common for China Customs to be doing one thing, and the SAIC doing another thing, and they do not coordinate with one another. They do not even pass files to one another. That is a real practical and logistical problem. There is also no agency coordination between province to province, from city to city.

How do you get the message to them on these issues? I do believe that one forum is the JCCT, which will be meeting this summer. Now, we do not want to be in the same position we were last year where we came up with a list of bullet points and then they do not make progress. We do need to get the message to the Chinese that they must make progress on these issues.

So on the criminal side, at the end of the day they have got to throw violators in jail. They have got to enforce their laws. We need to see statistics on that. We need transparency. We need to see that people are being prosecuted. They need better inter-agency coordination, and then they also need to dedicate more resources. Another issue is—and this is a role that the American Chamber and other organizations can play—is to encourage China to believe that if they protect intellectual property and do away with the companies that are making billions on counterfeit goods, there is a tremendous potential tax revenue that they are losing out on.

The IPR Roundtable raised that issue to the Chinese Government. Can you imagine the PRC Government's tax revenue if all companies were making legitimate products and they put the counterfeiters out of business? Because the counterfeiters are out of the

system, they are likely not paying taxes. They are not in the system, they are out of the system. As Dan mentioned, a lot of the counterfeiters are criminal organizations. They are not paying taxes in China. Those people should be paying taxes. The same thing is true with legitimate foreign companies that want to sell their goods in China and demand market access. If they are legitimately selling their goods, that potentially is tax revenue that the PRC Government can tap into.

So, those are things that the Chinese Government needs to be told, and not just, "you are going to be subject to a Section 301 investigation," but to be told some of the positive side on this.

Those are my comments for now. I would be happy to answer any questions that you might have on this issue.

[The prepared statement of Mr. Zimmerman appears in the appendix.]

Mr. FOARDE. Jim, thank you very much also for some useful and timely information.

I would like to let our panelists rest their voices for a moment while I make an announcement or two. I would like everyone to also attend next week's Issues Roundtable, which will be on unofficial religions in China. We will be looking at the religious groups that are not so-called "patriotic" religious groups. That roundtable will be on Monday, May 23, at 2 p.m. in room 2255 of the Rayburn House Office Building, so we hope to see you on the other side of the Capitol next week.

Also, the statements, and eventually the transcript, of today's roundtable, will be up on our Web site at *www.cecc.gov*. You will also find the transcripts and statements from all of our earlier hearings and roundtables. If you are not already signed up for our master mailing list, you can do that on the Web site and then you will get all of the announcements about hearings, roundtables, and other activities.

So, now let us go on to the question and answer session. As I said before, we will let each of the staff panel up here question either one individual panelist, or all of you, for about five minutes each. If the question is directed at just one panelist but the other two have comments, by all means, we would like to hear those responses, because the whole purpose of the exercise, from our point of view, is to hear your ideas and get those on the record.

I am particularly pleased this afternoon to exercise the prerogative of the chair and waive my own first set of questions to recognize my colleague, Demetrios Marantis, who has just joined Senator Max Baucus' trade staff. Senator Baucus was our first chairman and Demetrios is now working for him. Max Baucus spends a lot of time thinking about our issues and is in touch with us frequently. So, Demetrios, over to you, and welcome.

Mr. MARANTIS. Thank you very much for that kind introduction. I would like to thank the panelists. That was extremely useful. Given the recent release of USTR's Special 301 report, this roundtable is rather timely. I have one question that I would like to address to Eric, but I would be curious as well as to what the rest of the panelists think. The issue that has been of concern to Senator Baucus, as well as to the whole Finance Committee, relates to IPR enforcement in China.

As you probably know, all 20 Senators of the Finance Committee sent a letter on April 30, urging the Administration to step up its enforcement of the Trade-Related Aspects of Intellectual Propety Rights [TRIPS] commitments in China, with a view to a potential WTO dispute settlement case. My boss, Senator Baucus, was a bit disappointed that USTR's out-of-cycle review did not include the initiation of a WTO dispute settlement case against China, given that we have been hearing from the Administration that piracy in China is at "epidemic" levels and the losses, Eric, that you mentioned that the copyright industries are facing on a yearly basis, are pretty staggering.

So I just would like to get your thoughts as to what you all think the utility of WTO dispute settlement against China is, particularly on the copyright and trademark side of things, and why we are where we are in terms of not being in a place where we can initiate a dispute settlement case against China, and whether or not WTO dispute settlement is the way to go to address some of these issues, or if you have other thoughts as to what would be a more effective use of the Administration's resources. Thank you.

Mr. SMITH. Thank you, Demetrios. As you may know, the enforcement text of the TRIPS agreement is a part of the agreement that is not a bastion of clarity. To bring a case under Articles 41 and 61 against a country that has piracy at the levels of China, the first thing you would say is, how, possibly, could a country such as China be in compliance with any kind of enforcement obligation when you are running a 90 percent piracy rate? But in the WTO, you have to prove your case absolutely. And you are quite right. We asked for the commencement of WTO consultations. USTR decided not to do that. They decided to move forward with a process of using Article 63 of the TRIPS agreement to get more statistics from the Chinese Government about the exact nature of what is going on there, because as you know, China's system is wholly nontransparent. It is very, very difficult to find out what is going on, particularly when you are talking about cases brought and results obtained in cases.

We are working very closely with USTR right now in moving along that line. We understand what USTR did. It would not have been our first choice, but they made the decision to move forward in a deliberate way. They have invited us to go along with them. We are in the process of preparing what is going to be, or what will possibly be, a very large and extremely important case.

We wish that the language in those two sections of the TRIPS agreement were clearer and that we could use them with less risk of losing a case. We think we can win the case, but we have a ways to go to develop the evidence to get there.

Mr. FOARDE. Do either of the other panelists want to address that? You can have a minute or two, if you would like.

Mr. ZIMMERMAN. A quick comment on that. I agree with Eric. The language in the TRIPS agreement on enforcement is uncertain. To bring an action would be time-consuming. I think that the choice of remedies that the USTR has taken will probably move China faster. If they do not make progress, then there is the option of pursuing a formal enforcement action under TRIPS. I think, right now, the strategy is a smart strategy. With the various orga-

nizations pressuring, or working with USTR to pressure, China, we are hopeful that action will be taken this year. I do believe China knows that this year, 2005, the United States is very serious and wants action, and wants to see accomplishments this year.

Mr. CHOW. Let me just say, from the trademark perspective, I think many companies with trademarks in China are very reluctant to confront China. The whole idea of bringing a WTO dispute settlement action, or worse, much worse, a Special 301, is something that many of the companies on the ground are very reluctant to do because they do not want to do anything that is going to offend the Chinese Government. That is part of the issue here, that the multinational companies that are in China now have to decide how far they are willing to go. Many of them scream all the time at the U.S. Government, but they do not want to do anything to offend the Chinese Government. That includes Special 301, that includes WTO dispute settlement. So I think industry, on the trademark side, big companies, part of the Quality Brands Protection Committee that is the multinational companies in China that are lobbying the Chinese industry, they are very conflicted on this issue. They are not sending clear signals to the U.S. Government. USTR, of course, is going to listen to its constituency. There is a lot of reluctance to confront China.

Mr. FOARDE. Thanks, all three of you, for that response.

Let me recognize Susan Roosevelt Weld, who is the general counsel of the Commission. Susan.

Ms. WELD. Thank you very much, John. Thank you for all of your remarks. I am interested in whether you three think that bilateral cooperative efforts by the United States can do anything to help cure this problem. I guess I will start with you, Mr. Smith.

Mr. SMITH. This is a very frustrating topic. Some of my colleagues who I work with right now used to be in the U.S. Government, and they were engaged bilaterally with China. I have been engaged, the U.S. Government has been engaged, for 15 years now. With respect to this topic, enforcement, there really has been very little progress. Over the last year, following Wu Yi's commitment about substantially reducing IPR infringements, that has not happened. Is it going to happen in the next year? With Jim Zimmerman, we really hope so. But absent that progress and without the incentives that Mr. Chow is talking about, one begins to question whether or not the Chinese have the incentive to do this.

Over the long term, they must. They cannot continue to live as a counterfeit culture. The question is when? In the case of the copyright companies, unlike the trademark companies—I should not draw this distinction too harshly—our companies do not really even have market access. Many of the companies in the trademark area are doing business in China and making money. They are getting hurt by counterfeiting. Many of our companies are not making anything in China. So we have a slightly different perspective on this question, as we did in 1995 and 1996 when the trademark community did not join in the 301 action, which was basically a copyright industry driven action.

But now we are in a WTO world. A 301 bilateral world is much more difficult now. So, we really have to look, first, at multilateral

remedies. That is where you come up against Articles 41, 61, and the TRIPS agreement.

Mr. FOARDE. Does anyone else want to address that? Please, Jim. If you have a comment, go ahead.

Mr. ZIMMERMAN. I was going to add that this is the first step. The bilateral negotiation is the first step, and I do think it is a helpful step. We will just have to see how it plays out.

I am optimistic. We have to remain optimistic. Part of that optimism is based on some of the assurances that we received from Chinese Government officials, how they are serious about it, and they do want to improve. They want the relationship with the United States to improve, so they have an incentive to really make progress.

And when I say 2005 is the year, it is because we also understand that the U.S. Congress is under pressure from a lot of different quarters from people who are not happy, but at the same time, I think that China realizes that and understands that they are going to have to listen this time. It is just like in 1995, when they had the Section 301 hanging over their heads. Right now, they have got these negotiations that are hanging over their heads.

Mr. CHOW. Well, just going back to this whole issue of bilateral negotiations, I think that the United States is going to take its lead from industry. I can tell you that when I worked in China for a multinational company, we met with the U.S. Government. What we said to the U.S. Government was, "well, we would like you to talk to the Chinese Government, but please do not use our name and please do not make them angry." That is what we said, because that was essentially the attitude of the companies. So I think that the companies themselves have to make a decision: how far are they willing to push this, or is this really a situation that is more or less the status quo?

Mr. FOARDE. Thank you, all, very much.

Putting on these Issues Roundtables, although they may seem quite seamless, requires a great deal of organization and hard work. So we give the privilege of asking questions at each roundtable to the one staff member who has done the most heavy lifting to organize it. In this case, it is our friend and colleague, Adam Bobrow, our senior counsel for commercial rule of law. Adam, over to you for some questions.

Mr. BOBROW. Thank you, John. And thank you very much to the panelists. This has been very informative and we have heard a lot of very good testimony so far.

I would like to switch gears a little bit. We think of this sometimes as a simple situation in which you have people who want to see DVD movies or want to buy trademark products and other things, and some sort of a culture of willingness to let this stuff get made under the table without enforcement. The Chinese Government believes nobody is getting hurt, so what is the big deal, and that it is that simple.

But I would like to look a little bit behind that and see whether or not the panelists have any feeling about whether or not some of the policy decisions that the Chinese Government makes in other areas have led to this situation where there is no real incentive for enforcement against infringers.

Let me give a particular example. It is probably a bit outside your specific expertise, so you do not necessarily have to address the specific example. But in the case of China's 3–G standard that they are developing domestically, it is known as TD–SCMA. CDMA is a U.S.-company owned, IP-protected, patent-protected standard for cell phone communications. TD–SCMA obviously is going to be built—you can tell from the name—on top of that.

The Chinese Government has recently issued draft regulations that would seem to indicate that, in the situation under which there would be patents or other IP-protecting and underlying technology that is announced in the standard, they would issue a compulsory license for that technology without using the term. This is where I think the rubber hits the road.

Regarding IP domestically, the Chinese Government has decided who, what, where, when, and how it will generate a Chinese-owned IP system that will move their manufacturing economy up the value chain.

At the same time, enforcement of IP rights owned by innovators, whether they be foreign or domestic, have never really received the same sort of policy attention by the policymakers in the central government. Therefore, as Dan outlined, with the local enforcement authorities, and because those authorities unfortunately are tied up in a web with the illegal counterfeiters, there is perhaps too little incentive to get actual enforcement on the ground.

The first part of my question is, I guess, to what extent do you think that I am making this much too complicated? The second part of the question is how do you actually generate that will at the political or policy level in the central government to get the enforcement to occur at the local level? I will open it up to any of the panelists who would like to answer that.

Mr. SMITH. Maybe I could start. I think it is wrong to say that local Chinese rights owners are not being damaged by what is going on China. I think, in the trademark area, we have heard about whole cities being devoted to counterfeiting. But just the examples in our area, if you are a Chinese filmmaker, or you are a Chinese performer, or you are a music composer, or you are a software developer, you are in big trouble. You cannot make a return on your investment. Now, we know that these people complain all the time in the only way that they can, politically, to the Chinese Government about this problem, and they are not getting any recompense and it is very sad.

If you look at what has happened with other governments, governments have started to listen and realize that they are hurting themselves worse than they are hurting U.S. companies. So, maybe that is more specific to the copyright area than it is to other areas.

On the other hand, I think your general observation is probably close to correct. I think there are a lot of policymakers in China that have looked at this as, "how do we build into our system a 10 percent growth rate, because that is what we need to stay even, and rule of the law be damned. The fact that we have laws on the books and we are not enforcing them, we are letting them just go, we think that is what we need to grow."

I think Jim made the point that the growth rate from legal businesses is going to be, in our judgment, and we think the economic

literature supports this point, the growth rate from encouraging legal businesses is greater than encouraging businesses based on naked copying. China is going to have to realize that very soon. We hope Jim is right, that they realize it in 2005, because we are dying and we cannot wait too much longer.

Mr. ZIMMERMAN. A couple of comments. On the standards issue, there is a big debate going on in China as to whether or not the inclusion of patents and standards should be a voluntary process or a compulsory process. There were some draft regulations from the Standard Administrations of China released for public comment last September, and then there was a big uproar about that because it was basically a compulsory process. The Chinese Government backed off. Two things to China's credit on that: one, they did allow for public comment; second, it was a relatively transparent process.

Now the issue has not been resolved, but I can tell you this: there are some elements in China that believe the inclusion of foreign patents and standards could be characterized as foreign domination, given the history of foreign domination and foreign intervention in China. So there are a lot of people that do not like that idea. They do not like foreign standards being imposed on China, they want to create their own.

Unfortunately, that does not encourage innovation. The debate, I think, is a healthy debate going on in China right now, because they are trying to break away from being viewed as the low-valued knock-off economy. They want to move toward something where their homegrown IP has value, because as we have mentioned, that is where the true economic development lies—in China getting away from being a knock-off culture to one based on innovation, and we have to encourage China to move in that direction.

Many foreign companies are encouraging innovation because they are setting up R&D operations and hiring local engineers, hiring creative people in China, and showing them how to develop new technology that will be homegrown. China needs to protect that homegrown technology and to protect the foreign technology as well, give them equal status. But if they move in a direction where they are going to have a lack of incentives and force patent holders to be part of standards without any compensation, that will only perpetuate the problem.

The other question as to whether there is a government policy in general of supporting infringement? I do not think so. I think you give China too much credit when you suggest that they are developing a policy which encourages infringement. I think it is more a lack of resources, lack of coordination of agencies, lack of political will, and those are things that they need to correct.

Mr. CHOW. Just turning to the patent issue and the compulsory license issue, as far as I can see, this is really a different type of dispute. As far as I can see, I think this is a legitimate trade issue. I am not even convinced that what China is trying to do here is wrong.

I think every country wants to acquire advanced technology and that they want to implement policies that will allow them to do so. That is very different from counterfeiting, which is organized criminal activity. These are illegal factories that are not registered.

These are not state-owned enterprises that are registered, and that have a fixed permanent location, that have a legal identity, that have a business license. We are talking about illegal, underground factories financed by criminal organizations. There is no dispute about that, but that is completely wrong. Nobody in China argues that that should be in any way supported.

The other thing I want to mention also is I agree with Jim that I do not think there is a policy supporting infringement in China. I do not think that there is any coordinated view in the central government or any attempt, conscious or unconscious. I think that this process has begun because, very simply, counterfeiting and piracy are extremely lucrative economic crimes. There is so much money to be made, that criminal elements and other loose elements of society are just naturally drawn to it.

Mr. FOARDE. Let me now recognize Keith Hand, who is senior counsel with the Commission staff. Keith.

Mr. HAND. Thanks, John. Thank you for the presentations. They have been very interesting.

I would be interested in talking a bit more about the domestic pressures for enforcement. We have been touching on that issue here and there through the course of our discussion, and I was very interested in Jim's point that 80 percent of the infringement cases are brought by domestic entities for domestic infringement.

Are there domestic trade associations analogous to yours that are bringing pressure for greater enforcement or is advocacy in China more dispersed, an individual company with influence raising this issue with the Chinese Government?

On the issue of the infringement cases, is there a significant difference in plaintiff success rates and enforcement rates in domestic versus domestic cases as opposed foreign versus domestic cases?

Mr. ZIMMERMAN. First, the question on whether or not there is support by domestic associations. I do know with respect to DVD manufacturers, the Chinese organization that was responsible for managing that issue was leading the negotiations for the various Chinese DVD manufacturers to encourage them to negotiate with what was called the 3-C and 6-C group of patent holders—which are the foreign companies that hold the IP rights to the DVD technology. That association—and I cannot remember the name off the top of my head—encouraged its member companies to negotiate royalty-related agreements with the various foreign technology holders. They had mixed success. They were able to negotiate arrangements on behalf of several companies, but there was still room for improvement in terms of the negotiations. But the point is that there are some associations that are taking the lead. Now, I am not aware of what the film or the music industry is doing, but there are more and more domestic companies and more and more domestic organizations that realize the value of IP and realize that their members are losing out. So I think that if you were to look at some of the organizations that have been behind those issues, I think you'll find that they are keen to push the question, but I do not have the answer right now on that.

In terms of the success in litigation, it is a mixed bag for both domestic and foreign companies. I think that foreign companies are more successful in the courts in the major cities—and that is not

just IP, that is with regard to any kind of dispute. If you bring an action in a local court or provincial court there is a risk that the foreign litigant may experience local protectionism or that the local Party might be politically influential and impact the case. So, the foreigners will do much better in the larger cities. The courts are treating cases in Beijing and Shanghai professionally. But I do not have statistics in terms of the success rate, because sometimes success is measured in various ways; hence, even though a company might lose, the result might be fair. We find, in terms of arbitration cases before, like the China International Economic & Trade Arbitration Commission [CIETAC], CIETAC claims that in 75 percent of their cases involving foreigners, the foreign party prevails. My statement to CIETAC was to give themselves some credit because even though a foreign party may lose, the result may be fair. I have actually had cases where we have lost but the results were very fair. For example, I had a matter where the amount at issue was $20 million, but we lost and the amount that was actually awarded was $50,000. So, given the results, we actually won. Thus, it does not matter if you win or lose, it is whether or not the result is fair and whether or not the court or the arbitrators followed the law and parties' contracts.

Mr. SMITH. If I might respond to that question. I agree with Jim. The civil court system, and the IPR courts, and the intermediate courts in China have improved significantly. Unfortunately, civil litigation is not a way to get at criminal enterprises engaged in counterfeiting and piracy. It just is not deterrent. Certainly from our industry's standpoint, it is not the way to go for us. No one is making money, and you would make even less if you spent it on lawyers engaged in civil litigation because it would not really be deterrent.

That being said, the recording industry brought, over the last three or four years, maybe well over 100 civil cases against licensed CD and DVD factories. These were not underground plants, because you cannot bring a civil case against an underground plant if you do not know where it is. You can only bring a criminal case with the help of the government, and we are not getting criminal cases. Those cases were mostly settled for damages that had an impact, but it is simply not the way ultimately that you are going to deal with the problem of piracy, though it is very important to China to work on the rule of law and make their civil courts work. It just is not relevant in our area.

The second thing you asked is about trade associations. Yes, there are trade associations: China Audio-Video Association and Computer Software Association of China. First of all, many of these trade associations comprise primarily state-owned enterprises. How aggressive is that trade association going to be against its own government? You hear lots of talk in the background, but they are not going to be out there screaming like a private sector trade association in the United States might scream.

An exception to that is probably the Computer Software Association, which has a number of private company members. But even there, the politics within China—look, the Chinese are masters of divide and conquer, and that is what they are doing with us. Ev-

erybody is scared to death of saying anything negative about China for fear of retaliation. There is no question about that.

The last point I wanted to make, in response to you, Adam, is the Chinese invented the pirate format in Asia, the VCD. They invented it. About a year ago, or a year and a half ago, we heard news that they were going to "invent" or innovate a new DVD format, but this format would not have any protection on it. It would be a completely in-the-clear format. Of course, the motion picture industry was absolutely apoplectic about this possibility, and it has not happened.

Third, the Chinese Government has just recently announced—and there was a hearing in the House Government Reform Committee yesterday on this subject—a procurement regulation that, according to the Business Software Resellers Alliance [BSRA] member, would probably kill any ability of a foreign software company to sell software in China, because that procurement regulation would require state-owned enterprises, et cetera, to purchase only Chinese software.

So I do not subscribe to the view, and I do not think our members subscribe to the view, that there is any sort of great conspiracy here behind the scenes. I think there is just a combination of a lot of different things going on, a lot of lack of cooperation, and some agencies that have specific missions that are probably very anti-foreign. The combination of all of those elements gives you what we have today, which is a horrendous situation for IP owners.

Mr. CHOW. Civil litigation is for legitimate business disputes when you have a plaintiff and a defendant who are willing to show up in court. That is all right, and the local companies that are bringing these cases they have legitimate business disputes. But civil litigation does not preserve the element of surprise. When you deal with counterfeiters, you have to surprise them, because they are not there if you do not surprise them. So what most people in China do is they bring an administrative action, an enforcement action that is an ex parte action, where you show up and 15 minutes later the AIC or the PSB go with you and you raid the factory and then you seize all the goods. Then what happens is that there are penalties that do not create a deterrent. So, I think civil litigation certainly is important for China's long-term progress, but it is not the answer for counterfeiting.

Mr. FOARDE. Thank you all again for those answers.

I would like now to recognize my friend and colleague, William Farris, who is our senior specialist for the Internet, and has also taken over duties as our press director. William.

Mr. FARRIS. Thank you. One of the areas I look at is censorship in China. It seems like we were talking earlier about issues of political will and capacity. It seems like when it comes to censorship, China has a great deal of political will and a great deal of capacity. Mr. Smith, I believe you mentioned, perhaps indirectly, that China's method of handling cultural imports is affecting the ability of copyright holders to make money in China. You also mentioned that the two foreigners arrested in Shanghai were initially charged under Article 225, which, as I understand it, is the law on which the Supreme People's Court also has issued an interpretation that says that illegal publications would be prosecuted under that law.

I am wondering if you, or perhaps the rest of the panelists, might be able to further comment specifically on why they were arrested under Article 225, and why the charge was eventually changed to a charge under Article 217 of the criminal law, and also any issues relating to how China's censorship regime affects the ability of U.S. copyright or other intellectual property holders to make money in China. Thank you.

Mr. SMITH. Well, I think our industries face censorship in almost every developing country in the world, so we are used to having our movies and our music censored. You build around that. You can adjust to it. One of the difficulties in China, is that pirates do not go through censorship and, in the case of the music industry, for example, local music companies do not go through censorship. So, that is sort of a national treatment violation, right there.

The Internet is another example. I will just give you an example. I think I mentioned it in my testimony. There are something like 200,000 Internet cafes in China, with 100 to 300 seats each. Most of them are devoted to game playing. These Internet cafes are intensely regulated, but there is no regulation that says they cannot pirate, and in fact, they all do. They download off the Internet, they get pirated games. It is just a real big problem.

So the control that the Chinese Government has over its own society to prevent social misbehavior, to prevent pornography, many of these 225 actions that have been commenced over the last 10 years were really actions against pornographers. Now, there was pirated product seized in the raid, but the real gravamen, we think, of a lot of these criminal actions was to get at the pornographers, because that they view as a really serious problem that they need to stop, and we just would like to see them to make the judgment that piracy is like that.

Mr. FOARDE. Would any other panelist want to make a comment? Please, go ahead. Go ahead.

Mr. ZIMMERMAN. One of the concerns with Chinese law in general, and including the IPR judicial interpretation, is that it is very vague, very generally worded. It gives the government as much wiggle room as possible, and, unfortunately, much enforcement is in the hands of those who are interpreting the law.

Subjective enforcement is a concern because, without specificity, we have to guess how they are going to interpret or implement the law and regulations. That wiggle room creates problems because there is too much discretion in the hands of the PRC agencies. Such discretion is why some enforcement activities are politically motivated and the politics have to be played to encourage somebody to prosecute or to seize goods.

That is a problem with Chinese law, in general. It is very general, the way it is worded, and leaves a tremendous amount of discretion on the part of the agencies or the court with respect to the judicial interpretation. Unfortunately, we have to anticipate how the law is going to be applied and we have to have some faith that they will, because of outside pressure, move forward with criminal prosecution. That is the key thing here, is that at the end of the day, at the end of the year, we are going to count the success of achieving benchmarks, and we are going to find out if they put people in jail. It is not just the guy on the street that is selling the

DVDs that has no political power, no political strength, but it is the factory owners and the government officials protecting them. Those are the people that have to go to jail, and that is what we are looking for.

Mr. CHOW. We have talked a lot about the difficulty in obtaining enforcement, and we have not gone into a great deal of detail, but it is just really incredible how many obstacles there are to effective enforcement. I will just give you a very simple example. When I was working in China, we went to the Public Security Bureau [PSB], and we said, "Well, we know of a counterfeiter, and what we want you to do is to arrest them." What the PSB said to us was, "Well, will you give us a reward?" I said, "What do you mean?" "Well, we want 50,000 RMB per arrest." That is not that much. That is about $6,000 U.S. dollars. But the U.S. corporation has to worry about the Foreign Corrupt Practices Act, and of course we said no. But they would not do it unless you paid them a case fee, 50,000 RMB per head. So, that is just to give you an idea.

There are so many others, and I can go into detail about evidentiary issues and what counts as evidence and what does not. There are just so many issues and so many obstacles, it is very difficult to get that type of enforcement.

Mr. ZIMMERMAN. It is not a user-friendly system.

Mr. FOARDE. Let the record show that the comment was that it is not a user-friendly system. Let me pick up on the questions now. One for Dan Chow. I was struck by your comment on trading rights eventually or suddenly being able to be acquired by counterfeiting companies, domestic counterfeiting companies in China, which I take it was not the case before. How much relationship, if any, does this have with the trading rights commitments that the Chinese Government made in the WTO accession process?

Mr. CHOW. When China joined the WTO, China committed to further liberalize its economy and its legal system so that it could foster legitimate trade. Part of the same liberalizations which help legitimate trade also help the illegal trade in counterfeit goods. Specifically, what I mentioned was that, under China's pre-WTO system, only state trading companies had the privilege of exporting products from China. This is an example of the lifting of a restriction that is going to help both legitimate and illegitimate trade. So, for example, the reason why China has to eliminate the export monopoly that state trading companies have is to facilitate legitimate businesses who do not then have to go through the process of hiring a state trading company to export their products.

Well, if you eliminate the monopoly rights that state trading companies have on exports, that means anybody, including counterfeiters, can export without the help of a state trading company.

What has happened today is that counterfeiters find a cooperative state trading company that is willing to export counterfeit goods, but that involves work, that involves payments, and that is something of a barrier. But by lifting that export monopoly and by giving a general right to every company, except with respect to certain types of goods, such as cotton, which are restricted, now any company can export.

Now, if you are a counterfeiter and you can export to Eastern Europe where there is no legitimate product, so they cannot tell,

and where it appears that there is no specific criminal law directed at exports, what is going to happen is you are going to see an explosion in the amount of exported products from China. I believe, in the first half of 2004, there has been a sharp increase in the number of seizures by U.S. Customs. So the same measures that will liberalize trade in China and help legitimate trade will also, in the short term, I think, lead to an increase in commercial piracy.

Mr. FOARDE. I would be happy to have either one of you address that.

Mr. ZIMMERMAN. Just for clarification on that, there is a distinction between the trading rights and the distribution rights. To China's credit, last summer they did provide for wholly foreign-owned enterprises to have trading rights, and that was in the amended foreign trade law. That was six months before their WTO obligation kicked in. But on distribution rights, it is still something that we are waiting for. The new notice that came out two weeks ago, is still unclear on the process of obtaining distribution rights.

Now, the impact of all of that on IP issues is that because things are relaxing, I think you are going to find more and more counterfeits in the export market. So, with meeting the WTO obligations on trading rights, distribution, or whatever, it is going to make it worse because now they are exporting everywhere.

Mr. SMITH. We are actually a little bit more concerned on the import side, again, as part of the market access problem, getting legitimate product into China. Basically, the export of CD product, after the 1996 closures, went down to a trickle. Now it is back up. It is an interesting comment, because most of the exporting was not done before, and it was smuggled out. So, that has not made much difference.

But what we were really hoping for was to be able to import directly to the Chinese consumer without going through China Film or the China monopoly importer for the record industry, or the CMPIEC for book publishing. For those industries, all that is still in place right now. We still have to go through those monopoly organizations, in part because the trading rights did not apply in the film industry. In the publishing industry, we are trying to figure out now why publishers are importing through the monopoly. They should have full trading rights. They should be able to go directly to the consumer. So, these are things that need to be worked on and resolved.

I just want to say that what they did in the judicial interpretations is that they did kind of a back-handed thing. For somebody who exports or imports, it is not a direct offense. You are an accomplice to some other offense. I do not know quite how that is going to work. But they just did not go the whole way. To give you another example of this, there was an internal Supreme Court research study done before the judicial interpretations were issued, and that study recommended, I believe, that the threshold be measured by the of the value of the legitimate product, not of the pirated product. You can imagine, if you are selling a DVD for 60 cents, you have to have a heck of a lot of DVDs before you meet, for a major crime, the $54,000 threshold at 60 cents. That is a lot of product. It was recommended that they get rid of that. In the political processes, they worked through the JIs, or the judicial in-

terpretations, and that did not happen. In part, it was to maintain this kind of discretion that Jim was talking about. They did not want to have a hard-and-fast rule that said this is going to be a crime, this is not going to be a crime. They wanted to be able to make sure that they could play with it.

Mr. FOARDE. Our shadows are getting long this afternoon, but I think I would like to take the privilege to ask the last question for the afternoon and just pick up on a theme that I think both Jim touched on, and Eric as well, in your opening presentations, on how China compares with the sort of counterfeiting history of Taiwan, Hong Kong, and South Korea. If you could help us a little bit to understand your views about where China is on that continuum and get into that a little bit more deeply in the couple of minutes we have remaining, I think it will be very useful for us.

Mr. SMITH. I can say that it is a little difficult to talk about Taiwan in this context, because what happened was, from 1989 through 1998, they had an enforcement campaign that drove audio and video piracy rates, as I say, down to like 12 and 15 percent. We crowed about Taiwan as our success story. Then what happened, is the Taiwan government let the OD factories, the optical disk factories, go. They kind of relaxed and the pressure went off. All of a sudden, there were 60 factories. Organized crime took over and they were investing on the mainland, they were investing in Hong Kong, they were investing in Thailand and Malaysia, and it went out of control and piracy went back up to 50 percent. So, it is now back down. It is going back down again. I would say you could cite Taiwan as an example of a country very much like the mainland, but much smaller, where the political will was there.

Korea is another example. Within a period of maybe five years, they went from 90 percent piracy rates down to 15 percent piracy rates. So, again, a smaller country, a country that at the time had a government that was not as democratically oriented as it is now, and the piracy situation in Korea is not quite as good. It is a whole new thing. The Internet is in Korea now. It is the most wired country in the world and piracy is out of control. But back in the days before the Internet, piracy was under control.

So, our message is, China could do this. This is not impossible. You do not have to take every person on the street and make them a cop to stop piracy. It is called smart enforcement, deterrent enforcement, not just throwing bodies at it. The SAICs have 100,000 employees and they are doing trademark enforcement. I do not work much with the SAICs, but there are a lot of people. It does not necessarily take a lot of people. It takes smart enforcement, not bodies.

Mr. FOARDE. If either of you would like to comment on that in the minute or so we have remaining, please.

Mr. ZIMMERMAN. I think there is a pattern between Taiwan, South Korea, and China here, and also, with Mexico and Latin America, where you have countries that have underdeveloped legal systems and where their focus is on low-cost manufacturing. They are going to find a way to make money and make money off counterfeiting. I remember in the early 1970s in Mexico, there were knock-off eight-track tapes and cassettes that were readily available on the streets. I am not sure if you will find those today. I

think Mexico has made progress on IPR issues. But there is a pattern. China is, of course, a bigger country.

I do agree with what Eric is saying. What is required is smart enforcement. It is coordination of resources, dedicating more resources, and then having the political will to go after those criminal organizations and to shut them down. But we have also got to keep reminding China that there is a tremendous benefit for their own industry, for their own tax revenues to make this a priority. We cannot keep saying to them, "Hey, this is to protect foreign companies," or "this is to protect foreign IP holders." That is part of the equation.

The other part of the equation is that you have to protect your own industry, and, most importantly, to protect themselves and their reputation internationally. China has a lot to gain by being an international player. They have a lot to lose by being labeled as a hub for knock-off manufacturing. That reputation is not something that China wants or needs.

Mr. CHOW. I know that many people draw comparisons between Taiwan, South Korea, and China. But Taiwan and South Korea felt the pain of counterfeiting, and that has not happened to China. I am not sure if it is going to happen to China.

The other thing is that there is this basic assumption that we have that no nation can achieve a high level of industrial and economic development without respect for IP laws. But I am not sure that that historical lesson is going to apply to China. I mean, I think we may be seeing the emergence of a new type of economy, one in which piracy rates remain permanently higher than anything we have ever seen before, and the economy continues to grow. That is what is going on. The economy continues to grow at rates which are the envy of the world. China continues to be the largest recipient of foreign direct investment in the world, consumer wealth and spending continue to increase, all this against a background of a commercial piracy problem that has no parallels in world history. So, I do not know that the historical lesson is going to apply to China, and I think that China may test that. We may be seeing something new.

Mr. FOARDE. I take it from what we have heard before, particularly from Eric, that there is not universal agreement on that point, but I am glad that we heard a diverse set of views on this question.

Our time for this afternoon is up, unfortunately, so we are going to have to leave it there. I would like to thank, on behalf of Senator Chuck Hagel, our Chairman, and Congressman Jim Leach, our Co-Chairman, our three panelists, Eric Smith, Jim Zimmerman, Daniel Chow, and also all of you who came to listen this afternoon.

We hope you will join us again next week on Monday afternoon at 2 p.m. over in 2255 Rayburn for a roundtable on unofficial religions in China.

So we will call this one closed for today. Thank you all.

[Whereupon, at 3:34 p.m. the roundtable was concluded.]

A P P E N D I X

PREPARED STATEMENTS

PREPARED STATEMENT OF DANIEL C.K. CHOW

MAY 16, 2005

COUNTERFEITING IN CHINA

I. INTRODUCTION

In terms of size, scope, and magnitude, counterfeiting in China is considered by many to the most serious counterfeiting problem in world history. (As used here, counterfeiting refers to the unauthorized use of trademarks owned by another on identical or similar goods.) A recent study by the PRC State Council Research and Development Center reported that in 2001 the PRC economy was flooded with between $19–$24 billion worth of counterfeit goods. Brand owners in China estimate that 15 to 20 percent of all well-known brands in China are counterfeit and estimate their losses to be in the tens of billions of dollars. Counterfeiting is estimated to now account for approximately 8 percent of China's gross domestic product.

China is also a leading exporter of counterfeit products to other countries in Asia, Europe, and the United States. In 2003, China accounted for 66 percent or over $62 million of the $94 million of all counterfeit and infringing goods seized by the U.S. Customs Service at ports of entry into the United States. Mid-year figures in 2004 indicate that seizures are sharply higher with $64 million seized in the first half of 2004 alone. An ominous development is that beginning in 2004, exports of counterfeits from China to the United States and other parts of the world may begin to increase significantly for the foreseeable future.

II. ORIGINS AND CAUSES OF COUNTERFEITING

There are several explanations for the unprecedented size and scope of counterfeiting in China:

(1) *Foreign Direct Investment and Advanced Technology.* China's economic growth through the decade of the 1990s has been fueled in large part by foreign direct investment (FDI) from multi-national enterprises (MNEs). In the 1990s, China emerged as the world's second largest recipient of foreign direct investment behind only the United States and in 2002, China surpassed the United States to become the world's largest recipient of foreign direct investment with $50 billion of foreign capital inflows. FDI is the best means in the world today for the transfer of advanced technology, intellectual property, and other forms of valuable information. In many cases today the intellectual property component of a FDI in the form of patents, copyrights, and trademarks is the most important component of the foreign investment. For example, the value of the Coca-Cola trademark in China is worth more many more times to that company than the millions of dollars in capital that it has invested in China. The same is true for the patents and copyrights owned by pharmaceutical companies and software companies doing business in China today. However, while MNEs are creating a transfer of technology through FDI that is being absorbed into China's legitimate economy through joint ventures and wholly foreign owned enterprises some of this intellectual property is also being diverted into China's illegitimate economy as pirates steal this technology to engage in counterfeiting and other forms of commercial piracy. It is no coincidence that China, the world's largest recipient of FDI, advanced technology, and intellectual property also has the world's most serious commercial piracy problem.

(2) *State Support of Counterfeiting and Local Protectionism.* No problem of this size and scope could exist without the direct or indirect involvement of the state. In China, the national government in Beijing appears to be sincere in its recognition of the importance of protecting intellectual property rights, but national level authorities are policy and law-making bodies whereas enforcement occurs on the ground at the local level. At this level, local governments are either directly or indirectly involved in supporting the trade in counterfeit goods and are often reluctant to punish counterfeiters.

(3) *Ineffective Legal Enforcement and Lack of Deterrence.* China has a developing legal system that is weak in many respects by comparison to legal systems in advanced industrialized countries such as the United States. While China's intellectual property laws are now considered by most observers to be in compliance with the standards set by TRIPS, enforcement of these laws remains inadequate and fails to create sufficient deterrence of counterfeiting.

The combination of these factors—the world's largest influx of foreign direct investment and widespread access to advanced technology, direct or indirect government involvement and support of the counterfeit trade, and a weak legal system that does not create sufficient deterrence for counterfeiters in a very lucrative trade—has resulted in a counterfeiting and commercial piracy problem that is unprecedented in world history.

III. OVERVIEW OF COUNTERFEITING IN CHINA

The illegal trade in counterfeit goods in China can be divided into two components: manufacture and distribution:

(1) *Manufacture:* The manufacture of counterfeit products tends to be concentrated in China's southeast region in coastal areas near Taiwan and Hong Kong. Criminal organizations in Hong Kong and Taiwan involved in smuggling, prostitution, and narcotics have now branched out into counterfeiting because of its lucrative nature. These criminal organizations supply the capital and startup costs and use the borders between China and their headquarters in Taiwan and Hong Kong to frustrate and elude law enforcement.

(2) *Distribution:* Distribution of counterfeit products occurs through a series of large open air or partially enclosed wholesale markets. These wholesale markets are found in strategic locations around the country and are positioned to serve large densely populated urban areas. These wholesale markets are established and regulated by the local Administration of Industry and Commerce (AIC), a branch of the local government responsible for promoting, regulating, and policing commercial activity. Based on the experience of the author, every wholesale market in China traffics in counterfeit goods. As AICs are also one of the primary government entities in China charged with enforcement against counterfeiting, AICs are faced with a conflict of interest as they are charged with policing and enforcing the very markets in which AICs and the local government have a substantial investment and financial interest. Shutting down these wholesale markets would not only result in a direct loss of revenue to the AIC but would also have many repercussions as many retail businesses, hotels, restaurants, and nightclubs are all supported by the trade in counterfeit goods.

IV. BARRIERS TO EFFECTIVE ENFORCEMENT AGAINST COUNTERFEITING

(1) *Local Protectionism:* While it appears that central level leaders understand the importance of protecting intellectual property for promoting China's long-term economic development, central level authorities are legislative and policymaking bodies. Actual implementation and enforcement of the law occurs at the local level where there continue to be questionable commitments to suppressing counterfeiting, copyright piracy, and other forms of economic crimes. Local areas benefit directly and indirectly from counterfeiting. In some areas, counterfeiting provides jobs and generates revenue that are essential to support the local economy. In some cases, counterfeiters voluntarily pay substantial taxes to local authorities. In other cases, legitimate businesses such as hotels, restaurants, nightclubs, storage and transportation companies have been created to support the trade in counterfeit goods. The payment of taxes and the creation of lawful supporting businesses has integrated counterfeiting into the legitimate local economy. It is no exaggeration to say that some local areas in China are entirely supported by the trade in counterfeit goods and that local residents are ready to use any means necessary to protect their illegal trade. A crackdown on counterfeiting would result in shutdown of the local economy with all of the attendant costs of unemployment, dislocation, social turmoil, and chaos. Because the costs of a crackdown at the local level can be so severe, counterfeiting is heavily defended at local levels.

(2) *Inadequate Punishment:* Local protectionism and a weak legal system contribute to the lack of adequate enforcement against counterfeiting. The result is that the Chinese enforcement system does not create deterrence. To be sure there is no lack of enforcement activity. To the contrary, it is relatively easy to obtain an administrative action in the form of a raid and seizure action against suspected counterfeiters. The problem is that once the enforcement action is completed the level of fines and criminal prosecutions are so low that whatever sanctions are meted out do not create deterrence. For example, the average fine imposed on the counterfeiter or infringer in 2000 was $794, a figure that is so low as to be considered a cost of doing business in a very lucrative trade. The amount of compensation awarded to brand owners in 2000 stands at $19, a negligible amount. Damages awarded by AICs seek to award the brand owner the profits earned by the counterfeiter after deducting all expenses (as represented by the counterfeiter) and are not based upon economic losses suffered. As for criminal prosecutions, in 2000 only about 1 in 500

cases were referred to judicial authorities for criminal prosecutions. Enforcement in China does not create fear in counterfeiters or deterrence.

V. EXPORTS FROM CHINA

Recent changes indicate an ominous development: exports from China are likely to increase dramatically beginning in 2004.

(1) *Exports to the United States:* In 2003, U.S. Customs seized a total of $94 million of counterfeit and infringing goods in ports of entry at the United States. Of this total, products originating in China accounted for 66 percent of the total and $62 million of the total. The 2003 figures for China represent a significant increase over comparable 2002 figures when China account for 49 percent of all counterfeiting and infringing products and $48 million of the total $98 million of illegal product seized by U.S. Customs. Counterfeits from China and Hong Kong (through which many counterfeits produced in China are transshipped) accounted for $80 million or 75 percent of the total. No other country accounted for more than 3 percent of counterfeit products. As many counterfeit products, such as auto parts, that originate in China are transshipped through other countries, such as those in South America and through Canada, before ultimately entering the United States, China likely accounts for a significantly higher percentage than the 66 percent set forth the 2003 U.S. Customs statistics. It is possible that China accounts for as much as 80 percent or more of the counterfeits goods that enter the United States. Note that the $94 million figure represents only the value of the products that are seized by U.S. Customs in 2003, which can only be a tiny fraction of what enters the U.S. market. If the total value of the products seized represents 1 percent of the counterfeiting and infringing product that enters the U.S. market then the total value of counterfeits that entered the U.S. market in 2003 is approximately $10 billion with China accounting for between $6 and $8 billion of that total. It is possible that the actual figures are much higher.

(2) *WTO Commitments:* There is likely to be a significant increase in the amount of counterfeit products exported from China to the United States beginning in 2004 and for the foreseeable future for several reasons. In accordance with its WTO obligations, China has amended its foreign trade laws in December 2003 to eliminate the monopoly on export rights that had been limited to state trading companies. Under prior law, only certain designated state trading companies were permitted to lawfully export products from China to other countries. This restriction meant that counterfeiters had to find a compliant state trading company that was willing to work together with the counterfeiter in exporting the illegal goods overseas. To be sure, there was no shortage of export companies willing to work with counterfeiters in exporting counterfeit and infringing products, but this requirement nevertheless created an additional obstacle and costs that have now been removed. The effect of the elimination of the monopoly on exports rights means that anyone can now lawfully export products from China. As counterfeiters are likely to take full advantage of the elimination of this restriction, exports of counterfeits from China to the United States are likely to surge for the foreseeable future. U.S. Customs mid-year seizure figures for 2004 indicate that there is a sharp increase in seizure activity: $64 million in counterfeit goods were seized by mid-year 2004 compared to $38 million by mid-year 2003.

(3) *Lack of Criminal Laws:* China does not appear to have any current criminal laws that specifically apply to the export of counterfeit products. As the earlier discussion indicated, China has criminal laws against commercial scale counterfeiting within China, although the effective enforcement of these laws is impeded by various obstacles. In the area of exports, however, it is arguable that there are no applicable criminal laws at all, and that counterfeiters can export with impunity from both civil and criminal liability. As pressure mounts on China to obtain better enforcement results within China, it is likely that counterfeiters will turn increasingly to exports as a source of revenue.

Counterfeiting in China

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May 16, 2005

Overview

- MOST SERIOUS COUNTERFEITING PROBLEM IN WORLD HISTORY
- PRC ESTIMATES PUT COUNTERFEIT TRADE AT $19-24 BILLION PER YEAR AND 8% OF GROSS NATIONAL PRODUCT
- U.S. INDUSTRY GROUPS ESTIMATE LOSSES IN THE BILLIONS TO TENS OF BILLIONS PER YEAR
- 15-20% OF WELL-KNOWN BRANDS OF CONSUMER PRODUCTS ARE COUNTERFEIT
- DIRECT OR INDIRECT INVOLVEMENT OF GOVERNMENT ENTITIES
- EXPORTS FROM CHINA MAKE THIS A GLOBAL PROBLEM

Origins

- GROWTH OF CHINA'S ECONOMY
- ROLE OF FOREIGN DIRECT INVESTMENT AND TECHNOLOGY TRANSFER
- PROBLEMS OF POLITICAL AND LEGAL REFORM: LOCAL PROTECTIONISM AND INADEQUATE ENFORCEMENT

Major Distributors and Manufacturers of Counterfeit Goods in China

Harm to U.S. Brands in China

Figure One: Beijing Case Study

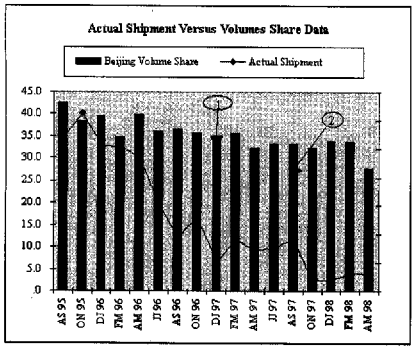
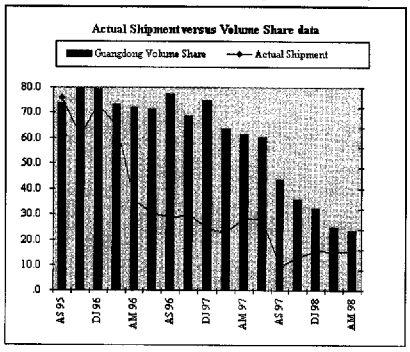


Figure Two: Guangdong Case Study



Administration of Industry and Commerce Trademark Enforcement Activity, 1997-2000

Year	Cases	Avg Fine	Avg Damages	Criminal Prosecutions
1997	15,321	$679	$40	57 total or 1 in 268 cases
1998	14,216	$699	$41	35 total or 1 in 406 cases
1999	16,938	$754	$40	21 total or 1 in 806 cases
2000	22,001	$794	$19	45 total or 1 in 489 cases

Source: State Administration of Industry and Commerce Annual Statistics

EXPORTS

- COUNTERFEITS FROM CHINA MAY ACCOUNT FOR 80% OF EXPORTS TO U.S. AND OTHER COUNTRIES
- COUNTERFEITS FROM CHINA SEIZED BY U.S. CUSTOMS IN 2003 VALUED AT $62.4 MILLION
- SIGNIFICANT INCREASE IN EXPORTS OF COUNTERFEITS FROM CHINA STARTING 2004 BACKED BY SHARP RISE IN 2004 MID-YEAR SEIZURE STATISTICS

Future Trends

- POLITICAL WILL
- WORLD TRADE ORGANIZATION AND TRIPS

PREPARED STATEMENT OF ERIC H. SMITH

MAY 16, 2005

Mr. Chairman, Members of the Commission and Commission Staff, IIPA and its members thank you for the opportunity to appear today to review China's record on enforcement of its copyright law against widespread piracy and China's compliance with its WTO-TRIPS obligations. IIPA represents the U.S. copyright industries. Its six member trade associations consist of over 1,300 U.S. companies, accounting for millions of U.S. jobs. The copyright industries, in 2002, contributed over $625 billion to the GDP, or 6 percent of the U.S. economy and almost 5.5 million jobs or 4 percent of U.S. employment. These companies and the individual creators that work with them are critically dependent on having strong copyright laws in place around the world and having those laws effectively enforced. On average, the copyright industries generate over 50 percent of their revenue from outside the United States, contributing over $89 billion in exports and foreign sales to the U.S. economy. Given the overwhelming global demand for the products of America's creative industries, all these numbers would be significantly higher if those trading partners, including China, that continue to allow piracy to flourish in their own economies were to significantly reduce piracy rates by enforcing their copyright law vigorously.

Before turning to the important topic of this Roundtable, I want to provide you with a brief update to IIPA's comprehensive February 2005 Special 301 submission on China to the U.S. Trade Representative. In that submission we called for entering into a new, multilateral dialogue in the WTO with the Chinese government as a way to persuade it to take aggressive action—as promised in the Joint Commission on Commerce and Trade Meetings over one year ago—to significantly reduce the rate of piracy in all IPR sectors including the copyright sector. We then provided a summary review of what had happened in China over the last year to redeem that commitment. Our conclusion: China has failed to comply with its commitment made over one year ago in the JCCT to significantly reduce piracy rates. While some modest reductions have occurred in some sectors, by no measure have piracy rates been significantly reduced. In fact little has changed in the marketplace for our members and their companies, despite reports of increased raiding activity and seizures of many pirate products. For the record, I am submitting a copy of that Special 301 submission which tells the story of the failure of an enforcement system to deter rampant piracy in the potentially largest market in the world.

On April 29, 2005, USTR issued its decision resulting from the out-of-cycle review of China's enforcement practices announced on May 3, 2004. USTR reflected in this decision its deep concern over China's lack of progress in the enforcement area by elevating China to the Priority Watch List. It also announced a number of other initiatives, one of which was to work closely with our industries with an eye on utilizing WTO procedures to bring China into compliance with its WTO obligations. Since that time we have met with USTR to begin this process and will work intensively with USTR toward the mutual goal of bringing China into compliance with its WTO TRIPS obligations, its bilateral obligations to the United States in the 1995 and 1996 IPR agreement and action plan, and its commitments made to our government in the JCCT process.

This process has now commenced in earnest. USTR will also be seeking information from the Chinese government under the transparency provisions of the TRIPS agreement, and is committed to using the JCCT process to encourage the Chinese government to implement key reforms on both the enforcement and the all-important market access front.

Mr. Chairman, our industries are deeply frustrated by the lack of real progress by China in taking effective action to deter piracy and to open up its market to legitimate cultural and high technology copyright products. China remains one of the most closed markets in the world for the U.S. copyright industries. Onerous market access restrictions affect all our industries. Notwithstanding Premier Wen's pledge to address the $162 billion trade imbalance between the United States and China by increasing China's imports from the United States, China is retaining—and, in some sectors, augmenting—market access restrictions for creative and high-tech products that represent America's comparative advantage.

Copyright piracy represents perhaps the largest barrier to effective market access in China. An average (and truly staggering) 90 percent piracy rate has persisted for years despite repeated "strike hard" enforcement campaigns, steamroller campaigns, and public statements from many high level government officials supporting stronger enforcement. While our Special 301 submission highlights the current situation in China, I wanted to give you a brief flavor of what copyright companies confront

in trying to do business in China in face of these trade barriers and these inexcusably high piracy levels.

Taking the business software industry first—one of our nation's most productive and important creative sectors: The software industry faces piracy rates in China of 90 percent, one of the highest in the world for that industry. China leads the world in the production and export of counterfeit software—software packages that are purposely designed to replicate the original legitimate product. Losses to U.S. software publishers were estimated by the Business Software Alliance (BSA) at $1.47 billion in 2004. China was the 6th largest market in the world for personal computers and ranked 26th in legitimate software sales. This increasing disparity not only damages the U.S. industry but hurts Chinese software developers as well.

China has failed to criminalize the most damaging type of piracy to the business software industry—the unauthorized use of software within businesses and government institutions. This is a violation of the TRIPS Agreement. Combined with the total absence of a criminal remedy is the absence of all but a few administrative actions against this type of piracy with woefully low and non-deterrent fines. As a consequence, piracy rates continue to remain at staggering levels.

To make matters worse, China is on the verge of shutting down access for U.S. and other foreign companies to the largest purchaser of software in China: the Chinese government. It would accomplish this by adopting draft government procurement regulations that would expressly favor Chinese software only. In short, the situation for this critical copyright sector is truly dire in China with no significant improvement in sight.

The U.S. motion picture industry is facing a 95 percent piracy rate in China (the highest in the Asia Pacific region, and among the highest in the world) which represents a worsening of the situation from the previous year. Losses to just the motion picture industry, from 1998 through 2004, are estimated at over $1 billion (not including losses from Internet piracy, which are growing alarmingly). While raids and seizures have increased somewhat following Vice Premier Wu Yi's 2004 enforcement campaign, administrative fines remain far too low to deter pirate activity and, as I will describe later, criminal cases have been extremely rare despite Chinese promises to use this TRIPS-required remedy. According to a recent newspaper report, the legitimate home video market in China represents about 5 percent of the estimated total market of $1.3 billion (which is itself a very conservative estimate). Of the 83 optical disc factories licensed by the government (and an unknown number of "underground" unlicensed plants), many continue to churn out pirate DVDs. The export of pirated home video product, which had slowed to a trickle after the U.S. Section 301 action (and threatened retaliation) in 1995–96, has resumed and is growing. The total optical disk plant production capacity, a significant amount of which is devoted to producing pirate product, is now close to 2.7 billion units annually. Optical disks sourced in China and containing pirated films have been seized in over 25 countries around the world. The massive quantity of pirated movie product available in China is evidenced by the fact that pirate prices start around $0.60 per unit the lowest price in Asia. As with the other copyright industries, any enforcement that occurs is conducted by administrative agencies, with overlapping jurisdiction and often little coordination, and fines imposed are a mere "cost of doing business." A recent anecdotal study, conducted by IIPA member, the Motion Picture Association (MPA), revealed that the average fine imposed per pirate home video product (DVD, VCD) seized in raids resulting from MPA complaints is only slightly higher than the cost of purchasing a blank disk—clearly of no deterrent value. The lack of deterrent administrative penalties is a key reason, in addition to the almost complete lack of criminal enforcement that piracy rates persist at 90 percent of the market and above.

Accompanying and reinforcing this piracy situation are onerous market access restrictions, including a Government-owned, monopoly importer, very limited competition in distribution, and a quota of 20 theatrical films allowed into China annually on commercial terms. The pirates capture 100 percent of the market for films not permitted legally in China. Even those films permitted theatrical release suffer piracy rates of 70–75 percent, because of the long delays before most American films are given screen time. Another consequence of the lack of competition in importation and distribution is the non-competitive pricing in the Chinese market. Cumbersome licensing requirements burdens the retail sale of legal home entertainment product, holding down revenue potential and helping keep the market in the hands of the pirates. These barriers and those to all our industries must be removed in the JCCT process.

The entertainment software industry, one of the fastest growing copyright-based industries, faces similar high piracy rates and estimates the value of pirated video games in the market at $510 million in 2004. Demand for entertainment software

products is growing rapidly but is being soaked up primarily by the pirates. This demand is exemplified by the exploding popularity of "massively multiplayer online roleplaying games" (MMORPGs) where literally thousands of players can compete against one another simultaneously. Demand for MMORPGs in China grew at 40–45 percent over expectations in 2004. This increasing demand has fueled, in part, the growth of Internet cafés in China. (It is estimated that there are close to 200,000 Internet cafés in the country, with a seating capacity of between 100–300 seats, of which 60 percent are involved in game play.) While U.S. game publishers, represented by IIPA member, the Entertainment Software Association (ESA), have engaged in some licensing of the cafés, the vast majority of the product used is pirated, either available at the café or downloadable from the Internet. This dire situation has been all the more exasperating since the Chinese government extensively regulates the activities of these Internet cafés and often and vigorously revokes licenses for actions the government deems inappropriate. However, as far as we know, the government has never sought to include in this extensive regulatory scheme prohibitions against the widespread and blatant piracy at these cafés in its business licenses (which are otherwise very thorough). Moreover, no copyright enforcement of any kind has occurred. The legal infrastructure governing the Internet still is not helpful to copyright enforcement. Takedown of pirate sites is negligible; penalties non-existent.

Cartridge-based handheld games are also hard hit by the pirates with manufacturing and assembly operations throughout China with exports throughout Asia, Latin America, the Middle East and Europe. Enforcement attempts have been relatively successful in terms of raids and seizures but, like with other industries, administrative fines are non-deterrent and criminal enforcement action very rarely undertaken, even against factories generating millions of dollars in illicit profits. Entertainment software products are also subject to a protracted content review process, by two separate agencies contributing to market entry delays. Given the immediate nature of the demand and lifecycle of best selling games, this leaves the pirates virtually uncontested in the market prior to the official release of a new title. There are also Internet and investment restrictions that must be significantly eased or abolished.

The U.S. book publishing industry, represented by IIPA member, the Association of American Publishers (AAP), faces both significant offset printing of pirated books, primarily in translated editions, and massive commercial photocopying of textbooks and reference books on and near University campuses. There are 580 licensed state-owned publishers in China, 50 of which are considered major. There are only a few privately owned publishers but they must buy publishing rights from the state-owned publishers. U.S. publishers issued 4500 translation licenses in 2004, a significant number but far below China's potential. All the best selling books are then virtually immediately pirated by outlaw "printers" and made available through independent bookstores, stalls and street vendors. To give an example, the famous self-help bestseller "Who Moved My Cheese" sold over 3 million copies in China. It is estimated, however, that the pirates sold another 6 million copies. The Harry Potter books, and other best sellers like Hilary and Bill Clinton's books "Living History" and "My Life," John Grisham's books and others all face a similar fate from the pirates. Former General Electric President, Jack Welch's biography, "Winning," has sold over 800,000 copies but with an equal number of pirate copies available in the market. English language textbooks are also heavily photocopied in their entirety and there are six known websites which make available entire copies of textbooks that are downloaded and then photocopied. Enforcement against this vast piracy is spotty and all done administratively through the local and national copyright bureaus. Any resulting administrative fines are non-deterrent. We know of no criminal enforcement. The book publishing industry also faces market access barriers—U.S. publishers are not permitted to publish, sign authors, or print their books in China.

The recording industry, represented by IIPA member, the Recording Industry Association of America (RIAA) did experience a minor reduction in the piracy rate for sound recordings, from 90 percent in 2003 to 85 percent in 2004 in "hard goods" piracy, but with significant increases in Internet piracy. Losses remain in excess of $200 million per year from continued optical disk manufacture and distribution within the Chinese market and significant levels of audiocassette piracy (still an important format in China). The recording industry faces many of the same problems with optical disk piracy confronting the motion picture industry. Millions of pirated music CDs are readily available throughout China. Some of these pirate products have found their way into the export market. China continues to rely on its failed administrative enforcement system, which relies on numerous inspections, product seizures and, when the pirate doesn't flee, the imposition of small, non-deterrent fines.

Internet piracy in China, as in other countries in the world, has become a huge problem for the recording industry. Thousands of active websites such as www.9sky.com and www.chinaMP3.com are giving away, or offering links to, thousands of pirated songs. (These not-for-profit acts of piracy are not criminalized in China, as they are, for example, in the United States.) International criminal syndicates are apparently using Chinese servers to hide their illicit activity (www.boxup.com) and many Asian pirate sites are doing a thriving business in China, such as www.kuro.com from Taiwan.

Market access restrictions are severe, contributing to piracy and market losses. U.S. record companies cannot "publish" or release a recording without permission of a state owned company and cannot manufacture, distribute or engage in retailing of its products, which artificially segments the market and makes it extraordinarily difficult for this world class industry to participate in the Chinese market. Its products are subject to censorship while domestic (as well as pirate) recordings are not—a national treatment violation.

All in all, the copyright industries estimate their total losses in excess of $2.5 billion in 2004 due to piracy in China. The simple fact remains that these losses and the 90 percent piracy rates will NOT be significantly reduced without subjecting major piracy to criminal enforcement accompanied by deterrent penalties and substantially increasing the administrative fines specified in the copyright law and imposing them in practice. To date, even after the JCCT commitments, this has NOT happened and there is a real question whether the Chinese government as a whole (Vice Premier Wu Yi has been a staunch defender of better enforcement) can muster the political will to take these absolutely necessary actions—actions that have been key to significant reductions in piracy levels in other countries in which our companies operate. China cannot exempt itself from the rules—that enforcement against piracy requires deterrence and criminal remedies. The global community recognized this when it fashioned the Article 61 criminal obligation in TRIPS and it has proven to be the case in practice.

The Commission has asked the key question that has trouble everyone associated with China's IPR regime: "Will China ever enforce its IPR laws." The article in the Far Eastern Economic Review,[1] provided to us by the staff, sets out the interesting thesis that this failure has nothing to do with "stages of development" or "cultural attitudes." We completely agree. These shibboleths have regularly been argued to excuse China (and other countries) from meeting their freely bargained-for WTO obligations. In fact, other countries have similar "cultural attitudes" and are at or near China's development level and they have done a far better job bringing deterrence to their copyright enforcement system thereby reducing piracy rates. Piracy is an economic crime and responds to economic disincentives placed in the pirates' way by an effective, deterrent enforcement system. If the risk is too high, the conduct will cease or be substantially reduced. The authors also set out the view that Chinese government control over its economy and the "command" nature of the government's involvement contains built in incentives to continue to permit infringements as a way of protecting tottering state-owned enterprises. We have no expert view on this but observe that China has sought to preserve the import and distribution monopolies that are pervasive in the copyright sector. The thesis seems to apply more, however, to the patent and trademark areas of IP protection, rather than to copyright, where it is becoming clearer to us at least that the harm from copyright piracy is falling increasingly on Chinese creators and Chinese companies (some rather large too). These companies, because they are either state-owned (and find it difficult to confront their own government for its failures), or are private (and the government, like many governments in developing economies, are not yet responsive to the entreaties of their private sector) face a governmental response that derives primarily from internal bureaucratic needs, first and foremost. An illustration might be the apparent unwillingness of the Chinese authorities to lower the thresholds for initiating a criminal prosecution so that they become workable in practice (a result not accomplished in our opinion in the new Judicial Interpretations issued in December 2004) and to follow with criminal prosecutions and deterrent penalties. The reason given is that bringing more criminal cases would risk overwhelming the enforcement bureaucracy. However, many other governments face this same potential argument and have nevertheless determined that criminal enforcement is a necessary condition to reducing piracy (as well as being a WTO obligation). Furthermore, we should not underestimate the problem that the central government faces in controlling what happens at the provincial level. We believe, however, that, through the Politburo and the Party structure, this impediment can be overcome,

[1] Anne Stevenson -Yang and Ken DeWoskin, China Destroys the IP Paradigm, Far Eastern Economic Review (March 2005).

if the political will is there. It may be that such political will CAN be generated if the proper "incentives" are there. An example of this would be when the Chinese government (at the highest "political" level), in 1996–97, closed many of the CD factories that were exporting pirate optical disk product globally under threat of U.S. trade retaliation.

Regardless of the reasons why the Chinese government has not, at least yet, decided to take deterrent criminal actions against major acts of piracy (as required by TRIPS), to make necessary amendments to its criminal law (as required by TRIPS), to further amend its Judicial Interpretations to reduce the hurdles to effective criminal prosecutions, and to increase administrative penalties and impose them at deterrent levels, they are nevertheless under an international obligation (in the WTO), and a bilateral obligation (under the 1995–1996 bilateral agreement settling the Section 301 case) to do so. Moreover, it is not in China's own interest to undermine its own domestic creative industry and to continue to foster trade friction with its key trading partners. Other governments in the Asian region have made the political determination that effective enforcement is in that country's own interest. China must do the same and do so NOW. Thank you very much for the opportunity to participate in this Roundtable.

INTERNATIONAL INTELLECTUAL PROPERTY ALLIANCE
2005 SPECIAL 301 REPORT
PEOPLE'S REPUBLIC OF CHINA (PRC)

EXECUTIVE SUMMARY

Special 301 Recommendation: IIPA recommends that USTR immediately request consultations with China in the World Trade Organization, and that it place China on the Priority Watch List pending an out-of-cycle review to be concluded by July 31, at which time further appropriate multilateral and bilateral action, including the possible establishment of a dispute settlement panel in the WTO, will be determined.

On February 9, 2005, IIPA submitted its comments[1] to USTR on China's progress in implementing the commitments it undertook under the Joint Commission on Commerce and Trade (JCCT), its WTO commitments and its 1995 and 1996 bilateral agreements and action plans to provide adequate and effective protection and enforcement for U.S. copyrighted products. These comments were part of the out-of-cycle (OCR) review process announced by USTR on May 3, 2004[2] and for which industry comments were sought by Federal Register Notice on December 14, 2004.[3] In that OCR submission, IIPA summarized the views of the copyright industries on what progress had been made since the JCCT meetings concluded. Below, we summarize IIPA and its members' findings and our conclusions:

- **Piracy levels have not been "significantly reduced" — they still are around 90% in all sectors.** China's actions in 2004 (and to date in 2005) have not produced substantial progress toward a significant reduction in copyright infringement levels, as promised by Vice Premier Wu Yi at the JCCT. China has not met its WTO TRIPS commitment to provide effective enforcement, and particularly criminal enforcement against piracy "on a commercial scale," nor its continuing bilateral obligations reflected in the 1995-1996 bilateral agreements and action plans. On October 12, 2004, IIPA submitted its comments in connection with the TPSC's request for industry views on China's compliance with its WTO commitments and concluded that China is not living up to its international obligations, in particular by failing to amend its criminal law to bring it into compliance with Article 61 of the TRIPS Agreement, and by its failure to translate those commitments into effective, deterrent enforcement in practice.[4]
- **The recently-amended Supreme People's Court's "Judicial Interpretations" (hereinafter "JIs") leave unanswered questions about China's political will to bring criminal prosecutions and impose deterrent penalties.** The new JIs make only minimal decreases in the monetary thresholds and continue to be calculated at pirate prices, but the new 1000/3000/5000 copy threshold may be helpful if implemented to bring more criminal cases against manufacturers and distributors. Online infringements that meet the thresholds are criminalized but the ability to use the new

[1] See http://www.iipa.com/rbc/2005/CHINA%202005_Feb9_PRC_OCR_Submission.pdf.
[2] See http://www.ustr.gov/Document_Library/Press_Releases/2004/May/Special_301_Report_Finds_Continued_Progress_But_Significant_Improvements_Needed.html.
[3] See http://a257.g.akamaitech.net/7/257/2422/06jun20041800/edocket.access.gpo.gov/2004/pdf/04-27373.pdf.
[4] See http://www.iipa.com/rbi/2004_Oct12_IIPA_CHINA_WTO_TPSC_Submission-rev.pdf.

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rule in practice has yet to be tested. Importing and exporting of pirate products are criminal, but not directly; liability is only under the rule governing "accomplices" — at significantly lower criminal penalties. End user software piracy appears not to have been criminalized. The rules were weakened with respect to repeat offenders. Industry is very concerned that the apparently grudging minor changes will not result in significantly more criminal cases with deterrent penalties and thus piracy levels will not be markedly affected. To the best of our knowledge, no criminal cases have yet been brought under the new JIs, so it is premature to assess whether they will make a real difference in practice in reducing piracy levels. In addition, the first line of implementation of this new interpretation will be the police (the Ministry of Public Security/Public Security Bureau or PSB). Effective enforcement will not become a reality if there is inadequate attention, investment and training by the PSB. However, police resources for this purpose have not been increased nor, to the best of our knowledge, were they involved in drafting the JIs. More importantly, that part of the PSB reportedly directly responsible for copyright enforcement has been uninterested in bringing criminal cases against copyright piracy and has so informed the U.S. Government. There needs to be a mandate for the PSB to treat criminal investigation and enforcement of IPR offenses as a top priority. Finally, criminal enforcement of copyright piracy continues to be burdened by the fact that Articles 217 and 218 of China's criminal code requires a demonstration that piracy is occurring for the purpose of making a profit, something very difficult to demonstrate, particularly in the online environment. TRIPS requires criminalization of "copyright piracy on a commercial scale" — not just piracy for the purpose of making a profit.

- **However, raiding activity has increased for most sectors.** As a result of Vice Premier Wu Yi's leadership at the JCCT and, in August 2004, in forming the National IPR Protection Working Group (which she heads as Group Leader) and the National IPR Protection Office (NIPO), a one year national anti-piracy campaign was kicked off in September 2004. These actions, and prior actions taken immediately following the JCCT meeting, have given rise to increased raiding activity (though almost entirely at the administrative level), to higher seizures of pirate product, and what would appear, at this early stage, to be better coordination of administrative enforcement in the regions. Nevertheless, despite Wu Yi's singular efforts, IIPA members report no meaningful decrease in the national piracy rates, which still are estimated to be around 90% in all copyright sectors.

Actions to be Taken by the Chinese Government

To redeem its JCCT commitments and to meet its TRIPS obligations, the Chinese authorities must take the following further steps immediately and through July 31, 2005:

- Commence criminal prosecutions using both the monetary and new copy thresholds and carry these forward promptly to impose deterrent penalties. The Economic Crime Division of the PSB should be made responsible for all criminal copyright enforcement and be provided sufficient resources and training to very substantially increase criminal enforcement under the new JIs.
- Under the leadership of Vice Premier Wu Yi, constitute a single interagency authority at the national and provincial/local levels to undertake administrative enforcement against piracy of all works. This authority would have the responsibilities similar to those formerly exercised by the National Anti-Pornography and Piracy Working Group (NAPPWC)[5] for audiovisual works and would have the full authority to administer fines

[5] Due to the re-organization of the functions of the NAPPWC in 2005, that body will now only focus on major pornography/piracy cases. NAPPWC's coordination function has been withdrawn and provincial offices are to be closed down early in 2005.

and to refer cases to the Ministry of Public Security and the Supreme People's Procuratorate for criminal prosecution, under referral guidelines that are equal to or better than the JIs. Such authority must have the full backing of the Party Central Committee and the State Council. Far greater resources must be provided to this enforcement authority. All administrative enforcement, and enforcement by Customs at the border, must be significantly strengthened.[6]

- Issue a final set of comprehensive and transparent regulations governing enforcement on the Internet, including the liability of Internet Service Providers, which follow the recommendations made in this submission, and including effective "notice and takedown" mechanisms and without unreasonable administrative evidentiary burdens. Establish within this single interagency authority described above special units (at the national, provincial and local levels), whose purpose is to enforce the law and these new regulations against piracy on the Internet.
- Amend the Criminal Law to comply with the TRIPS Article 61 requirement to make criminal all acts of "copyright piracy on a commercial scale." These must include infringing acts not currently covered, such as end user software piracy and Internet offenses conducted without a profit motive.
- Amend the new JIs to ensure that sound recordings are fully covered.
- Significantly increase administrative penalties/remedies, including shop closures, and monetary fines and impose them at deterrent levels.
- Fully implement China's WTO market access commitments and begin now to liberalize its market access rules and overall business climate to permit effective operations by all copyright industries.
- Permit private companies and trade associations to undertake anti-piracy investigations on the same basis as local companies and trade associations.

By the end of 2005, China must

- Through amended copyright legislation or regulations, correct the deficiencies in China's implementation of the WCT and WPPT, and ratify the two treaties.
- Significantly ease evidentiary burdens in civil cases, including establishing a presumption with respect to subsistence and ownership of copyright and, ideally, permitting use of a U.S. copyright certificate, and ensure that evidentiary requirements are consistently applied by judges and are available in a transparent manner to litigants.

Each of the measures noted above is necessary to strengthen China's intellectual property enforcement regime. The true test, however, is the impact of China's actions and policies on U.S. sales and exports of copyrighted works. A piracy rate hovering around 90 percent has denied the U.S. copyright industries and our national economy what should have been a long-standing trade surplus in American music, movies, books and software. It is essential that China rectify this imbalance between its widespread use of U.S. copyrighted works and its negligible trade in legitimate products. It is not enough for China to introduce new copyright laws or to temporarily escalate enforcement activity, if such actions do nothing to increase sales of legitimate U.S. products or halt the production and use of illegal copies. Similarly, intellectual property reforms are of little value to U.S. right holders if China persists in maintaining and erecting other trade barriers that limit or foreclose access to the Chinese market. If markets for U.S copyrighted products are closed or market access severely restricted, intellectual property rights are of limited value. IIPA thus recommends that USTR also measure China's progress

[6] In the area of trademark enforcement undertaken by one ESA member company and involving handheld and cartridge based games, the new JIs are unclear on whether the authorities are able to seize components and parts that make up the counterfeit products. This is essential and must be clarified.

according to additional benchmarks that signify meaningful gains and opportunities for U.S. copyright owners. IIPA looks forward to working with USTR on developing these additional benchmarks.

PEOPLE'S REPUBLIC OF CHINA
Estimated Trade Losses Due to Copyright Piracy
(in millions of U.S. dollars)
and Levels of Piracy: 2000-2004[7]

INDUSTRY	2004		2003		2002		2001		2000	
	Loss	Level	Loss	Level	Loss	Level	Loss	Level	Loss	Level
Motion Pictures	280.0	95%	178.0	95%	168.0	91%	160.0	88%	120.0	90%
Records & Music[8]	202.9	85%	286.0	90%	48.0	90%	47.0	90%	70.0	93%
Business Software[9]	1465.0	90%	1787.0	92%	1637.3	92%	1140.2	92%	765.1	94%
Entertainment Software[10]	510.0	NA	568.2	96%	NA	96%	455.0	92%	NA	99%
Books	50.0	NA	40.0	NA	40.0	NA	130.0	NA	130.0	NA
TOTALS	2507.9		2859.2		1893.3		1932.5		1085.1	

THE STATE OF COPYRIGHT PIRACY AND ENFORCEMENT IN CHINA

Piracy Continues at Unacceptably High Levels Despite China's JCCT and Other International and Bilateral Commitments

Several of IIPA's members have undertaken surveys of the market since the summer of 2004 in an effort to measure progress in reducing piracy levels. These surveys, which were provided to USTR on a business confidential basis, provided a detailed review of piracy at the retail level and provided data on seizures from destination countries of pirate DVDs. Other data provided to USTR covered enforcement actions in which either those industries were involved or for which the data was provided by the Chinese government. Because of the lack of transparency in the administrative and criminal enforcement system and the inability to compile meaningful statistics directly, as opposed to relying on Chinese government information (which is rarely sufficiently granular to draw meaningful conclusions), the data presented in these surveys and in this submission are incomplete at best. While certain selected information is available, like, in some cases, what shops, distribution centers or factories were raided (and such data was provided, where available, to USTR), a meaningful picture of the scope of the

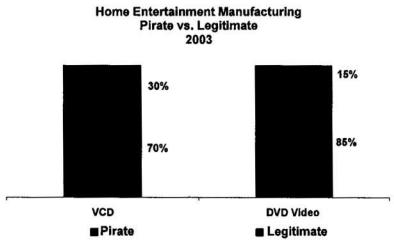
[7] The methodology used by IIPA member associations to calculate these estimated piracy levels and losses is described in IIPA's 2005 Special 301 submission at www.iipa.com/pdf/2005spec301methodology.pdf.
[8] The estimated losses to the sound recording/music industry due to domestic piracy are US$202.9 million for 2004, and exclude any losses on sales of exported discs. This number is also based on a "displaced sales" methodology.
[9] BSA's final 2003 figures represent the U.S. software publisher's share of software piracy losses in China, as compiled in October 2004 (based on a BSA/IDC July 2004 worldwide study, found at http://www.bsa.org/globalstudy/). In prior years, the "global" figures did not include certain computer applications such as operating systems, or consumer applications such as PC gaming, personal finance, and reference software. These software applications are now included in the estimated 2003 losses resulting in a significantly higher loss estimate ($3.82 billion) than was reported in prior years. The preliminary 2003 losses which had appeared in previously released IIPA charts were based on the older methodology, which is why they differ from the 2003 numbers in this report.
[10] ESA's reported dollar figures are preliminary and reflect the value of pirate product present in the marketplace as distinguished from definitive industry "losses." The methodology used by the ESA is further described in Appendix B of this report.

piracy problem must be drawn from the gross statistics available primarily from the Chinese government, supplemented by industry-generated statistics. What follows, first, is a description of the current, updated, piracy situation facing the copyright industries in China and, second, 2004 enforcement information that is available to those industries.

Piracy in the home video and the audiovisual market generally: MPA reports that, in 2004, China Customs claimed to have seized approximately 79.6 million optical discs which were intended to be smuggled into China. At the same time, the NAPPWC reported seizing a staggering 165 million discs during this same period in the domestic market. These numbers (a total of over 244 million pirate discs in 2004) exceed any data that IIPA has seen from prior years and is indicative of the continuing vast scope of the piracy problem.[11] In 2003, NAPPWC seizures were down to 64 million disks (reportedly due primarily to complications of the SARS epidemic), compared to the 78.8 million discs seized in all of 2002. This also serves as evidence of stepped up enforcement which most IIPA members have reported following the JCCT announcements. However, based on these new market surveys (which are only a partial look at best), the percentage of pirate product available in the marketplace continues to support the piracy level estimates we provide in this submission.

In 2004 there were reportedly 83 licensed plants in China, with 765 operating production lines. This is up from 71 plants and 569 lines reported for 2003. 152 of these lines are dedicated to producing DVDs. Total capacity, excluding the production of blank CD-Rs, is now 2.67 billion units annually — a staggering figure when viewed in conjunction with the prevailing 90% piracy rates. These above numbers do not count underground plants, whose locations have increasingly been dispersed to more rural areas in China. Reports emanate from China regularly about raids on such plants, but we are unable to ascertain, in almost all cases, the disposition of any enforcement actions against their owners. Because industry is forbidden from conducting investigations, only Chinese authorities have any ability to identify and raid these underground factories.

China is one of the leading global manufacturers of pirate product. *Understanding and Solutions* estimates that in 2003, 69% of the VCD and 85% of the DVD discs manufactured in China were pirate product.



Source: Understanding & Solutions

; pronounced. *Informa Media* reports that
ered as a direct result of piracy. Part of the
than cinema tickets. According to market
) to $1.20 and $2.00 to $2.50 for a pirate
ost of a movie ticket in Beijing.[13] Further,
available in the pirate market long before
a. Pirate videos of *Harry Potter and the*
ter Tomorrow — with Chinese subtitles —
lease, reportedly for $1.00 per copy.

[11] In evaluating these seizure statistics provided by Chinese authorities, it must be kept in mind that (a) seizures of pirate product involving U.S. copyrighted material is not broken out, (b) it is not known how many of the discs seized contained pornographic or otherwise politically unacceptable material or involved legal violations other than copyright piracy. The lack of transparency makes it difficult therefore to ascertain a true picture of the anti-piracy enforcement situation in China.

[12] Motion Picture Association, April 2004.

Another measure of the level of piracy is the sale of VCD and DVD players. The VCD and DVD player dominate the Chinese home entertainment market. In 2003, *Screen Digest* estimated that 84.4 million, or 24% of television households had a VCD player, whereas 26.4 million, or 8% of television households had a DVD player. The DVD player has recently seen explosive growth in China. Between 2000 and 2002, the number of DVD households grew by 23.4 million, or 867%.

At the same time the number of legitimate DVD discs sold to consumers in China grew at a much slower pace. In fact, in 2003 the number of DVD discs sold to consumers was a mere 0.3 per DVD household. This is inconsistent with the trends seen in Hong Kong, a similar market, which is dominated by the VCD player. In 2003, the average DVD household in Hong Kong made 4.3 DVD disc purchases. Clearly, economic circumstances influence buying patterns of consumers, but the discrepancy between these two markets is in large part due to the piracy epidemic within China. It is unlikely that Chinese consumers are investing in DVD players only to leave them gathering dust in their living rooms; more likely is that consumers are investing in pirate film collections.

Export piracy: MPA has also been experiencing a marked increase in exports of DVDs from China to the U.S., the UK and other countries and has provided USTR with charts showing destination countries and some information on the Customs seizures themselves.[14] Exports have been steadily increasing over the last three years and show no signs of abating. In addition, exports of pirated music sound recordings have been found in several Southeast Asian countries. It is the hope that the new anti-piracy campaign announced in August 2004 will reduce this problem, which, as we know, slowed to a mere trickle in 1996-97 following the Chinese government's decision to avoid U.S. government trade retaliation by shutting down the export trade in pirate video and audio product. (Exports of very high quality counterfeit software continued throughout this period, however.)

Internet piracy: With respect to Internet piracy generally, it continues to grow rapidly in China and the problem is discussed in the sections devoted to each industry sector. In 2003, we reported that 78 million people were then on line (up from 58 million users in 2002 and 33.7 million in 2001). In 2004, that number has jumped to 94 million, making China the largest user of Internet facilities in the world.

Specifically, for audiovisual works, this piracy, which is also increasing, involves the sale of "hard goods" (VCDs and DVDs—all formats) as well as the illegal streaming of films. As discussed below, MPA's attempts to enforce against piracy have significantly increased but with only some success. As detailed in the enforcement section, in 2004, MPA sent out 3,905 cease and desist letters. As the majority of these were sent to P2P targets it is not possible to determine the compliance rate. Where cease and desist letters were sent to other than P2P targets (mostly streaming sites), the compliance rate was a very disappointing 17%.

Broadcast, Cable and Public Performance Piracy: Other types of audiovisual piracy also continue in China, including the unauthorized public performance of U.S. motion picture product, which continues mostly unchecked in hotels, clubs, mini-theaters and even government facilities; television piracy, particularly at the provincial and local level; and cable piracy (over 1,500 registered systems) which routinely pirate U.S. product.

[13] *Informa Media Group*, "Global Film: Exhibition & Distribution", 2003.
[14] MPA reports that there is evidence of Chinese DVD exports to Australia, Belgium, Hong Kong, Japan, Sweden, the U.K. (185,000 disks seized from January-September 2004), UAE and the U.S.

Piracy in the Market for Sound Recordings: As IIPA reported last year and as is reflected in the submissions made by RIAA during the OCR pendency, the crisis in the local and international music industry continues for a fifth year in a row. Losses, under the new methodology begun in last year's submission which counts displaced sales are estimated at $202.9, a decrease from an estimated $289 million in 2003. The estimated national piracy rate is 85%, down from 90% in 2003. OD piracy continues at a high level and cassette piracy remains a significant factor in the marketplace. The recording industry is looking to the new enforcement campaign to deal with piracy by factories, both licensed and underground, and piracy at the retail level which remains at massive levels, though the increased raiding in 2004 has had some impact on losses and the piracy rate.

Internet Piracy: Internet piracy was a significant concern for the recording industry in 2003, and, as predicted in last year's submission, the situation has worsened in 2004. Websites in China such as www.9sky.com and www.chinaMP3.com are giving away or offering links to thousands of pirated songs. (The new JIs do not criminalize non-profit, free Internet transmission, and it is unclear if the inclusion of advertising as indicative of "for-profit" activity will cover music files on a multi-content Internet site). RIAA estimates there are thousands of active websites hosting infringing MP3 files, and that some of these have thousands of infringing files. The industry is also concerned that international online pirate syndicates are using China-based servers to hide their infringing files. One such example is www.boxup.com, which offers songs to paying members (and therefore, if the thresholds are met, should be subject to criminal prosecution under the new JIs). Also overseas pirate sites have been offering their services in China. Taiwan's Kuro is one such example. We understand that Kuro now has a server in China.

The record industry has approached NCAC and the Beijing Copyright Bureau to assist with administrative enforcement. They were told that they must await formal issuance of the new NCAC regulations.[15] While enforcement assistance is welcome, low administrative penalties issued in other piracy cases do not bode well for deterrent enforcement against Internet piracy. It is unclear whether the new regulations will cover P2P services, like Kuro, now under indictment in Taiwan.

Piracy in the market for entertainment software products: The market for PC games, console games, and games played on handheld devices is continuing to grow in China. It is the market for online gaming, however, where the growth has been significant in the last few years. Piracy rates are still extremely high for the industry. A number of entertainment software publishers have entered the market and Sony and Nintendo entered the market in 2003 and 2004, respectively. Given these levels of piracy, they do so at considerable risk.

Internet piracy has also become a significant problem, more so than illegal factory OD production. In 2004, there were an estimated 200,000 Internet cafés in China with 100-300 computers at each location with about 60% of the patrons playing games. Typically, these cafés purchase one legitimate copy, or use a pirated copy and load it on each computer. Customers are also generally permitted to download games from *warez* sites and even to burn their own CD-Rs on the premises. The industry is seeking to license these cafes but this process, given the nature of the marketplace, is inevitably slow, absent real enforcement. Although the government has taken actions against several Internet cafes, such actions have been focused on ensuring that the cafés do not allow "unhealthy information to be spread

[15] The latest draft of the NCAC Internet regulations appears to require notices "in writing" and would not permit email notifications. If this pertains in the final regulations, the compliance rate of ISPs is likely to drop markedly. The draft regulations are discussed in detail below.

through the Internet" and requiring that cafés install blocking software for pornographic sites and materials, and other similar sites. There are also other significant restrictions on Internet cafés such as keeping them a specific distance from schools[16] and these regulations are vigorously enforced. However, the government regulations do not address piracy specifically and no enforcement actions have been taken to ensure that the cafes use only legitimate or licensed entertainment software products. China must include copyright provisions in the business licenses it issues to Internet cafes for as Internet and online gaming continues to grow, the cafés are likely to be the primary means for Internet access for much of the Chinese population.

Furthermore, as the market for entertainment software (particularly online gaming) continues to grow, the Chinese government must also ensure that the law and regulations are adequate to take aggressive action against all types of online piracy. The Chinese video game market is likely to be dominated by online gaming; it is essential that the appropriate legal framework be in place to provide copyright owners as well as law enforcement agencies with the necessary tools to protect copyrighted works in the online environment. A particular problem for entertainment software publishers is the existence of offline or pirate servers in China. These unauthorized servers operate sites which emulate a publisher's online game and thereby divert traffic and potential subscribers from the legitimate site. ESA member companies have attempted to contact Chinese ISPs to request that access to such sites be disabled, but to no avail. Unfortunately, existing Chinese law and regulations has not yet clearly addressed this problem.[17] Neither do there yet seem to be any legal incentives to encourage ISPs to cooperate with right holders in expeditiously disabling these unauthorized or pirate servers.

The manufacturing and assembly of cartridge-based handheld games also continues to be a massive problem in China. Counterfeit Nintendo products continue to be produced in mass quantities in China, and exported throughout Asia, Latin America, the Middle East and Europe. Until the factories engaged in assembling counterfeit cartridge-based products are closed permanently, and significant fines and jail sentences imposed, it will remain difficult to stem the massive production of counterfeit video games in the country. The new JIs now set copy thresholds for initiating criminal actions in the area of trademarks, but they do not appear to address the situation involving a seizure of vast quantities of component parts, which is the prevailing scenario in actions involving cartridge-based games. During a raid, administrative authorities may seize hundreds of the component parts waiting to be assembled into the final counterfeit cartridge game in a factory — that is, the printer circuit boards (PCB) which contain the video game software, the plastic cartridges which will house the PCBs, as well as the labels and instruction manuals to accompany the final pirated product. It seems the case that notwithstanding the seizure of hundreds of these component parts, as they have not yet been assembled into the final product, i.e., what may constitute a "copy," the JI thresholds may be interpreted as not applying. This would present a serious impediment to pursuing criminal actions against pirates engaged in the manufacture of thousands of counterfeit cartridge games. It is unclear how law enforcement authorities will thus treat instances where they find hundreds of these component parts during a raid, but which have not yet been assembled into the finished counterfeit video game cartridge. Nintendo is concerned that this seeming gap may actually make it easier for pirates to elude seizures and arrest, as fully assembled products

[16] Some news reports noted that the government would also begin imposing restrictions against the use of entertainment software products in Internet cafés. However, the restrictions do not appear to have been imposed though news accounts have been scarce.
[17] The draft Internet regulations, discussed below, do not address the problem of pirate servers located outside China.

will be immediately removed from the factories and transported (under cover of night) to various locations, thus leaving no finished product on the premises.

Piracy in the market for business software: Unauthorized use of software in enterprises in China causes the vast majority of piracy losses faced by the business software industry. Losses also occur in the retail market, including the loading of pirate software on the hard disks of computers as part of the sale of computers. The market is also characterized by huge exports, on a global basis, of high-quality counterfeit software packages. The software industry has struggled for years to persuade NCAC to devote sufficient resources to raiding/auditing enterprises that use unauthorized software. There have been some recently successful administrative actions against end-users (see enforcement discussion) and, as part of the new anti-piracy campaign following the JCCT, the authorities in many of the major cities have announced plans to increase enforcement against software piracy and some have even referenced end-user piracy. However, enforcement remains spotty and resources are still woefully inadequate at the national and local copyright administrations and bureaus. The new JIs did clarify that fake (end-user) licenses fall within the scope of "without permission of the copyright owner." However, the industry's most important priority — to persuade the SPC to amend its JIs to make end-user piracy a criminal offense under TRIPS — was apparently not met.

To significantly reduce the piracy levels for business software, the government, through the existing authorities — the new National IPR Protection Working Group, the State Council, the NCAC and the Ministry of Information Industry — should issue a policy statement or order, accompanied by a national public education campaign, requiring enforcement authorities to enforce the law more vigorously against enterprise end-user piracy. Actual enforcement should be placed under the authority of the new interagency mechanism described above, and enforcement actions should be followed up by the allocation of sufficient resources and their employment in the vastly increased administrative raiding of enterprises using unauthorized software. Without these actions, there is no possibility, in the view of the software industry, of significantly reducing the world's highest piracy rate — 92% of the market!

Unauthorized use of software in government ministries remains a problem, even though in February 1999, the State Council reissued a "Notice" originally released by the National Copyright Administration of China in August 1995 ordering all government ministries at all levels to use only legal software (the so-called "Red Top Decree"). A number of other decrees requiring the legal use of software were issued after this, including a joint decree by four ministries. The most recent was a circular issued by the State Council on the use of legal software by local governments. In the circular, government agencies at the provincial level are requested to legalize their software by the end of 2004, and government at lower levels are to accomplish software legalization by the end of 2005. Some progress has been made but the problem persists, causing large losses for the industry. The value of these decrees is in showing transparent implementation not only to the software industry but also, more important, to the private sector. The government should issue a public report on the status of its internal legalization, including the agencies that have legalized their software use and the amount of public procurements of software resulting from such legalization efforts. Following government legalization, the Chinese government should also issue a decree for the use of legal software in state-owned enterprises since there is no practical way to carry out enforcement and deterrence.

As part of the government legalization effort as well as to implement the 2002 Government Procurement Law, MOF and MII drafted Implementing Methods for Governmental Procurement of Software. The Methods describe new government procurement practices in

software that are unique to China and that bear little relation to the principles of the WTO Government Procurement Agreement (GPA), whose goal is to ensure non-discriminatory, pro-competitive, merit-based and technology-neutral procurement of goods and services so that governments can acquire the best goods to meet their needs for the best value. The regulation would effectively prevent U.S. software companies from selling software products and services to the Chinese government. When viewed in the context of China's 92% software piracy rate, this discriminatory measure would effectively close China's largest software market to U.S. competition. The U.S. software industry has already lost billions of dollars in export revenue due to rampant piracy and counterfeiting in China; a ban against government procurement of U.S. software would eliminate the industry's best opportunity to expand exports to China and set a dangerous precedent for China's procurement policies in other major economic sectors. Addressing this problem is a very high priority for the U.S. software industry.

While enterprise end-user piracy is the most pressing problem for the business software industry in China, counterfeiting and hard disk loading are also major problems. Indeed, China is the source of some of the most sophisticated counterfeit software anywhere in the world. Industry representatives report that high quality counterfeits are produced in large quantities both for the domestic Chinese market and for worldwide distribution, with software available in multiple languages. However, this problem is unlikely to be brought under any semblance of control without aggressive criminal enforcement.

Piracy of books and journals: Previous IIPA Special 301 submissions detailed the successful effort of the Chinese government, in cooperation with the publishing industry, in dealing with the formerly rampant problem of print journals piracy.[18] While these significant improvements are for the most part continuing in 2004, publishers are starting to see increased photocopying of print journals, in part as a result of the lack of sufficient government funding for legitimate journals purchasing by universities. The Chinese government should monitor use of print journals closely to ensure that its successes of prior years are not eroded.

Problems abound for other published materials as well. Illegal commercial photocopying has, for the first time, become the chosen mode of book piracy in China, at least with respect to academic materials. While photocopying had previously taken second place to print piracy in China, decreasing costs of photocopy paper and other necessary materials have resulted in a sharp increase in photocopying in 2004. This photocopying takes place primarily on university campuses, as well as secondary schools and English language teaching programs. Many of these programs draw students by advertising their use of full color, high quality books, and then provide photocopies of books to students upon enrollment.

Despite the rise in photocopying, traditional reprint piracy continues to remain a major problem in China, particularly of higher education textbooks and trade bestsellers. Popular books such as Bill Clinton's *My Life* and J.K. Rowling's latest Harry Potter® book, *Harry Potter and the Order of the Phoenix*, were heavily pirated. The Chinese government needs to take action against hard goods piracy of books with the same vigor with which it tackled journals piracy in 2001.

Counterfeiting problems also abound. IIPA has previously reported the publication of totally bogus books purportedly written by a famous author. This happened most recently with the Harry Potter® series, with Chinese publishers producing at least three additional books about Harry under Rowling's name. One of the publishers was caught and subjected to a $2,500 fine.[19] Furthermore, well known business and academic trademarks, such as those of

[18] See IIPA's 2003 Special 301 country report on the People's Republic of China, pages 25-26, available at http://www.iipa.com/rbc/2003/2003SPEC301PRC.pdf.
[19] Id.

the Harvard Business School, are used illicitly to promote sales of books by implying a nonexistent affiliation or endorsement.

Translation piracy also remains a problem for foreign publishers. Publishers continue to report production of illegal translations, of both textbooks and bestsellers, largely by second-channel distributors. The scope of this problem grows larger in smaller cities and provinces.

Internet piracy: Publishers have noticed alarming increases in electronic journals piracy over the past year. University gateways are routinely left open for illegal access by unauthorized users, and file-sharing among users is on the rise. In fact, publishers now report more illegal downloads of online journals as well as digital license violations in China than anywhere else in the world. This problem extends to databases containing other types of published data as well. The Chinese government should take steps to ensure that commercial or institutional users are abiding by their license agreements.

Furthermore, piracy over the Internet is increasingly affecting not only journals, but also academic textbooks and bestsellers, with several websites offering hundreds of scanned published titles for download. Bestsellers are, of course, distributed over peer to peer networks with impunity. This phenomenon is likely to grow during 2005 unless the government is able to take steps to ensure effective measures are available to rights holders to defend their materials.

Enforcement: Raiding and seizures have increased for most copyright sectors; administrative penalties remain too low to provide a deterrent; criminal enforcement under Articles 217 and 218 has not yet begun; and, consequently, piracy levels have not yet declined.

Vice-Premier Wu Yi's commitment to "significantly reduce piracy levels" will not be met by the time of this submission. Indeed, overall piracy rates have remained virtually constant from 2003 to 2004.

China does not presently meet its WTO/TRIPS commitments on enforcement and particularly TRIPS Articles 41, 50 and 61 (provide enforcement which "on the ground" deters further infringements, provide effective *ex parte* civil search orders, and provide specific deterrent criminal remedies). To meet this obligation, IIPA recommends that China implement a system in which the Party Central Committee and the State Council ensure that the enforcement authorities (a) cooperate more closely with affected industries (including permitting U.S. associations to undertake investigations in China); (b) significantly increase transparency (c) give Vice Premier Wu Yi even greater and "publicly announced" authority to intervene at all levels, to organize an effective interagency enforcement authority throughout the country, and to coordinate the nationwide enforcement effort; (d) significantly increase administrative penalties and actually impose them at deterrent levels, including closing retail stores that deal in pirated goods; (e) amend the Criminal Law to increase criminal penalties and cover all types of "commercial-scale" infringements; and (f) use the new Judicial Interpretations to their fullest to prosecute — publicly — significantly more infringers under Article 217 and 218, not just for pornography, "illegal business operations" or smuggling. None of these objectives has as yet been met.

In the following sections, we report on what we know about the level of enforcement in the administrative, criminal and civil enforcement system in China in 2004.

Administrative enforcement

As noted above, NAPPWC appears to have been the most effective administrative enforcement mechanism in China, with a continued large number of raids, seizures and detentions.[20] With the change of the functions of NAPPWC in 2005, it is essential that a similar authority be created to take over the responsibilities of nation-wide coordination of anti-piracy operations and that its jurisdiction be extended to cover enforcement in all copyright sectors, including computer software. It is also critical that this new authority NOT be charged with dealing with pornography, but only piracy, and that it be mandated to have an effective and transparent reporting system. If pornography is included, it will never be known whether the authorities are enforcing for that crime or for IPR violations.

With respect to existing administrative enforcement, NCAC's title verification program continues to work well for only one industry—the motion picture industry—with, in the year 2004, a total of 2,881 title verification requests submitted by MPA, and 146 titles challenged by MPA and I.F.T.A. found to have been unauthorized.

Even with the myriad cases handled by NAPPWC,[21] the lack of transparency in the enforcement system, particularly the lack of industry access to levels of fines and other penalties for infringement, makes it almost impossible to judge whether there have been advances in deterrent enforcement. We do know, however, that the piracy rates remain universally high and thus we have no alternative but to conclude that the administrative enforcement system is not having any serious impact in the marketplace. This is not to say that industry does not welcome or does not fully support these efforts, simply that the Chinese government must focus on vastly increased deterrence as the key to reducing piracy rates. To date it has not done so. The following summarizes the deficiencies in the administrative enforcement system:

- Fines are too low, both as written and as imposed;[22] these need to be increased significantly, imposed in practice and widely publicized throughout China, and the results provided to the U.S.G. as promised in the bilateral IPR agreement.
- The system is almost entirely nontransparent; it is, with some recent exceptions, impossible to ascertain what penalties are imposed in particular cases. This extends to the Chinese public as well as to foreign right holders. Right holders cannot, for example, obtain documents from the government on the activities of CD plants (even though every order the plant accepts must be recorded and reported to the authorities). Foreign right holders are usually told that these are "national confidential documents." IIPA members have no evidence that these practices will change.
- There is a lack of time limits for investigations, leading to long delays and a resulting failure to deter pirates.
- There is still "local protectionism" by administrative agencies involving politically or financially powerful people engaged in pirate activities.

[20] It must be noted, however, that the primary mandate of the NAPPWC is to rid the market of pornography or other material deemed by the government to be politically or socially unhealthy.

[21] MPA does confirm, however, that most of these cases involved pornographic material with only a small number limited to purely pirate product. Nevertheless, the interagency body reported the "arrest" of 6,912 offenders and the seizure of 11 illegal production lines (5 DVD lines and six VCD lines). Two OD factories were also penalized. In one of these cases where MPA has information (reported in the text below), the licensed factory was in Hunan and, in July 2004, was fined RMB80,000 (US$9,660) by GAPP related to copyright infringement. This fine, for an OD factory, is clearly not a deterrent.

[22] Fines can be up to three times the value of the pirated goods measured at pirate prices, but fines as actually imposed are woefully low.

- NCAC continues to fail to use its authority effectively to deal with the all-important problem of corporate end-user software piracy.

The software industry: As a result of the increased attention to enforcement in the second half of 2004, BSA reports an end-user raid on a design and engineering company which resulted in the detention of four persons and the seizure of 24 computers. This is among the first such actions that has resulted in the detention of an employee from a company engaged in unauthorized use of business software. In October 2004 in Shenzhen in Guangdong Province, six shops engaged in selling pirated software were raided and the software confiscated. In Shangxi Province, two design companies using unauthorized copies of AutoCAD and 3DMAX were raided in October by the Xi'an AIC, the Xi'an Press and Publications Bureau and the Xi'an PSB. Twenty-four copies were seized and the offenders were fined a paltry RMB 2000 (US$242). BSA also notes that the NCAC took very seriously the administrative enforcement of two major CD-replicators (Beijing, Tianjin), and pro-actively did PR to generate awareness and deterrence. These two cases were included among the top ten 2004 IPR infringement cases published by the State Council Office of Intellectual Property Protection.

The entertainment software industry: A number of ESA member companies are active in the Chinese market, with a few engaged in domestic enforcement either through local counsel or its own in-country anti-piracy program. In particular, Nintendo has undertaken a significant number of administrative actions in Guangdong Province, though these actions have been taken largely under the trademark law to protect the globally famous "Game Boy" brand. While trademark actions have generally proven easier to prosecute than copyright cases for Nintendo, available penalties are as low, or lower, than those imposed for copyright infringement. The efforts of the Chinese administrative authorities (specifically in Guangdong Province), in cooperation with Nintendo representatives, have resulted in raids against a number of retail shops and factories. Raids against the factories have also revealed that they are (directly or indirectly) connected with Hong Kong and Taiwanese factories (for instance, funding was often supplied by a Taiwanese national, or a Hong Kong "affiliate" office often served as a conduit for transmitting orders to the factory on the Chinese mainland.

The motion picture industry: MPA's separate submission reports in detail on the joint administrative raids in which it was involved in 2004. These joint raids represent only a fraction of the total raids conducted by NAPPWC and by local authorities without notice to the affected association or company. In 2004, 573 joint raids against retail shops were conducted in Shanghai, Beijing, Shenzhen and Guangzhou. MPA is encouraged to report that 145 of these shops, principally in Beijing, were closed after the raids — 510 shops were fined; the average range was from RMB1,000-RMB5000 (US$121-US$604). A very few fines exceed this and it is encouraging that one shop named "The 74th Store of Yongshengshiji AV Center," located in Congwen District of Beijing, was fined RMB50,000 (US$6,041). The average fines remain notoriously low, however, and are hardly a deterrent.

Other information on the level of administrative fines is spotty. The General Administration of Press and Publications (GAPP) ran a raid against a licensed VCD factory on July 27, 2004. The factory had seven lines and reportedly produced very significant quantities of pirate product from 1998 to 2004. The factory was ordered to cease operation from July to September 2004 and was fined only RMB80,000 (US$9,666). Temporary closures and fines of this level will not deter factory-level piracy. However, MPA was pleased to have at least received notification of the action. We hope this bodes well for greater transparency in the future.

The statistics reported below by MPA for administrative cases come from the Chinese authorities. It cannot be confirmed as covering only U.S. pirate movies but may involve other product. It also cannot be confirmed that the fines levied were just for copyright piracy; they could cover pornography or other legal violations beyond copyright piracy.

The recording industry: In its business confidential submission to USTR, RIAA/IFPI noted the lack of transparency that pervades China's administrative enforcement system and reported on isolated actions taken by local and provincial enforcement authorities against factories, distribution centers, retail establishments and street vendors. The recording industry rarely receives information on the level of penalties imposed following those raids, and where information is made available, it is generally distressing. In one raid in Shenyang conducted by the local AIC for example, where over 3000 pirate music CDs were seized, the industry learned that the fine imposed was only RMB30,000 (US$3,625) or a little over US$1.00 per pirate CD!

Better information is available from the authorities in Shanghai (the Shanghai Culture Inspection Team), where transparency is somewhat improved. After looking at the data put together from Shanghai, RIAA estimates that the fines ran from about RMB500 to RMB5000 per incident (US$60-US$604). However, of the total number of cases, 90% resulted in warnings; only 10% in fines. The authorities also closed approximately 19 warehouses in 2004, but these were only facilities where more than 10,000 copies of pirate product were found. This is a clear example of the non-deterrent nature of the administrative process and Shanghai is far better than other provinces/cities.

The book publishing industry: U.S. book publishers have heard of isolated instances of action taken by enforcement authorities against book pirates, but almost entirely on behalf of Chinese companies. Publishers are working with local authorities to increase government administrative activity on behalf of U.S. companies and will be monitoring the degree of cooperation more closely during 2005, though the lack of transparency in the system is a major hurdle.

ADMINISTRATIVE COPYRIGHT ENFORCEMENT STATISTICS FOR 2004 PEOPLE'S REPUBLIC OF CHINA			
ACTIONS	MOTION PICTURES	BUSINESS SOFTWARE	TOTALS
NUMBER OF RAIDS/SEARCHES CONDUCTED	1,153	12	1,165
NUMBER OF ADMINISTRATIVE CASES BROUGHT BY AGENCY	914	12	926
NUMBER OF DEFENDANTS FOUND LIABLE (INCLUDING ADMISSIONS/PLEAS OF GUILT)	894 (20 cases pending)	9 (2 cases pending)	903
RATIO OF CONVICTIONS TO THE NUMBER OF RAIDS CONDUCTED	77.5% (894/1,153)	75% (9/12)	78% (903/1,165)
RATIO OF CONVICTIONS TO THE NUMBER OF CASES BROUGHT	100%	75%	
NUMBER OF CASES RESULTING IN ADMINISTRATIVE FINES	798	0	798
TOTAL AMOUNT OF FINES LEVIED			
RMB$0-1,000 (UP TO US$120)	209	0	209
RMB1,001-5,000 (UP TO US$604)	264	0	264
RMB5,001-10,000 (UP TO US$1208)	188	0	188
RMB10,000 AND ABOVE (ABOVE US$1208)	137	0	137
TOTAL AMOUNT OF FINES ORDERED IN HOW MANY CASES (E.G., $XXX IN Y CASES)	RMB$4 million (US$483,284) in 798 cases	US$174,735 in 9 cases	

Criminal enforcement

IIPA and its members (and the USG) have pressed China for years to use its criminal law to prosecute pirates, since it is the only viable means effectively to reduce piracy levels in China. While criminal enforcement does occur periodically under other laws such as those dealing with pornography, smuggling or running an illegal business (Article 225 of the Criminal Code), it will be difficult for China to convince its people that piracy is an economic crime that damages the Chinese economy and Chinese culture until there is a publicly announced commitment from the State Council/Vice-Premier level and an ample record of convictions for "piracy" with deterrent penalties.

IIPA and its members hope that that process begun last April with Vice Premier Wu Yi's announcements, and, in particular, the recent amendment to the SPC Judicial Interpretations will mark the beginning of an initiative and not its highpoint. Further discussion on the new JIs is set out below.

IIPA members have consistently had difficulty in gathering information on the use of the criminal law against acts of piracy. When we hear of convictions, we discover that they are usually under other laws, like pornography or "illegal business," not piracy. China publicly announces the seizure and destruction of pirate product on a regular basis, but seems rarely to publicly announce a jail term or deterrent fine for piracy per se. This must change.

The recording and motion picture industry: RIAA has reported in their business confidential submission to USTR that it has no knowledge of any criminal "piracy" prosecution involving its product. MPA, on the other hand, last year reported some statistics it was able to unearth. It reported last year that in 2002, 19 criminal cases had been brought and concluded (with reported sentences of six months to 6 years) in Beijing involving that industry's products—apparently none in any other city. It reported that, in 2003, 30 cases were filed in Beijing and Shanghai, with again, 80% in Beijing. However, it also reported that, to the best of its knowledge, only three of these cases were brought under the criminal "piracy" provisions, Article 218, the high threshold having been met in those 3 out of 49 total cases over 2 years. The rest of the cases were basically censorship/pornography cases brought under Article 225 of the Criminal Law. Jail terms were, however, significant in most of these cases (though the Chinese have traditionally treated pornography very seriously) indicative of the fact that a criminal prosecution, as contrasted with an administrative proceeding, is likely to result in some deterrence—if properly and widely publicized and directly identified with piracy.

In July 2004, the Chinese government announced a major raid conducted by the Economic Crime Investigation Division (criminal copyright enforcement, as noted earlier, is normally undertaken by the less-efficient Social Order Division)[23] of the MPS, assisted by the Shanghai PSB and the U.S. Department of Justice and U.S. Customs. Over 210,000 DVDs were seized in the raid and six people were arrested, including two U.S. citizens. 20,000 of the DVDs were to be sold in the U.S. and the rest were to be transmitted via the Internet to 25 countries. These six defendants were prosecuted under the "operating without a license" provisions in Article 225 of the Criminal Code.

We have also heard from Chinese representatives that there have been other criminal convictions specifically prosecuted under the criminal piracy provisions, though the ones cited have involved Chinese origin works and all have admitted that these cases are very, very few.

[23] In fact, a senior official in the Social Order Division of the PSB told a visiting US Government delegation during 2004 that copyright piracy was an offense generally committed in the rural regions of China and not warranting criminal prosecutions.

We have inquired on many occasions about the existence of criminal convictions purely for piracy offenses and we have received no confirmations.[24]

[24] 2002 may have marked the year of the first pure piracy case ever, involving a factory in Guangdong Province, where two defendants were sentenced in March 2002 to two years' imprisonment for copyright piracy only. This case involved the Foshan Jinzhu Laser Digital Chip Co. Ltd., which had accepted a phony order for 920,000 DVDs from a Taiwan defendant [who was fined RMB 400,000 ($48,329)]. In addition to the prison terms, three lines were removed, and the GAPP revoked the plant's license. There were other rumors of criminal piracy convictions in Anhui Province but no confirmation was obtained. Another case in Shanghai involved the *Dictionary of Cihai*, but again it appears that this was not a pure copyright case. IIPA has received informal reports of two book-piracy cases which were decided purely under Article 217 and 218, but these may be the Anhui cases for which we have no confirmation.

Bringing criminal cases was not only an obligation in the U.S.-China 1995 Memorandum of Understanding and [Enforcement and Market Access] Action Plan, but is a clear TRIPS requirement. China's JCCT obligations include a commitment that China will "subject a greater range of IPR violations to criminal investigation and criminal penalties," and that criminal sanctions will be applied "to the import, export, storage and distribution of pirated and counterfeit products" and that criminal sanctions will also apply to on-line piracy. China is not now in compliance with either that bilateral agreement, TRIPS or its JCCT commitments. As discussed below, industry is skeptical whether the lowered thresholds and other amendments to the JIs will be implemented in such a way to result in the commencement of many significant criminal prosecutions, though we fervently hope that we are wrong. This is the only way, in industry's view, that "piracy levels can be significantly reduced" in China, as promised by the Vice Premier.

Other copyright industries: Except for the statistics cited above, no other industry reports having a criminal case—for piracy—brought or concluded with respect to their products. Indeed, the recording industry, which has brought myriad civil cases against licensed OD factories, continues to voice its frustration that the criminal authorities (the Public Security Bureau) are not taking actions against underground plants where civil actions are not possible.

While the copyright industries welcome actions under Article 225 of the Criminal Law, real deterrence won't be brought to the criminal system until a significant number of widely publicized cases are brought under Articles 217 and 218. For this to happen, there must be political will to bring those cases. Below MPA and BSA report the criminal cases they have been told about, but again, it is likely that, in the case of audiovisual product, few or no such cases were prosecuted for "piracy," but under other provisions, such as operating an unlicensed business under Article 225 or for pornography. Until the authorities commence accurate and granular reporting of these statistics, it will be very difficult to evaluate progress in the enforcement system.

CRIMINAL COPYRIGHT ENFORCEMENT STATISTICS FOR 2004 PEOPLE'S REPUBLIC OF CHINA		
ACTIONS	**MOTION PICTURES**	**BUSINESS SOFTWARE**
NUMBER OF RAIDS CONDUCTED	42	2
NUMBER OF VCDs SEIZED	15,172,549	2500
NUMBER OF DVDs SEIZED	22,221,488	
NUMBER OF CD-Rs/DVD-Rs SEIZED	27,157	
NUMBER OF INVESTIGATIONS	50	2
NUMBER OF VCD LAB/FACTORY RAIDS	8	
NUMBER OF CASES COMMENCED	34	1
NUMBER OF INDICTMENTS	30	1
NUMBER OF DEFENDANTS CONVICTED (INCLUDING GUILTY PLEAS)	48	1
ACQUITTALS AND DISMISSALS	2	
NUMBER OF CASES PENDING	13	1
NUMBER OF FACTORY CASES PENDING	0	
TOTAL NUMBER OF CASES RESULTING IN JAIL TIME	21	
SUSPENDED PRISON TERMS		
MAXIMUM 6 MONTHS	5	
OVER 6 MONTHS	1	
OVER 1 YEAR	6	
TOTAL SUSPENDED PRISON TERMS	101 MONTHS	
PRISON TERMS SERVED (NOT SUSPENDED)		
MAXIMUM 6 MONTHS	3	1
OVER 6 MONTHS	14	
OVER 1 YEAR	25	
TOTAL PRISON TERMS SERVED (NOT SUSPENDED)	42	

Number of cases resulting in criminal fines		
Up to $1,000	2	1
$1,000 to $5,000	6	
Over $5,000	10	
Total amount of fines levied (in US$)	313,020	362

Civil enforcement

As noted above, one positive development is the increasing sophistication and effectiveness of the IPR courts throughout China. For this reason, Chinese right holders and, increasingly, U.S. right holders have used the civil system as a means to bring some deterrence to the enforcement system in China, given the demonstrated failures of the criminal and administrative enforcement systems.

The recording industry: The recording industry has brought over 235 cases against factories since 2002 and many others (through 2004, 202 cases) against retailers and Internet pirates. Ninety-one of the factory cases remain pending. Total damages/settlement amounts in all these civil cases brought by the recording industry amounted to US$1.9 million. While there may be some limited deterrence associated with these amounts, it is clear that China can not rely upon civil actions to significantly improve the business climate, and that criminal actions are sorely needed. It must also be noted that the industry rarely is made whole for the damages they sustain in these civil cases. In only a few cases do the record companies even recoup their litigation costs (awards average 30% of actual litigation costs). The largest award/settlement in this range of cases was RMB600,000-800,000 (US$72,493-US$96,657). These judgments/settlements were against factories suspected of producing millions of units of pirate music CDs at profits which far exceed these meager damages—thus demonstrating that engaging in large scale production of pirate materials, even when you get caught, is presently a rational business decision in China.

As noted above, the recording industry continues to face massive Internet piracy in China but has been required to fight this problem through cease and desist letters to ISPs and, where necessary, civil litigation. More than 2000 cease and desist letters were sent in 2004, with a compliance rate of 75%, a significant improvement over the 30% in 2003. The industry has now completed 17 civil Internet cases. A recent case was won against www.tyfo.com, one of China's most popular pirate websites. Damages awarded were RMB 370,000 ($45,000) which, while significant, is low given the damage done. In summary, while these cases have been successful, monetary damages have been very low and hardly a deterrent to further infringements. The maximum received in an Internet case was approximately RMB170,000 for 15 songs (US$1,370 per song) in the case against www.tj.cn, awarded by the Tianjin No. 1 Intermediate Court. Compliance has generally been good by the ISPs but litigation and *ex officio* action by Chinese enforcement authorities will be necessary to make a significant difference. Moreover, the industry is very concerned about the new draft Internet regulations, which if adopted, would severely threaten this compliance rate. RIAA/IFPI has brought a number of civil suits against ISPs and websites, which have been reported, in earlier submissions. Some success has been achieved.

The motion picture industry: The motion picture industry also embarked on a civil litigation program in 2002, with a total of ten civil cases having been brought under the recent Copyright Act amendments, all of them successful. Four cases against factories were settled. Six cases against three retailers in Shanghai resulted in a damages in favor of the plaintiffs based on statutory damages of up to RMB500,000 (US$60,410) available under Article 48 of

the 2001 amendments to the Copyright Act. However, evidentiary requirements remain burdensome and unnecessary. Further amendments to the Copyright Act should establish a presumption with respect to subsistence and ownership of copyright and permit, for example, a U.S. copyright certificate to be used.

In 2004, MPA has issued 4,055 cease and desist letters to ISPs in China, primarily for P2P piracy. This was an almost ninefold increase over 2003. However, the compliance rate was, as noted earlier, only 17%. The new "Interpretations" in combination with NCAC's soon-to-be completed Internet regulations, plus an easing of the burdens to followup with civil cases with significant, and deterrent, damages, must change this result. Any civil enforcement strategy must also be accompanied by aggressive use of China's administrative enforcement machinery, under the new JIs criminal enforcement.

As discussed in detail in prior submissions, the new copyright law amendments have made certain positive changes that should assist in bringing successful civil cases against infringers.

- Provisional remedies were added in Articles 49 and 50 and, as we understand it, it is intended that these operate on an *ex parte* basis.
- Court-determined "pre-established" damages can now be awarded under Article 48 up to a maximum of RMB500,000 (US$60,410) where the "actual losses suffered by the holder of the right or the profit earned by the infringing party cannot be determined."

The software industry: These changes are significant improvements, though U.S. right holders have continued to have some problems in successfully bringing civil cases in China, particularly the business software industry. Until this year, very few cases have been brought and concluded. However, the trend has been encouraging with respect to the Chinese civil court system's willingness to take on and decide end-user cases. There have been, as of this date however, only six such cases. The first two, involving AutoDesk and Adobe, were decided in favor of the copyright owner but evidence of actual damages (which were substantial —in one case over US$250,000) ended up being rejected and the cases were decided under the new statutory damages provisions of the copyright law amendments. In one case the damages were RMB500,000 (US$60,410) and in the other RMB115,000 (US$13,894 including court costs). A third case was settled under pressure from the judge for only RMB50,000 (US$6,041). In the fourth case, against a large interior design company in Beijing with 15 operations, NCAC finally agreed to raid two locations. After about eight months, NCAC awarded only RMB270,000 (US$32,621) in fines and the copyright owner then sought to bring civil actions in the courts against four other branches of the enterprise. In October 2003, the Beijing High Court, for the first time ever, awarded damages based upon the number of copies times the retail price—a total in damages of RMB1.49 million (US$180,023). In the two recent cases, the courts supported almost all the claims made by right holders. In one case the damages were RMB378,200 (US$45,695) — the decision is on appeal — and in the other RMB290,900 (US$35,147). While this is a major victory for the software industry, any significant dent in the rate of software piracy in China will need the widespread application of administrative enforcement by NCA and the criminalization of enterprise end-user piracy. BSA also remains concerned that evidence preservation orders are still coming too slowly and are too difficult to obtain, in view of China's TRIPS obligations in this important area.

Also of significance is a decision in the summer of 2004 in the Shenyang Intermediate People's Court which ruled against end users of unauthorized software. The case involved Chinese software (RIP2.1). The court made use of the presumption in the 2001 copyright

amendments to require the defendants to show that their use was legal. The eight defendants were unable to do so and damages of RMB100,000 ($12,082) were imposed.

The book and journal publishing industry: In the area of piracy of literary works —in a major salutary development—a Beijing Intermediate Court rendered a judgment in September 2003 (in a case commenced in 2000) which sought damages against the Beijing New Oriental School. This school had for years administered the TOEFL and GRE tests to Chinese students seeking entrance into U.S. universities. ETS alleged that the school has been stealing ETS's highly secure test questions and test forms and selling them to its students at a significant profit. The school also distributed these highly secret test questions widely in China. ETS claimed that the security and integrity of the tests have been compromised to the extent that it has led some U.S. universities to doubt the authenticity of all test scores from China, harming the entrance prospects of Chinese students. (Over 10% of the 800,000 students taking the TOEFL test worldwide come from China). New Oriental had been unsuccessfully sued before and the size of the infringement was staggering, with New Oriental adding an average of 10,000 students per month and with a nine-month waiting list. The court finally concluded a case that had been rife with procedural hurdles, and awarded damages of US$1.2 million to both ETS and GMAT.

U.S. publishers have brought a number of civil cases in the past year, but have been hampered in some important cases by non-transparent and onerous evidentiary burdens. The industry has a number of civil cases pending and will be monitoring the progress of these in the coming months.

Civil Copyright Enforcement Statistics for 2004 PEOPLE'S REPUBLIC OF CHINA				
ACTIONS	**Motion Pictures**	**Business Software**	**Book Publishing**	**Totals**
Number of civil raids conducted	0	0	0	0
Post-search action	0	0	0	0
Cases pending	0	0	0	0
Cases dropped	0	0	0	0
Cases settled or adjudicated	2	2	0	4
Value of loss as determined by right holder ($USD)	0	0	0	0
Settlement/judgment amount ($USD)	US$30,000	US$82,860	0	US$112,860

Statutory Law and Regulations: The New Judicial Interpretations, the Criminal Law, the 2001 Copyright Amendments, and the Draft Internet Regulations

The new Supreme People's Court judicial interpretations

On December 21, the Supreme People's Court issued its long-awaited, and promised, amendment to its Judicial Interpretations of the Chinese Criminal Law. IIPA has reviewed these amendments and comments on them as follow:

- As a fundamental matter, whether the new Judicial Interpretations are positive or not will depend entirely on the **political will** of the Chinese authorities to use them aggressively to bring criminal cases and to impose deterrent penalties on pirates. In IIPA's view, this is a necessary condition for China to redeem its JCCT commitment to "significantly reduce piracy levels."
- Even though some of the thresholds were reduced, and some significantly, it remains to be seen whether, given that the Chinese, for inexplicable and unjustifiable reasons, chose to retain measuring the thresholds at pirate prices, there will be any difference in the number of cases **in practice**.
- If the JIs, as they came out in the end, are any measure of the government's ultimate political will to use the criminal process to reduce piracy, then we cannot be very optimistic since the improvements were so minimal.
- The new "copy" thresholds do hold some promise, particularly if requirements to prove sales are unnecessary. However, 1,000/3,000 copies (individuals/units for the lower penalties where jail time is not mandatory and fines are set by the judge and not in the JIs) and 5,000/15,000 copies (individuals/units for the mandatory three year minimum jail term) still place a heavy burden on enforcement authorities and will only result, it would seem, in the possibility of prosecuting the very biggest pirates — not much different than under the previous JIs. We note that the 1000 copy threshold (for individuals, not units) is <u>double</u> the threshold for prosecuting for illegal business operations under Article 225. We also note that in an apparent inadvertent drafting error, sound recordings are not covered in the copy threshold provisions. Finally, the copy thresholds apparently do not apply to Article 218 offenses involving only "sales." We understand that the SPC has taken the position that "sales" is not the equivalent of "distribution" and that the latter implies some connection with the entire supply chain, beginning with manufacture. This must be clarified since it may result in excluding from possible criminal prosecution owners of warehouses where large seizures have been made, where there is no evidence of the owner being involved in production and where the monetary thresholds have not been met.
- The Chinese government took the exact opposite approach from that suggested by the copyright industries and the U.S. government: they kept "profits" as the main test, with "business volume" as a secondary test at a higher threshold. Only when the pirate price is "unknown" can we apparently measure the threshold by the legitimate price. China is still the only country in the world that uses pirate "profits" as a criterion for what is criminal and what is not. Some benefit may come from the new ability to aggregate income amounts over multiple raids, however.
- They also inexplicably failed to abolish the individual/unit distinction; most sophisticated pirates will now have an even greater incentive to operate only as a "unit" to avoid the lowered "individual" thresholds.

- It is positive that the act of importing and exporting has been added to the JIs, but, again, importers and exporters will not be held liable for direct infringement under Article 217 or 218 but only be held liable as "accomplices" under Article 27 of the Criminal Law. This Article is written in such a manner as seemingly to "encourage" judges to impose the most minimal penalties.
- Specific reference to Internet offenses is also good but it will be even more difficult to provide proof that the thresholds have been met than would be the case with physical piracy. Again, in what is likely an inadvertent drafting error, sound recordings are not covered!
- End-user software piracy "could" be covered as a crime, but BSA reports that all indications are that the intention is NOT to cover it — a huge deficiency. It is also unclear how hard-disk loading piracy of software in the wholesale and retail channels can be adequately covered by the new JIs, given the excessively high copy thresholds.
- It is unclear why the provisions on repeat infringers was removed entirely, rather than strengthened by applying the higher, rather than the lower, tier of statutory penalties.

As noted earlier, it is critical that the PSB be given the resources necessary to implement the new JIs and that the Economic Crimes Division be put fully in charge of criminal copyright enforcement.

Section 217 and 218 of the Criminal Code criminalizing copyright piracy must be amended to comply with TRIPS.

The JIs, as proposed by IIPA, were not amended to rectify the critical TRIPS incompatibilities in Article 217 and 218 of the Criminal Code. IIPA has noted in prior submissions that the criminal piracy articles of Chinese law are deficient on their face, and thus violate TRIPS Article 61, which requires the criminalization of all "copyright piracy on a commercial scale." These articles must be amended, inter alia, (1) to criminalize end-user piracy; (2) add reference to all the exclusive rights now provided in the law (including the new WIPO treaties rights and unauthorized importation; (3) add criminalization of violations of the anti-circumvention provisions and rights management information; (4) criminalize Internet and other offenses that are without "profit motive" but that have impact on right holders "on a commercial scale"; (5) eliminate distinctions between crimes of entities and individuals; and (6) increase the level of penalties overall.

The 2001 Copyright Amendments must be further amended to bring the law into compliance with TRIPS and the WIPO "Internet" treaties.

The amendments to China's 1990 copyright law were adopted on October 27, 2001, and IIPA's 2002 and 2003 submissions provide great detail on both the positive changes, as well as the deficiencies, in these amendments.[25] The amendments sought to bring China into compliance with its WTO obligations and added many provisions that sought to implement the requirements of the WIPO Copyright Treaty (WCT) and the WIPO Performances and Phonograms Treaty (WPPT). The deficiencies detailed in these prior submissions were not fixed by the December 2001 regulations governing computer software or the regulations to the

[25] See IIPA's 2003 Special 301 country report on the People's Republic of China, pages 33-36, available at http://www.iipa.com/rbc/2003/2003SPEC301PRC.pdf. Copyright Law of the People's Republic of China, Adopted at the Fifteenth Session of the Standing Committee of the Seventh National People's Congress on September 7, 1990, Amended in Accordance with "Decision to Amend Copyright Law of the People's Republic of China," Adopted at the Twenty-Fourth Session of the Standing Committee of the Ninth National People's Congress on October 27, 2001 (translation on file at IIPA).

Copyright Law, which became effective on September 15, 2002. The following are the key deficiencies in the 2001 amendments that still need to be corrected:

- The most glaring deficiency is that criminal liability is not affected and there are apparently no plans to amend the Criminal Code. As noted, the current Criminal Code articles on copyright violate the TRIPS Agreement.
- While the Law [Article 47(6)] provides anti-circumvention protection, it does not fully implement the WIPO treaties obligation, in that it: (1) does not expressly prohibit the manufacture or trade in circumvention devices, components, services, etc.; (2) does not define "technical protection measures" to clearly cover both "copy-controls" and "access controls"; (3) does not make clear that copyright exceptions are not available as defenses to circumvention violations; (4) does not expressly include component parts of circumvention technologies (assuming devices are covered); (5) imposes an "intent" requirement as to acts (and business/trade if such activities are covered), which might make proving a violation difficult; and (6) does not provide for criminal penalties for circumvention violations (since the copyright law only deals with civil and administrative remedies).
- While the law protects against "intentionally deleting or altering the electronic rights management system of the rights to a work, sound recording or video recording" without consent of the right holder [Article 47(7)], this protection may not fully satisfy WIPO treaties requirements and requires further elaboration. For example, the law does not expressly cover "distribution, importation for distribution, broadcast or communication to the public" of works or other subject matter knowing that RMI has been removed or altered without authority, as required by the WIPO treaties, nor does it define "electronic rights management system" in a broad, technology-neutral manner.
- Temporary copies are not expressly protected as required by Berne, TRIPS and the WIPO treaties. As with the copyright law prior to amendment, protection of temporary copies of works and other subject matter under the 2001 copyright law remains unclear. According to an earlier (February 2001) draft amendment of Article 10, "reproduction" as applied to works was to include copying "by digital or non-digital means." The phrase "by digital or non-digital means" was removed from the final version of Article 10(5) prior to passage. Article 10(5) also fails (as did the definition of "reproduction" in Article 52 of the old law, which was deleted, and Article 5(1) of the 1991 Implementing Regulations) to specify that reproductions of works "in any manner or form" are protected. Addition of either of these phrases might have indicated China's intent to broadly cover all reproductions, including temporary reproductions, in line with the Berne Convention, TRIPS and the Agreed Statement of the WIPO Copyright Treaty.[26] As it stands, the current Article 10(5) description of the reproduction right includes "one or more copies of a work by printing, photocopying, copying, lithographing, sound recording, video recording with or without sound, duplicating a photographic work, etc." Objects of

[26] The agreed statement to Article 1 of the WIPO Copyright Treaty provides,

> [t]he reproduction right, as set out in Article 9 of the Berne Convention, and the exceptions permitted thereunder, fully apply in the digital environment, in particular to the use of works in digital form. It is understood that the storage of a protected work in digital form in an electronic medium constitutes a reproduction within the meaning of Article 9 of the Berne Convention.

Dr. Mihály Ficsor, who was Secretary of the WIPO Diplomatic Conference in December 1996, has stated that the term "storage" naturally encompasses temporary and transient reproductions. Ficsor notes that "the concept of reproduction under Article 9(1) of the Convention, which extends to reproduction 'in any manner or form,' must not be restricted just because a reproduction is in digital form, through storage in electronic memory, and just because a reproduction is of a temporary nature." Mihály Ficsor, Copyright for the Digital Era: The WIPO "Internet" Treaties, Colum.-VLA J.L. & Arts (1998), at 8. See also, Mihály Ficsor, The Law of Copyright and the Internet: The 1996 WIPO Treaties, their Interpretation and Implementation (2002).

neighboring rights (Articles 37, 41 and 44) mention "reproduction" (e.g., Article 41 provides sound recording and video recording producers a "reproduction" right), but the Article 10(5) description is not expressly applied *mutatis mutandis*. It should also be noted that the Article 41 reproduction right for sound recording producers does not expressly extend to indirect reproductions, as required by TRIPS (Article 14.2) and the WPPT (Article 11). China has apparently conceded in the TRM process in Geneva that its law does not encompass temporary copies.

- A new compulsory license (Article 23) permits the compilation of "[p]ortions of a published work, a short work in words or music, or a single piece of artwork or photographic work" into elementary and high school (so-called "el-hi") textbooks, and "State Plan" textbooks (which we are still trying to determine would not include university textbooks, which would cause even greater concern for U.S. publishers); in addition, sound recordings, video recordings, performances, and broadcasts apparently are subject to this compulsory license. IIPA hopes that the Chinese government will confirm that this compulsory license provision will not be read to apply to foreign works and other subject matter since it would violate the Berne Convention and TRIPS if it did. It would also violate the International Treaty regulations referenced above (which implemented the 1992 U.S.-China Memorandum of Understanding [MOU]), even if it were further confirmed that it only applies to foreign printed materials used in elementary or high school "textbooks" (hard copies). The significant damage to publishers would be further exacerbated if "State Plan" were to encompass university textbooks and/or if "textbook" includes forms other than "printed" forms (e.g., digital forms or multimedia). The regulations must be framed to exclude foreign works or to limit their scope in a manner consistent with the Berne Appendix.
- The provisions on collecting societies leave unclear whether this provision extends to the creation of anti-piracy organizations which can "enforce" the rights of their members in the association's name. This change is sorely needed in China, particularly for the benefit of foreign right holders, and other laws or regulations which inhibit the formation of such organizations should also be amended or repealed. Regulations did not clarify this point.
- The treatment of works and sound recordings used in broadcasting continues to remain woefully deficient and out of date. While Article 46 spells out that broadcasters must obtain permission to broadcast "unpublished" works (e.g., an exclusive right), Article 47 provides a mere "right of remuneration" for the broadcast of all other works, with the sole exception of cinematographic and "videographic" works. Such a broad compulsory license (not even limited to noncommercial broadcasting) is not found in any other law, to IIPA's knowledge. Furthermore, the broadcast of sound recordings is not even subject to a right of remuneration by virtue of Article 41 and Article 43. Record producers should not only enjoy full exclusive rights for both performances and broadcasts in line with modern trends, and this treatment appears to conflict with the "Regulations Relating to the Implementation of International Treaties" promulgated in 1992. Article 12 extends these rights to foreign cinematographic works and Article 18 applies that Article 12 applies to sound recordings. The authorities, though asked, did not clarify this contradiction in the Implementing Regulations to the Copyright Law discussed below. Provisions should be added to ensure that certain uses of sound recordings that are the equivalent of interactive transmissions in economic effect should be given an exclusive right. An exclusive importation right should also be added.
- The draft does not take advantage of the opportunity to extend terms of protection to life plus 70 years and 95 years from publication. This is the modern trend.
- A full right of importation applicable to both piratical and parallel imports should have been included.

Deficiencies also occur in the enforcement area:

- Administrative fines need to be substantially increased. The equivalent of injunctive relief must be provided and clarified.
- Again worthy of particular emphasis, however, is the failure of these amendments to address the lack of TRIPS-compatible criminal remedies, probably the single most important change that must be made to open up the Chinese market closed by staggering piracy rates around 90%. Criminal remedies must be extended to include violations of the TPMs and RMI provisions in order to comply with the WIPO treaties obligations.

IIPA also urges China to ratify the WIPO "Internet" treaties by the end of 2005.

The Supreme People's Court's Internet Interpretations and the NCAC's Draft Internet Interpretations

The Supreme People's Court issued its "Interpretations of Laws on Solving Online Copyright Disputes," with effect from December 20, 2000.[27] These were amended at the end of 2003.[28] As announced at the JCCT, NCAC and MII were to issue Internet-related regulations by the end of 2004. A draft was released in April 2004 and another in November 2004.[29] These regulations deal entirely with the liability of Internet Service Providers and with the details of "notice and takedown," and, we understand, are being issued pursuant to Article 58 of the 2001 copyright law amendments pursuant to which the State Council reserves to itself the task of issuing regulations on the "right to transmit via information networks."

Clarification is necessary on how these draft regulations interrelate with the current 2003 "Interpretations" of the Supreme People's Court.

With respect to the 2003 amended SPC "Interpretations," they are deficient or unclear in several respects:

- Article 3 remains problematic. It appears to provide a loophole for the reprinting, extracting or editing of works, once they have appeared on the Internet with permission and remuneration. While the copyright owner can give notice that it does not want its work used further, this "quasi compulsory license" is unworkable in practice. Copyright owners should not have to undertake these notification burdens when they are granted exclusive rights under the Conventions.
- Many of the provisions of the "Interpretations" overlap with the NCAC draft regulations discussed below but it is unclear, for example, whether the notice requirements set forth in the NCAC regulations would also apply in the context of a civil infringement case brought before the courts. There are also inconsistencies. Article 6 seems to imply that the ISP must provide the "author" with information identifying the infringer. This is not part of the NCAC regulations.

[27] "Interpretations of the Supreme People's Court on Laws for Trying Cases Involving Internet Copyright Disputes" (Adopted at the 1144th session of the Judicial Committee of the Supreme People's Court on Nov. 22, 2000).

[28] Decision on Revising "Interpretation of the applicable law and some other matters for hearing computer network copyright-related disputes by the Supreme People's Court" by the Supreme People's Court (Adopted by the Trial Committee of the Supreme People's Court at No. 1302 meeting on Dec. 23, 2003).

[29] Administrative Measures on Copyright under the Environment of the Internet (Draft), April 2004. Administrative Protection Measures on the Right of Communication through the Information Network (Draft), National Copyright Administration of China; Ministry of Information Industry, November 2004. English translations on file at IIPA.

- Article 5 makes ISPs fully liable where they are "aware" of the infringement, either before notice from the right holder or after receiving notice and failing to take down the infringing site. Is this a more liberal test than in the NCAC draft regulations? The ISP must also have "adequate evidence" of infringement. What constitutes "adequate evidence" of infringement? Will it be the same as the onerous requirements for an administrative action? All this must be clarified. The "Interpretations" also do not apparently require an "immediate" takedown as provided in the draft NCAC regulations.

The NCAC draft regulations, revised and issued in November 2004, continue to be inadequate in dealing with the realities of infringement on the Internet and must be further redrafted. Below are a few of the deficiencies:

- It is important that ISPs that are in a position to control content not be subject to any limitations on liability. The current language in Article 2 should be clarified to this effect.

- The requirements in draft Article 8 on the content of the notice are unworkable. Articles 5, 7, 8 and 10 imply that only the "copyright owner" can supply the notice, and not an authorized representative of the owner, such as a trade association. This change must be made. Article 8 then continues to list the requirements for a valid notice. The Article requires that the "copyright owner" supply an "ownership certificate of copyright." This is followed by four other documentary requirements. These are unclear and far too onerous to be practical. All that should be required, as in the DMCA and the U.S. FTAs, is a statement that the copyright owner has a good faith belief that the material is infringing and that the statement in the notice is accurate. There is also no provision which allows the right holder to "substantially" comply with the notice requirement. Indeed, Article 10 permits the ISP to ignore the notice if it is literally "without any of the content prescribed in Article 8."

- A fundamental flaw in the draft regulations is the requirement in Article 10 that all notices be made "in written form." Virtually all notices globally are accomplished via *electronic* communications (e.g., email). This provision would seem not to permit this, making the provision wholly impractical and unworkable. It would severely reduce the already low compliance rates for takedowns in China.

- The prior draft was fortunately changed to require the ISP to "immediately" take down the infringing content upon receiving notice, but the complex notice requirements and the "writing" requirement may vitiate this positive feature.

- Article 7 allows the ISP to "put back" the alleged infringing materials upon receiving a counter-notification. However, no notice to the copyright owner of such action is required. Clearly the copyright owner needs to be advised of the putback notice and given time to take further action. This is in the DMCA and FTAs and an essential part of an effective notice and takedown system. Interestingly, Article 7 says "may" which seems to indicate the "put back" is not mandatory. But this is still a poor substitute for notifying the copyright owner.

- The knowledge requirement in Article 11 is too strict. Under the DMCA and the FTAs, an ISP is liable if it "knows" or if it is "aware of facts or circumstances from which infringing activity is apparent" (DMCA, Article 512). That needs to be a feature of these regulations. It is very difficult to prove actual knowledge but easier to show facts

from which the ISP should have known that the material being transmitted was infringing.

- There is no clear right in NCA to order the equivalent of injunctive relief, just the right to fine, and then only three times "income" (which as we know is virtually impossible to prove). Thus, the maximum fine will realistically be only "up to RMB100,000." This is hardly an effective deterrent to mass infringements. Also, administrative fines can only be imposed if the infringing conduct "impairs the social and public interest" as a condition. NCA has not done well by the software industry using this language. It should be eliminated. Finally, the right to seek injunctions from a civil court must be clarified and preserved. This raises again the critical question of the interrelationship of these regulations with the SPC "Interpretations."

- There is nothing in the revised draft regulations requiring the ISP to disclose the identity of the infringer, except to NCA directly. In turn, there is no requirement that NCA disclose that identity to the right holder enabling the bringing of a civil or criminal case. An effective and expeditious notification system is a critical element to effective Internet enforcement.

- Finally, Article 4 paragraph 2 defines where an infringement occurs as the place where the server is located. If this is literally the rule, then ISPs have no obligation to take down infringing material emanating from servers in Taiwan or the U.S. or any other country. Moreover, servers can be moved virtually instantaneously. Administrative agency jurisdiction should never depend on the location of the server. Again, such a system is simply unworkable.

The Urgent Need for Improved Market Access

China must eliminate its onerous market access restrictions and create a competitive marketplace that can meet domestic demand.

Most of the copyright industries suffer from non-tariff and tariff trade barriers, which severely limit their ability to enter into business, or operate profitably, in China. These are only selected barriers that affect the named industries:

Entertainment software: Hard goods versions of entertainment software titles must go through an approval process at the GAPP. It is believed online versions of games will need to go through an approval process at the Chinese Ministry of Culture before distribution is allowed. The rules and regulations are not transparent at this time.

For hard goods, in many instances, the approval process takes several weeks to several months to complete. Given the prevalence of piracy, it is important that any content review process be undertaken in as expeditious a manner as possible. Protracted content reviews result in considerable delay before a newly released video game title is approved for release in the Chinese market. In the meantime, pirated versions of these games are sold openly well before the legitimate versions have been approved for release to the retail market. Such a delay affords pirates with a virtually exclusive period of distribution for newly released titles. The Chinese government should enforce these regulations and clamp down on pirates who distribute games that are not approved by GAPP for sale in the country.

There is also concern that this review process may now be bifurcated between these two agencies. It would be extremely helpful to the industry for this review function to be lodged with only one agency. Already, there are video games, which though distributed through physical optical disc media, also have an online component. Having to undergo two separate content review processes before two different agencies would be burdensome to entertainment software publishers, adding not only additional costs but also further delay in releasing new product into the market. Further, transparency in the review process would help game companies in preparing games for the market.

In addition, there are other investment and ownership restrictions that must be abolished.

Book and journal publishing: In IIPA's 2004 submission, we detailed some of the existing barriers for the U.S. publishing industry. China was required to eliminate some of these barriers by December 11, 2004, in accordance with its WTO commitments. Under the agreement, publishers must be afforded full trading rights (the right to freely import directly into China), and be permitted to engage (with wholly owned companies) in wholesale and retail distribution activities. While it appears that China has fulfilled many of these commitments with its 2004 Foreign Trade Law, which went into effect on July 1, this law has produced as many questions as answers, and the U.S. publishing industry awaits clarification on a number of issues, including how the Foreign Trade Law provisions interact with other laws and regulations pertaining to the publishing industry as well as those restricting foreign investment generally.

In addition to the questions that remain regarding trading rights and distribution, other activities essential to effective publishing in China remain off limits to foreign publishing entities. These include the right to publish (including editorial and manufacturing work) and print books and journals in China without restrictions (except for a transparent, quick and non-discriminatory censorship regime) and the right to invest freely in all manner of publishing related activities without ownership restrictions. Restrictions on these activities result in greater expense to publishers and consumers alike, and discourage development of materials prepared specifically for the Chinese market. These restrictions also create delays in distribution of legitimate product in the Chinese market, opening the door for pirate supply of the market. China's WTO commitments as to these activities must be clarified, and existing regulations prohibiting these activities should be repealed.

Finally, restrictions and high fees related to access to foreign servers result in high costs to publishers of electronic materials (such as academic and professional journals) in making their products available in China, resulting in fewer, lower quality options available to Chinese scholars and students.

Motion picture industry

Import quotas: Limits on the number of films imported into China continue. Under the terms of China's WTO commitment, China has agreed to allow 20 revenue-sharing films into the country each year, up from a previous limit of 10. The Chinese are insisting that the 20 are a "maximum," not a "minimum." This interpretation is not in accordance with its WTO obligations and should be corrected. Moreover, the needs of the market far exceed the legal films now available as demonstrated by the huge market in pirated optical discs. The monopoly import structure is the main tool by which these quotas are imposed and enforced. China must begin immediately to dismantle all these archaic, protectionist and discriminatory restrictions. Note that SARFT has previously informally tied any increase in the number of foreign films imported into China to the expansion of the domestic industry.

Monopoly on film imports and film distribution: China Film continues to hold a state enforced monopoly on the import of foreign films. China Film also held the monopoly on the distribution of foreign films until Huaxia Distribution was authorized by SARFT to be the second distributor of imported films in August 2002. Huaxia is a stock corporation with investment from over 20 share holders, the largest of which is SARFT, with over 20%, then China Film, Shanghai Film Group and Changchun Film Group, each with about 10%. SARFT requires that the distribution of all foreign films brought into China that are revenue sharing be distributed equally by the Government's mandated foreign film distribution duopoly. Foreign studios or other distributors cannot directly distribute revenue sharing foreign films. This restriction of legal film supply leaves the market to the pirates and they are taking full advantage of this limitation. China should begin now to eliminate all barriers to the import and distribution of films, including all investment and ownership restrictions.

Cinema ownership and operation: "The Interim Regulations for Foreign Investment in Theaters" effective on Jan 1, 2004 restricts foreign ownership of cinemas to no more than 49% but provides for 75% in the "pilot cities" of Beijing, Shanghai, Guangzhou, Chengdu, Xi'an, Wuhan and Nanjing. Foreigners are not permitted to operate cinemas. For the growth and health of the industry, foreigners should be allowed to wholly own and independently operate cinemas.

Broadcast quota: Under SARFT's "Regulations on the Import and Broadcasting of Foreign TV Programming" effective on 23 October 2004, the broadcast of foreign film and television drama is restricted to no more than 25% of total air time each day and is not permitted to be broadcast during prime time between 7:00 PM and 10:00 PM on any forms of television broadcast other than pay television without SARFT approval. A channel's other foreign television programming (news, documentary, talk shows, travel etc.) is restricted to no more than 15% of total air time each day. Foreign animation programming must follow the same censorship procedure as general programming and cannot exceed 40% of total animation programming delivered by each station on a quarterly basis. Since new regulations on the animation industry became effective in April 2004, only producers of domestic animation programming can import foreign animation programming and can only import the same proportion of foreign animation programming as they produce domestically. The quota on air time should be raised to at least 50%, and the prime-time quotas should be eliminated altogether. China should begin now to eliminate all these discriminatory restrictions.

Retransmission of foreign satellite signals: Foreign satellite channels may only be shown in three-star hotels and above and in foreign institutions. Moreover, foreign satellite channels beaming into China are required to uplink from a government owned satellite for a fee of $100,000, placing a significant and unnecessary financial burden on satellite channel providers. The up-linking fee should be eliminated because it inhibits the development of the television market. Indeed, all these restrictions and barriers should be eliminated.

Television regulations: Under the 1997 Foreign Investment Guidelines, companies that are wholly or jointly owned by foreign entities are strictly prohibited from investing in the broadcast industry. MPA member companies are not allowed to invest in broadcast stations or pay television systems. China TV Program Agency under CCTV, the government acquisition arm, must approve all importation of foreign programming under the guidance of SARFT. The "Interim Management Regulations on Sino-Foreign Joint Ventures and Sino-Foreign Cooperative Television Program Production Enterprises" effective on 28 November 2004 sets out that:

- Foreign companies can hold up to 49% stakes in production ventures, which must have

initial capital of at least US$2 million (or US$1 million in the case of animation companies). Local partners can be private, but must be existing holders of a production license.

- Foreign partners must be "specialized radio or TV ventures", a requirement aimed at ensuring the liberalization brings in expertise that will help the industry — although an indirect role for non-media investors may be possible.

- The joint ventures must also have a unique logo — a provision intended to ensure they are not used to promote the brand of foreign parents.

- Ventures must use "Chinese themes" in two-thirds of programs — the government will ensure that foreign-invested TV ventures produce original content rather than adapt their overseas programs for mainland audiences.

All such restrictions should be abolished along with other foreign investment restrictions embodied in the June 1995 foreign investment guidelines, which restrict investment, on a wholly owned basis, in other important segments of the film, video and television industries.

Taxation: The theatrical and home video industries have been subject to excessively high duties and taxes in China. These levels have a significant impact on revenues and continue to hinder market access. With its accession to the WTO, however, China committed to reducing import duties by approximately one third; duties on theatrical films were reduced (from 9% to 5%) and home video imports (reduced from 15% to 10%). These should be fully and fairly implemented.

Internet regulation: To monitor the Internet, economic and telecommunication-related ministries have staked out their turf on the web and have drafted competing regulations that are often vague and inconsistent. The State Council has been charged with creating a clear, effective and consistent Internet policy. Until the State Council completes its work, however, the landscape of existing regulations will remain confusing, with the Internet governed by regulations promulgated by a dizzying array of ministries and agencies. A stable, transparent and comprehensive set of regulations is necessary to guide the development of the Internet and e-commerce in China. China has also attempted to regulate and censor content on the Internet through regulation and technological controls. For example, the State Secrecy Bureau announced in January 2000 that all websites in China are to be strictly controlled and censored. In addition, the State Council set up the Internet Propaganda Administration Bureau to "guide and coordinate" website news content in April 2000. Jointly issued by the State Press Publication Administration and the Ministry of Information and Industry, the Provisional Regulation on Management and Control of Internet Publications became effective August 1, 2002, providing an additional mechanism for the government to intensify supervision of newspapers, periodicals, books and audio-visual content available online. The Ministry of Culture published "Interim Regulations on the Administration of Internet Culture," effective July 1, 2003. These regulations require that providers of Internet-based content (with any broadly defined "cultural" attributes) receive MOC approval prior to distribution in China. The National Copyright Administration of China will publish regulations on the use of copyright material on the net in early 2005. SARFT also claim governance of certain censorship rights on the Internet.

From a technological standpoint, China maintains firewalls between China and foreign Internet sites to keep out foreign media sites, and regularly filters and closes down Chinese sites that are seen as potentially subversive. In September 2002, for example, both the Google and Alta Vista search engines were blocked without explanation or acknowledgement by the government. While the industry respects the rights of China to ensure that its population is not subject to content that may be questionable under Chinese values, the breadth of China's restrictions on the Internet are unprecedented. Such restrictions will likely limit the growth in the sector and severely restrict the ability of MPA member companies to distribute product via this nascent distribution medium.

Recording industry: The recording industry is also severely hampered both in the fight against piracy and in helping to develop a thriving music culture in China by the many and varied market access and investment restrictions that affect the entire entertainment industry, specifically:

Censorship: Only legitimate foreign-produced music must be approved by Chinese government censors. Domestically produced Chinese sound recordings are NOT censored. China should terminate this discriminatory process. Censorship offices are also woefully understaffed, causing long delays in approving new recordings. Censorship should be industry-administered, as in other countries. If not possible, steps must be taken to expedite the process so that legitimate music can be promptly marketed, preventing pirates from getting there first. For example, staff shortages must be filled. In the near-term, China should be pressed for a commitment to (1) end discrimination in censorship; and (2) complete the approval process within a reasonable period (e.g., a few days). In the long term, censorship should be abolished.

Producing and publishing sound recordings in China: U.S. record companies are skilled at and desirous of developing, creating, producing, distributing and promoting sound recordings by Chinese artists, for the Chinese market and for export from China. However, onerous Chinese restrictions prevent this from occurring. For example, for a sound recording to be brought to market, it must be released through an approved "publishing" company. Currently only state-owned firms are approved to publish sound recordings. China should end this discrimination and approve foreign-owned production companies.

Further, production companies (even wholly owned Chinese ones) may not engage in replicating, distributing or retailing sound recordings. This needlessly cripples the process of producing and marketing legitimate product in an integrated manner. China should permit the integrated production and marketing of sound recordings.

U.S. record companies may market non-Chinese sound recordings only by (1) licensing a Chinese company to produce the recordings in China or (2) importing finished sound recording carriers (CDs) through the China National Publications Import and Export Control (CNPIEC). China should permit U.S. companies to produce their own recordings in China and to import directly finished products.

Distribution of sound recordings: Foreign sound recording companies may own no more than 49% of a joint venture with a Chinese company. However, the recently concluded "Closer Economic Partnership Agreement" (CEPA) between China and Hong Kong permits Hong Kong companies to own up to 70% of joint ventures with Chinese companies engaged in distributing audiovisual products. China should grant MFN status to U.S. record producers per the terms of the CEPA.

Business software industry: The software industry's ability to increase exports to China — and recoup billions of dollars in piracy-related losses — is severely limited by China's failure to take the steps necessary to create a fair and level playing field for U.S. software developers and other IT companies. As noted in USTR's 2004 Report to Congress on China's WTO Compliance, "China's implementation of its WTO commitments has lagged in many areas of U.S. competitive advantage, particularly where innovation or technology play a key role." Of particular concern to BSA is China's pending software procurement regulation (described above), which would effectively prevent U.S. software companies from selling software products and services to the Chinese government.

The Chinese government procurement market represents one of the most significant growth opportunities for the U.S. software industry, which derives more than half of its revenues from exports. The Chinese government sector is the primary purchaser of software in the world's largest emerging market for IT products. According to a recent study conducted by IDC, the Chinese market will continue to grow at a compound annual rate of 25.8 percent, making it a $5.1 billion market by 2007. This explosive demand for software and other IT products will be fueled in significant part by government IT procurements.

IIPA is thus deeply concerned about China's plan to close its government procurement market to U.S. software products and services. The U.S. software industry has already lost billions of dollars in export revenue due to China's ongoing failure to address rampant domestic piracy and massive counterfeiting; a ban against government procurement of U.S. software would eliminate the U.S. software industry's most meaningful opportunity to expand exports to China, and would set a dangerous precedent for China's procurement policies in other major economic sectors.

These are not theoretical concerns; U.S. software companies are already experiencing the harmful effects of China's restrictive procurement policy in the marketplace. According to media reports, U.S. companies are being excluded from government procurement deals in several provinces as a direct result of the government procurement law. Thus, China's decision to close or greatly restrict its government procurement market to much of the world's best software products is already translating into losses in export revenues.

China's proposed domestic software preference reflects a troubling trend toward protectionism in the technology sector, which has resulted in a number of industrial policies designed to promote the use of domestic content and/or extract technology and intellectual property from foreign rightholders. If left unchecked, these discriminatory industrial policies would significantly limit imports of U.S. software products into the Chinese market. China's JCCT commitments to legalize government software use and combat software piracy would

therefore be of very limited value.

PREPARED STATEMENT OF JAMES M. ZIMMERMAN

MAY 16, 2005

AMCHAM-CHINA'S VIEWS ON CHINA'S IPR ENFORCEMENT RECORD

Thank you Mr. Chairman and staff members for this opportunity to present the views of the American Chamber of Commerce, People's Republic of China.

My name is James M. Zimmerman. I am the Vice Chairman of the Board of Governors of AmCham-China and Co-Chair of AmCham's Legal Committee. I am a partner and Chief Representative of the Beijing office of the international law firm of Squire, Sanders & Dempsey L.L.P.

AmCham-China, which is based in Beijing, is an organization that represents the interests of the American business community in China. Along with its sister organization in Shanghai, AmCham-China represents over 2000 companies and individuals from virtually every state in the union, including small to medium sized businesses and U.S. exporters without a formal presence in China. We do not represent the interests of Chinese companies or the PRC government. AmCham-China and its member companies are in the field every day fighting for market access for U.S. products and services.

One of our core tasks is to meet with the Chinese government on a broad range of issues such as for greater market access of U.S. goods/services, timely implementation of China's WTO obligations, increased enforcement of intellectual property, and continued improvement of China's legal system and business environment.

AmCham-China and its member companies—given our on-the-ground presence and years of in-country first-hand experience—are committed to assisting this Commission and Members of Congress in obtaining information and data to assist it with respect to its investigation concerning the issues addressed in this forum today.

I am here today to share our concerns and efforts with respect to IPR protection and enforcement in China.

Since its accession to the World Trade Organization (WTO) in December 2001, China has made significant improvements to its laws governing intellectual property rights (IPR). However, there has been minimal progress in establishing a system of effective enforcement.

Indeed, counterfeiting and piracy problems in China are worsening and affecting both Chinese domestic and foreign brands. More sophisticated infringement schemes, combined with an increasing number of exporters, mean more counterfeits are showing up in foreign markets. Piracy not only amounts in a tremendous loss of revenue to IPR holders, but is also a consumer health and safety issue since counterfeit product rarely meets stringent quality standards.

The violation of intellectual property rights impacts almost all industry sectors including consumer and industrial goods. Among a few examples, computer software, films, music recordings, clothing, cosmetics, auto parts, pharmaceuticals, and food and beverages have all felt the sting of piracy.

In the media sector, it is common for a newly released film in the United States to surface within days of its American release as a pirated copy in China. Pirated DVDs in high quality packaging are now widely available in DVD stores throughout Beijing, despite the Chinese government's repeated commitments to crack down on piracy.

Piracy is a deeply frustrating problem for our members. More than three-quarters of respondents to the 2004 AmCham-China & AmCham-Shanghai membership questionnaire are negatively impacted by China's poor IPR protection. Ninety percent of our members believe China's IPR protection is ineffective.

AmCham-China believes that the answer to the problem will only be tackled with stronger national leadership to address IPR enforcement issues.[1] Large department stores and markets openly selling counterfeit and pirated goods are widespread throughout China, including in Beijing itself. Chinese agencies report that they periodically raid these markets, sometimes imposing modest administrative fines on vendors. However, the fact that these markets continue to operate in the public eye,

[1] We are pleased with Vice Premier Wu Yi's commitment, made on behalf of the Chinese government at the April 2004 Joint Commission on Commerce and Trade (JCCT) meetings, to make specific improvements in IPR laws and regulations; strengthening IPR education and enforcement; ratifying the WIPO digital treaties; establishing a joint U.S.-China IPR interagency working group to tackle enforcement issues; and promulgating the judicial interpretations on criminal liabilities standards covering prosecution, conviction, and sentences. However, the 2004 commitments have not bee fulfilled and more work needs to be accomplished.

with seemingly no fear of meaningful legal penalty, creates the impression that China's national leadership lacks the will to stop counterfeiting and piracy.

Among other things, we believe that strong IPR protection is not just to protect the interests of foreign multinational corporations but also to guard the rights and interests of domestic intellectual property rights holders and to protect the health and safety of consumers worldwide that may purchase pirated goods.

With these general comments in mind, AmCham-China supports the USTR in placing China on a Priority Watch List and initiating WTO consultations with China under the TRIPS agreement. We believe that China needs to be put on notice in the strongest and most direct terms possible, that the IPR problem must be effectively contained or the USG will be forced to either take WTO action (with all the uncertainty that entails given the untested nature of the WTO TRIPS Agreement).

AmCham is in favor of exploring ways to taking action against specific regions, cities, or provinces in the PRC that are areas of flagrant IPR abuse, or specific Chinese companies which engage in repeated and gross violations of IPR.

While enforcement efforts have been lax, we believe the Chinese are growing more aware of their poor performance on IPR there is nowhere near the required effective and deterrent enforcement measures as required by WTO. As we have stressed to the PRC leadership, the key to enforcement is credible criminal sanctions that deters commercial-scale IPR counterfeiters and pirates.

For its part, AmCham-China has developed an exchange and education program of its own to encourage more effective enforcement in China and this program in general includes, among other things, the following components:

- *IPR Index of Enforcement:* AmCham-Beijing has created an IPR Index which measures whether China's IPR enforcement is improving or not. We are currently conducting the baseline survey and plan to publish the results three times a year. This information will be available to the public, including the PRC and U.S. governments. We recognize that we in the private sector—here and in China—need to provide much more data on specific examples of inadequate Chinese enforcement. Our IPR Index will aid this effort and we are also taking steps to advise and inform our members of the importance of collecting and sharing such information directly with the USG.
- *Legal Exchange and Education Efforts:* AmCham is pressing various PRC government agencies and judiciary to take certain key steps during the next year.[2] In short, we have stressed to the PRC government that several laws must be amended/adopted to provide stronger protection, enhanced penalties, and further clarification of standards. As part of its efforts, AmCham-China and AmCham-Shanghai jointly publish an English/Chinese language issues White Paper on an annual basis for purposes of educating the Chinese government on areas of concern for U.S. business, and included in the White Paper is a detailed analysis of U.S. industries' concerns with IPR enforcement. At the end of this Statement is a draft of excerpts from our White Paper and reflects some of the issues we continue to emphasize to the PRC leadership.
- *Benchmarks and Performance Criteria:* This will be indicative of its commitment to IPR (we developed this list independently but it bears many similarities to the list of tangible results expected of China in USTR's April 30 Special 301 Report):

  —Impose criminal sanctions against a significant number of large-scale Chinese counterfeit operations. This crackdown should be widely publicized in the media.

  —There should be a significant decline in seizures of counterfeit goods at US and EU ports as a result of Chinese customs interception actions.

  —Chinese patent authorities should avoid retroactive rulemaking which undermines the perceived value of Chinese patents and creates unpredictability for foreign investors. An example of this behavior is the invalidation of Pfizer's Viagra patent.

[2] On January 19 2005, an AmCham delegation met with key members of the PRC Supreme Peoples Court (the "SPC") to exchange views on the Interpretation by the SPC and the Supreme People's Procuratorate (the "SPP") on Several Issues Concerning Application of Laws in Handling Criminal Cases Involving the Infringement of Intellectual Property (the "Judicial Interpretation") that was effective in December 2004. While the language of the Judicial Interpretation left much to be desired, Justice Huang Songyou, Vice President of the SPC, assured us that the Chinese government was serious about fulfilling its WTO commitments and gave priority to IPR protection. As stressed to the SPC, the key to enforcement is credible criminal sanctions that deter commercial-scale IPR counterfeiters and pirates. We believe that the SPC (the highest court in China) understands that effective action must be taken.

—China should substantially increase its budget dedicated to enforcement of IPR and give national police the authority to operate across jurisdictions within China.

—China should substantially increase the budget for the Trademark Office to resolve the backlog of invalidation cases pending (i.e., 20,000 cases and some pending since 1999).

AmCham further believes that the U.S. Government should dedicate additional resources to counter the effect of PRC-based counterfeiting and to support China's efforts to develop an effective enforcement system, including the following:

- Significant increase of U.S. Customs personnel dedicated to interception of Chinese counterfeit goods.
- Increase in U.S. Customs' cooperation in cross-border criminal investigations with China and EU.
- U.S. government, particularly USPTO, to engage in more cooperative technical assistance programs to assist China in raising the level of IP practice so that U.S. companies can benefit. An improved patent/trademark examination system may expedite the grant of IP rights to U.S. companies.

In summary, the AmCham-China and AmCham-Shanghai believe that China has made progress in the past three years with respect to its IPR laws, but much focused and aggressive work remains in order to elevate China's system to international standards and to give worldwide IPR holders a comfort level that their intellectual property interests will be respected and protected in China, and that infringing parties will be punished. China's IPR standards and regulatory system—as a work in progress—requires strong national leadership and the dedication of capital and resources to be more effective and respected.

Thank you for this opportunity.

EXCERPTS OF AMCHAM-CHINA AND AMCHAM-SHANGHAI'S DRAFT 2005 WHITE PAPER CONCERNING INTELLECTUAL PROPERTY RIGHTS ISSUES

Central Government Resources: The Chinese leadership needs to devote more of its political capital and bureaucratic resources to shaping a national IPR strategy and putting into place an effective IPR enforcement regime. There is a need for revised laws, regulations, and policies. The most glaring deficiency in China's IPR regime at this time is in the need to revise the one key law that was not revised when China joined the WTO—its criminal code, which should be revised to provide stronger protection, enhanced penalties, and further clarification of standards. More attention is needed on the "big impact items to improve local enforcement, raise public awareness and strengthen intellectual property customs protection, and enhance interagency coordination.

Interagency Coordination: The lack of coordination among the many Chinese government agencies responsible IPR enforcement prevents effective enforcement. The Administrations for Industry and Commerce Trademark Divisions (AIC), AIC Economic Supervision Divisions, Technical Supervision Bureaus (TSB), Copyright Administration offices, Customs, Public Security Bureaus (PSB) Social Order Divisions, and PSB Economic Crimes Investigation Divisions (ECID), to name a few, have overlapping jurisdiction and authority. Jurisdictional issues need to be resolved and a program adopted to improve coordination.

Customs Enforcement: Since its WTO accession, China has liberalized its foreign trade regime. This is a welcome development. An unintended consequence, however, is that exports of counterfeit and pirated goods from China have increased sharply in the past two years and are now a global problem. Further liberalization contemplated by the revised Foreign Trade Law may well accelerate this trend. Although verbal assurance from the Supreme People's Court provides otherwise, there is nothing in the written laws that indicates that it is illegal to export counterfeit goods from China. This should be rectified and enforcement resources provided.

The PRC Intellectual Property Customs Protection Regulations, in effect from March 1, 2004, and the related implementing rules, promise to improve IPR customs enforcement. We are hopeful that Chinese customs will invest in the organizational and equipment upgrades necessary to make these regulations fully effective. This includes the purchase of a centralized computer system to enable customs officials to track the activities of counterfeiters and copyright pirates.

The regulations themselves, however, contain several weaknesses. There are no provisions to transfer suspected cases of criminal liability to the public security organs. AmCham-China and AmCham-Shanghai are also concerned about the removal of administrative penalties from the customs regulations and hope that such pen-

alties will be reinstated. Presently, however, there appear to be no punishments for willful trade in infringing goods.

Chinese regulations require IPR owners to carry a heavy burden for protecting their intellectual property. For example, companies must provide customs officials with precise information as to which port(s) counterfeit goods will be going through, even though such information is very difficult to obtain. IPR owners also are required to post bonds to cover the risk of counterclaims in the event that a court finds the detained goods are not counterfeit. The procedures and amounts are unreasonably burdensome, especially because the courts require a separate bond in the event that a seizure leads to litigation. We believe IPR owners should be allowed to post a single bond at the China Customs in Beijing covering the risk of counterclaims for all customs branches.

*Criminal Enforcement: The AmCham welcomes the release of the Judicial Interpretation on Issues Concerning Application of Laws in Handling Criminal Cases Involving the Infringement of Intellectual Property, effective in December 2004. While the Judicial Interpretation significantly reduces the numerical thresholds to trigger criminal IPR prosecutions, we are disappointed that the Judicial Interpretation fails to include language concerning, among other things, the criminal liability for exporters of counterfeits and organizational end-users (and specifically with respect to the misuse of software products); methods for calculating value of semi-finished infringing products; enhanced penalties for repeated offenders, violations of health and safety, and other aggravating circumstances; and a clear definition of "illegal business income" which appears to allow the use of the infringing party's prices and not the actual loss by the genuine owner of the IPR. Moreover, the distinction between individual and corporate infringing activity (with the threshold for unit or corporate activity being significantly higher than for individual activity) is unfortunate since it will simply encourage criminals to incorporate to avoid criminal liability. In the end, the true test of effectiveness of the Judicial Interpretation—and the resulting work of the courts and prosecutors—will be whether it is effective in deterring the rampant infringement of IPR in China and in bringing more criminal prosecutions and convictions in IP cases.

Administrative Enforcement: The existing system for administrative enforcement of regulations against piracy and counterfeiting needs to be improved. The AIC and the TSBs are key agencies providing support to intellectual property rights holders, but their effectiveness is limited by policy and legal problems. For example, there are no minimum standards for administrative fines; only a maximum standard. Consequently, our members report the amount and scope of administrative fines is dropping. We encourage the government to unify standards at the local level, combat local protectionism, and enhance interagency coordination.

Administrative Fines for Trademark Infringement: The State Council issued implementing regulations for the PRC Trademark Law, which entered into effect on September 15, 2002. These regulations provide, inter alia, for a dramatic increase in the maximum administrative fines that may be imposed on counterfeiters, from the prior 50 percent of turnover to the current 300 percent. Unfortunately, these increases in maximum potential fines have yet to result in a significant increase in actual penalties imposed. This is mainly due to the lack of guidelines from the State Council and the Trademark Office of the SAIC as to how fines should be calculated.

Administrative Enforcement of Software Copyright: Copyright authorities at the local level are crippled by inadequate manpower, training, and resources. Appropriate steps should be taken to ensure that the National Copyright Administration (NCA) and their local offices responsible for enforcing copyrights are adequately supported, such that rights holders can have reliable access to administrative and civil remedies provided under relevant laws against end-user and other copyright pirates. Effective coordination needs to be established with the SAIC to increase the enforcement capability of the local Copyright Administration offices. There must be reliable administrative enforcement coupled with deterrent penalties to prove that corporate end-user piracy bears administrative liability. We look forward to the prompt enactment of administrative rules by the NCA and the Ministry of Information Industry (MII) to deal with Internet piracy, takedown notice procedure and ISP liability.

The following issues related to the Computer Software Protection Regulations (issued by the State Council on June 4, 1991 and amended on December 20, 2001) should be addressed: (1) the regulations should be modified to clarify that temporary copies of software are protected; (2) the exception under Article 17—which allows for the unlimited use of any software for the purposes of learning and studying the design—should be amended since it goes well beyond what is permitted under the Berne Convention and the TRIPS Agreement; (3) the exception under Article 30 of the Regulations—which creates a significant loophole in the liability of corporate

end-user pirates by allowing an exception to liability in cases where a party is deemed to have acted without knowledge—should also be amended as inconsistent with international standards; and (4) the requirement under Article 30 that allows for a compulsory license in situations if destruction of the illegally used software would bring great loss to the infringer—should be deleted or amended as it is vague and goes beyond the exceptions and limitations permitted by the TRIPS Agreement.

Local Standards and Local Protectionism: There is significant variation among localities for interpreting liability thresholds. Currently, the provinces and municipalities have very different thresholds for determining copyright infringement. For example, the Shanghai PSB has issued its own IPR crime arrest and investigation guidelines, but we are not aware of any current efforts to provide nationwide standards. In many cases, local protectionism renders administrative enforcement ineffective. After raiding counterfeiters, trademark owners too often encounter local AICs that are reluctant (delays are often more than six months, and sometimes more than a year) to release the official administrative penalty decision letters. This has seriously hindered trademark owners' efforts to recover damages from counterfeiters in court. We welcome steps to bring cases against administrative authorities for abuse of their authority in rendering insignificant fines. We also believe that administrative authorities should be encouraged to make their decisions publicly available to ensure the system is fully transparent and in accordance with the law.

Patent and Trademark Registration and Protection: Improving the trademark registration process would help deter counterfeiters who preemptively register well-known trademarks, trademark imitations, and even blatant copies of the trade dress of others. Unfortunately, the China Trademark Review and Adjudication Board (TRAB) and Chinese courts do not take bad faith into consideration in cases of preemptive trademark registration, trademark imitation, and trade dress infringement. There is also considerable delays with respect to trademark invalidation petitions before the Trademark Office, which reportedly has 20,000 undecided cases pending with some disputes filed in 1999 remain undecided.

Similarly, the China Patent Reexamination Board (PRB) and the Chinese courts rarely take bad faith into consideration when reviewing preemptive patent filing at either the invalidation process with the PRB or infringement suits in court. Currently, a legitimate rights owner has little recourse against counterfeiters that file utility and design patents, knowing that such filings lack novelty.

Delays in receiving patents or being granted market access are another problem. SIPO is understaffed to handle the large volume of applications. With the resulting backlog of patent applications, it can take up to five years to receive a patent.

The thin legal grounds underlying the State Patent Office's decision to invalidate the use-patent for Viagra represent a step backwards. In its decision to invalidate the patent, SIPO relied on new guidelines issued after the patent had been granted, and then did not allow the patentee the opportunity to meet the revised data provision standard of the new guidelines. The SIPO decision has been appealed to the courts and at this writing is still in litigation. Although we are most concerned with SIPO's rationale and procedure in invalidating this patent, which set an unfortunate precedent, we also note that the patent did not protect that legal producer. Domestic pharmaceutical companies widely copied the product and sold it through a variety of legal and illegal channels.

Patents and Standards: The intellectual property policies of the standards working groups in China do not conform to international practices. International standards organizations have an intellectual property policy that defines how intellectual property is contributed and made available for implementation of standards. Generally, Chinese standards groups in high tech areas (Advanced Visual Standard (AVS), Radio Frequency Identification (RFID), Linux, Intelligent Grouping and Resource Sharing (IGRS), etc.) either have no such policy, or an unreasonable policy requiring mandatory patent pool participation, unreasonable disclosure, and compulsory licensing.

The common practice is to require members of standards working groups to place all related patents in the patent pool and to entrust only the standards group to license the technology. In addition to creating monopolistic control, mandatory patent pool participation devalues patents in subsequent negotiations, cross licensing, and defense of intellectual property. Patent disclosure obligations in working groups typically apply to the entire company rather than the individual representing the company, and cover not only patents necessary to the standard in question, but all related patents, including third party patents and patent applications. Such disclosure standards are overly broad and impractical. This is compounded by rules in some working groups that non-disclosed patents must be licensed royalty free or not asserted.

The AVS Working Group is making an effort to cooperate with international standards experts to develop an appropriate IPR policy and related legal documentation. We recommend that relevant agencies and other Chinese standards organizations study this example.

Patent Protection for Computer Software: Patent examination guidelines and practices only allow patenting software-related inventions in the form of the computer that executes software (apparatus claims) or methods for operating computers using software (process claims). Protection is not allowed for computer readable media claims or programs that cause a computer to implement an innovative process (program product claims). As a result, the only one likely to be a direct infringer is the end-user who actually uses the software. This limits the use of software-related patents to protect the intellectual property of the industry. Many governments, such as the United States, Germany, Japan, and Korea have already recognized program product claims. China's failure to do so is not only discouraging to foreign companies, but also denies protection to Chinese software enterprises at home and leaves them facing an unfamiliar environment in international markets full of competitors seasoned in patent protection of program products. We recommend revision of the patent examination guidelines to accept program products claims.

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