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## China Business

Feb 15, 2007

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### Knocking out China's knock-offs

By Daniel Allen

BEIJING - Resourceful and resilient, China's armies of merchants and middlemen have long been infamous for the counterfeiting of brand-name products.

Today, blatant breaches of intellectual property rights (IPR) continue to sour the country's trade relations with the developed world and deter overseas companies from operating in the Chinese market.

Conditions in this land of economic opportunity are experiencing a rapid sea-change, however, and in the intensifying IPR battle

China's pirates are now starting to see more than a few symbolic shots fired across their bow.

In producing its 2006 White Paper, the American Chamber of Commerce in China surveyed 76 US companies operating in the Chinese market. Over half of those questioned reported that their business was being damaged by inadequate IPR protection, and over a third said that the number of counterfeit copies of their products had increased since 2005. Unsurprisingly, 98% said that they selectively introduced products in China to mitigate potential losses.

In October 2006, Nancy Pelosi, the recently elected Democratic Speaker of the US House of Representatives, forwarded a letter to President George W Bush calling for immediate action to

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promote and safeguard American intellectual property around the world.

Signed by many leading US politicians, the letter in part states that "no country in the world has done more to undermine American IP than China ... we call on the administration to immediately file a broad-based challenge in the World Trade Organization [WTO]. The United States should use the WTO Agreement on Trade Related Aspects of Intellectual Property Rights [TRIPs] to challenge China's flagrant abuse of international rules governing intellectual property rights."

China has slowly but surely gained ground in its effort to control IPR infringement. Since joining the WTO in 2001, legal frameworks have been strengthened with updates to IPR-related laws and new regulations forged in compliance with the WTO agreement on TRIPs. Despite these measures, China remains a hotbed of counterfeiting and piracy. If a product manufactured by a Western or Chinese company sells well, it is likely that illegal copies will hit the market in double-quick time.

Industry observers estimate that 15% to 20% of global brand-name products marketed in China are counterfeit, and that losses to legitimate manufacturers now run in the tens of billions of dollars annually.

The International Intellectual Property Alliance (IIPA), which represents the movie, music and entertainment software industries, estimates that about 90% of DVDs, CDs and digital games hawked by Chinese street vendors and sold in Chinese shops are still pirated, despite recent attempted crackdowns. "The vast majority of copyright holders are not making money in China, or are making a fraction of what they ought to be making or are making in neighboring countries," says IIPA president Eric Smith.

Employing millions, the black market in China is a significant segment of the economy. Illicit manufacturers operate factories across the country, producing cheap knock-offs so cleverly packaged that they are hard to distinguish from the genuine article. Many of these counterfeit goods end up on the global market, and often it is impossible for distributors to tell whether they are receiving bootleg or bona fide products.

#### **International invective**

After years of delicate and ultimately fruitless diplomacy aimed at



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halting the widespread piracy of American brands in China, the US abandoned its softly-softly approach in 2004 by appointing a full-time intellectual property attache to its Beijing Embassy.

Despite this move, and work by other foreign individuals and organizations, one Beijing-based American IPR expert paints a disheartening picture. He says: "We have still not reached a turning point in the war on counterfeiting. Generally speaking, we cannot say that individuals and companies in China today recognize that there are clear, predictable, deterrent risks to engaging in infringement activity, and that they should structure their activities to avoid any willful commercial-scale infringement.

"There is physical evidence of continued willingness to infringe all around us - in Beijing and other major cities in markets and businesses, including in the online environment. Seizures of counterfeit goods by foreign customs authorities, such as US Customs and Border Protection, continue to rise. To truly reduce local protectionism, it would be useful to pay officials nationally, rather than locally. This would include judges, prosecutors and police and administrative enforcement officials. China also needs

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to amend its criminal law, which predates the 2001 WTO agreement."

Government data reveal that most of China's IP cases are still handled by its idiosyncratic administrative system rather than in civil or criminal courts as in Europe or the US. The proportion of cases transferred from administrative authorities for criminal prosecution also varies between regions. Furthermore, China's IP

cases tend to cluster in specific regions. For example, a large majority of high-tech-related infringements occur in Shenzhen, while cases of trade secret theft and consumer product counterfeiting are concentrated in prosperous cities like Beijing and Shanghai.

It's not only America that is concerned with protecting its national interests in China's IPR arena. The IPR working group of the Beijing-based European Chamber of Commerce in China (EUCCC) comprises a wide range of European companies, law firms and consultants engaged in anti-counterfeiting work and research on IPR-related legal matters.

In November 2006, Peter Mandelson, the current EU trade commissioner, witnessed the signing of a memorandum of understanding between the EUCCC and Chinese provincial representatives of the State Office of Intellectual Property Protection. Mandelson recently repeated his call for a crackdown

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on the trade in fake European goods in Beijing as "a sign of China's willingness to take its WTO responsibilities seriously".

### A case in point

Large urban wholesale markets, such as Beijing's Silk Street and Yashow Market, are well known hubs of counterfeit distribution, jam-packed with fake merchandise selling at a fraction of the cost of the genuine equivalent. In 2006, after a series of IPR-related court cases, Silk Street landlords signed a memorandum with European fashion and sportswear brands, vowing to crack down on IPR infringements. Under its terms, if a vendor is discovered peddling counterfeit goods the landlord should suspend sales, and on second offense terminate the vendor's lease.

However, as is often the case in China, theory and practice don't exactly correlate. Silk Street's predecessor, Silk Alley, was notorious for fake consumer goods. Situated within full view of the US Embassy, this crowded *al fresco* maze of stalls became such a draw card for *laowai* (foreigners) that Lonely Planet's Beijing guidebook recommended the market for the purchase of Louis Vuitton handbags, Billabong surfwear and a host of other knock-off designer products.

The Silk Alley operation was also the nemesis of trademark lawyer Joseph Simone, a Beijing-based partner in the American law firm Baker & McKenzie. After lobbying successfully for the closure of Silk Alley, Simone was dismayed at the construction of Silk Street in its place, a five-story department store hosting five times as many fake product vendors as before. Even today, despite all the promises and agreements, a quick walk around the store reveals a huge number of counterfeit items on sale. A notice at the main entrance may list a dozen luxury brands ostensibly banned from the shelves, but inside nearly all are available for purchase (credit cards welcome).

In mid-2006, Baker & McKenzie announced a year-long campaign to fight the production and trade of fake products on behalf of Adidas, Puma, LV, CK, Chanel, Gucci and other international leading brands, which were all exasperated at the ongoing ineffectiveness of China's anti-piracy enforcement.

Simone explains that the government body tasked with deterring and investigating the production of fake goods, the State Administration of Industry and Commerce (SAIC), can only impose fines and close factories, and that's not enough.

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"Factory owners aren't afraid of fines because they're too low. What people are afraid of is the police," he says. However, with rising rates of violent crime, busting counterfeiters of DVDs is a low priority. In a time-consuming and unwieldy process, local SAIC offices must build cases, often aided by foreign companies, and then hand them over to the police. It's hardly surprising, therefore, that the incarceration rate for counterfeiters in China remains woefully low.

### **High-tech heist**

Illegal copying in China doesn't stop at consumer goods. Unlike DVDs and clothing, far more counterfeit IT products are sold over the Internet than by street-corner vendors. Rather than low-budget family-run operations dealing in easily copied packaging, many of these products are sophisticated replicas created by high-tech processes. According to the Business Software Alliance, the piracy rate for software in China in 2005 was about 86%, resulting in losses for manufacturers of nearly US\$4 billion.

Counterfeit and pirated software in China is a long-term problem. To date, proposed remedies have been mostly of the *zhibiao* type

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(alleviating the symptom) rather than the *zhiben* type (eradicating the disease).

Raids on fake software markets are sporadic, and penalties for infringers usually minimal, meaning that vendors simply relocate and set up shop again once attention is focused elsewhere. Controlling the illegal downloading of software, music and movies via the Internet is also hugely problematic. Hazy laws and myriad

bureaucratic obstacles mean that even if companies know that their products are being illegally copied and sold, it is extremely difficult to prosecute perpetrators.

#### Enforcement emphasis

Most attorneys and industry executives agree that the current IPR problem in China is as much about infrastructure as experience. Improving China's enforcement of its IPR laws will clearly require further substantial changes to the country's legal system.

Official statistics reveal that Chinese courts handled a total of 3,567 cases concerning the manufacture of fake products and illegal sales of pirated products in 2005, a rise of 28% over the previous year. While this is encouraging, the Chinese government still faces a tough challenge in establishing a watertight and enforceable legal framework that will discourage streetwise Chinese citizens from becoming involved in counterfeiting.

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Despite the figures and circumstantial evidence to the contrary, there are numerous signs that the Chinese government is taking the issue of IPR protection seriously. To showcase China's efforts to safeguard IPR and heighten public awareness, China's first IPR protection web site was launched in April 2006 ([www.ipr.gov.cn](http://www.ipr.gov.cn)).

Under a new State Council program also introduced last year, aimed at "bringing IPR infringement activities under effective control", government officials who do not enforce IPR protection will be severely punished. And, in an attempt to crack down on software piracy, the government has ordered all computers manufactured in China to be pre-installed with authorized operating systems before they leave the factory.

In December 2006, China's legislature, the National People's Congress, deliberated on a bill that will pave the way for China to join two World Intellectual Property Organization copyright agreements. These agreements will update rules related to digital technology, and also grant rights to producers of sound recordings.

Long Xinmin, director of China's National Copyright Association, explains: "Joining the treaties will improve China's copyright protection campaign and improve the country's image." The Chinese government also signed a memorandum with four British and US trade associations related to software licensing in the same month.

#### Future focus

Piracy is a global problem that will never be completely eliminated. However, the bottom-line impact can be lessened. Just as music companies, rightly or wrongly, made peace with MP3 file-sharing services like Napster, so manufacturers from America and Europe must implement strategies for dealing with counterfeiting by developing new revenue models that emphasize service offerings based on IP.

Such models may include lower prices for developing markets such as China, universal licensing schemes to sell music, films, games and software on a subscription basis, and the emphasizing of revenues that flow from service and support rather solely relying on product sales.

China's \$200 billion plus trade surplus with the US (nearly \$160

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per capita) makes it hard for anybody to justify the Chinese counterfeiting of US products, but there is also an increasingly compelling national case for stronger IP protection. Some of the people facing the greatest problems are in fact China's own companies struggling to capitalize on their innovations and creativity; film director Zhang Yimou and others in the Chinese motion picture industry are very active in anti-piracy and anti-counterfeiting work.

As Chinese incomes continue to grow, and as more and more Chinese companies seek to protect their own brands, counterfeiting will undoubtedly decrease. This was the case in Japan and Korea, both notorious for counterfeiting in their time. Chinese companies are innovating in ever larger numbers and want to see their products effectively protected. As James Haynes, chairman of the American Chamber of Commerce in China's IP forum comments: "Without adequate IP protection China will be unable to develop IP itself, and will not be capable of becoming an innovative society."

Another major motivator for house cleaning is China's goal to supplant India as Asia's top software outsourcing center. The nation's leaders and CEOs are fully aware that to realize this long-cherished dream far more rigorous IPR protection is essential. Furthermore, the growing number of overseas companies looking to establish research and development centers in China need to be reassured that their carefully guarded products and processes will not be counterfeited with impunity as soon as they begin operations.

International pressure, cooperation and guidance and continued monitoring and lobbying by law firms all have their place in ensuring that the Chinese market is an increasingly secure environment for overseas companies. However, the major drivers for change in China's IPR environment are, and will surely continue to be, self-interest, economic prosperity and a rising standard of living for the average Chinese citizen.

***Daniel Allen** is a freelance writer and photographer from London who has lived in China for the past three years.*

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