INTELLECTUAL PROPERTY RIGHTS ISSUES AND IMPORTED COUNTERFEIT GOODS

HEARING

BEFORE THE

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INTELLECTUAL PROPERTY RIGHTS ISSUES AND IMPORTED COUNTERFEIT GOODS

Wednesday, June 7, 2006

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION
Washington, D.C.

The Commission met in Room 385, Russell Senate Office Building, Washington, D.C. at 8:35 a.m., Chairman Larry M. Wortzel, Vice Chairman Carolyn Bartholomew and Commissioners C. Richard D'Amato and Kerri Houston (Hearing Cochairs), presiding.

OPENING STATEMENT OF CHAIRMAN LARRY M. WORTZEL

CHAIRMAN WORTZEL: Good morning. We've got some members of Congress on the way up to make statements. We'll go through our opening statements until they get here and then interrupt for them to speak.

This is the fifth hearing in the U.S.-China Economic and Security Review Commission's 2006 reporting cycle. In December we explored China's participation in the WTO negotiating process. In February, we assessed China's internal stability and the problems that faced China's leaders. In March, the Commission examined China's military strength. In April, we went out actually to Strategic Command and looked at their nuclear and missile programs and information warfare. We also evaluated China's industrial subsidies in April.

These hearings provide a background on how China interacts with the world community and how the Communist Party maintains its power. Today's topic, Intellectual Property Rights and the Import of Counterfeit Goods, is an examination of domestic governance in China and interactions with the global economy.

The central government makes commitments to the United States on a regular basis. China's government has passed laws that govern intellectual property rights, but the implementation and the enforcement of those laws must improve. Local governments still condone or participate in counterfeiting unless the central government takes focused action.

The fact that products with the Beijing Olympic logo have been

well protected in China shows that China can enforce laws when the government sees it in its interest to do so.

So I'll look forward to hearing from today's panelists. Today's chairs will be Commissioners Dick D'Amato and Kerri Houston, and they will open. But first, Congresswoman Watson, we're delighted to have you here; thank you for coming.

[The statement follows:]

Prepared statement of Chairman Larry M. Wortzel

Good Morning. This is the fifth hearing in the US-China Economic and Security Review Commission's 2006 reporting cycle. In December, the Commission explored China's participation in the WTO negotiations process. In February, we assessed China's internal stability. In March, the Commission examined China's military strength. And in April, we evaluated China's industrial subsidies.

These hearings provide a background to how China interacts with the world community and how the communist party maintains its power. Today's topic, intellectual property rights issues and the import of counterfeit goods, is an examination of domestic governance in China and China's interactions with the global economy.

The central government makes commitments to the United States on a regular basis. China's government has passed laws that govern intellectual property rights. However, implementation and enforcement of those laws must improve. Local governments still condone or participation in counterfeiting unless the central government takes focused action. The fact that products with the Beijing Olympic logo have been well protected shows that China can enforce laws when the government sees it in its interest to do so.

I look forward to hearing from today's panelists. Today's cochairs, Commissioners Dick D'Amato and Kerri Houston, will open following an introduction from Vice-Chairman Carolyn Bartholomew.

PANEL I: CONGRESSIONAL PERSPECTIVES

STATEMENT OF DIANE WATSON, A U.S. CONGRESSWOMAN FROM THE STATE OF CALIFORNIA

MS. WATSON: Thank you so much and I want to thank the Cochairs Richard D'Amato and Kerri Houston for holding this important hearing on China's enforcement of intellectual property rights and for inviting me here to testify today. I want to acknowledge Chairman Larry Wortzel and Vice Chairman Carolyn Bartholomew as well as the other commissioners who are here.

Protection of intellectual property is of central importance to the current and future economic health of the United States as well as to the future of global trade. According to the 2006 Economic Report to the President, intellectual property accounts for more than one-third of the value of all U.S. corporations, an amount equal to almost half of the United States GDP.

Chris Israel, Coordinator of IP Enforcement at the U.S. Department of Commerce, is on point in characterizing the United States' capacity for innovation as one of our nation's greatest comparative advantages. IP protection is the key to our nation's future.

Unfortunately, intellectual property piracy has become the scourge of international trade. It is a disturbing and potentially debilitating byproduct of the emerging global economy. By some estimates, counterfeiting now accounts for five percent to seven percent of world trade. It shows no signs of abating, is highly lucrative, and represents a growth industry for criminal cartels as well as terrorists.

Some now contend that counterfeiting and piracy are as profitable as trading in illegal narcotics and a lot less risky.

China is widely viewed as the model country for intellectual property piracy and for good reason. U.S. companies lose an estimated $2.5 billion a year due to piracy of copyrighted materials. Roughly 95 percent of all CDs and DVDs manufactured in China are counterfeit.

Amazingly, counterfeit products account for 15 to 20 percent of all products made in China or approximately eight percent of its GNP. Moreover, many of these counterfeit products end up reentering our domestic U.S. market. U.S. Immigration and Customs Enforcement estimates that nearly 70 percent of all pirated goods it seizes at our borders originate in China. This is a very sobering statistic.

The adverse impact of pirated goods is directly felt by American producers, consumers, and workers in terms of higher prices, lost revenues, wages and jobs.

The theft and piracy of software in China is equally staggering. The Business Software Alliance estimates that for every two dollars' worth of software purchased legitimately, one dollar's worth is obtained illegally.

The entertainment software industry notes a growing problem with software piracy in the estimated 200,000 to 300,000 Internet cafes in China. On average, each cafe contains 200 computers. Tens of millions of clients use the computers annually. Internet cafe owners typically purchase one piece of legitimate software and then illegally upload the software to their other computers.

As you already know, I represent the 33rd Congressional District of Los Angeles and Culver City, and it's home to a number of major entertainment companies including Sony Studios, the Culver Studios, Capitol Records, Raleigh Film and Television Studios, and American Film Institute.

According to the figures compiled by Americans for the Arts, approximately 30,000 people are employed in creative industries located in my congressional district. More than 18,000 people who work in the

33rd Congressional District make a living from film, radio and television, industries whose profits and future viability are dependent on strong IPR protection and enforcement.

My congressional district also includes parts of Hollywood, the historical home of our nation's movie industry. The Motion Picture Association of America estimates that in 2005, its member companies lost approximately $244 million in revenues to Chinese piracy. The cost of Chinese piracy to the entire property rights community was more than $2.3 billion with losses more than 10.6 billion over the last five years.

Also, according to MPAA, piracy has reached almost 100 percent of the retail market in China with private DVDs of the latest U.S. theatrical releases available within days of international release. The export and transshipment of pirated optical disks continue to grow. The MPAA reports that there are 1,500 registered cable and television systems that pirate U.S. motion pictures to every corner of the world.

The loss of jobs and revenues in my congressional district from IPR piracy has, to my knowledge, never been calculated, but I would conservatively estimate that the loss of jobs is at least in the multiples of hundreds, if not thousands, and the loss of revenues are easily in the multiples of millions.

When you consider the economic multiplier effect and the number of subordinate workers--caterers, transport specialists, make-up artists, extras, and so on--that make a living from the entertainment sector, the losses are even more staggering.

So let me assure you that many of my constituents do not view IPR piracy as an abstract concept or a victimless crime. It is very real to them and their families. It means the difference between having a job and unemployment.

Two years ago, I introduced a bipartisan resolution, H.R. 576, urging the government of the People's Republic of China to improve its protection of intellectual property rights. It passed the House overwhelmingly by a vote of 416 to three.

The resolution recognized China's efforts to deal with the serious problems of IPR violations as well as strongly encouraged China to redouble its efforts to rectify a very serious problem.

It recommended that the Chinese government implement more effective customs and border measures to prevent the export of pirated goods to the U.S. and other countries; encouraged the government of China to fully and comprehensively implement a legal framework to protect intellectual property rights; and urged the government to provide greater market access to foreign producers of legitimate products to reduce the demand for counterfeit goods.

Two years later, China has not appreciably made progress in the

enforcement of IPR laws. Despite the fact that China has strengthened many of its IPR laws since its accession to the WTO in the year 2001, it has failed, for example, to reduce the level of pirated goods seized at the U.S. borders or to decrease the incredible level of CDs and American motion pictures illegally reproduced within its borders and distributed worldwide.

To date, the government of China has not prosecuted a single criminal case against software end-user piracy. It has also failed to prosecute one criminal copyright case involving sound recordings. It is, therefore, not surprising that piracy rates of physical copyright products in China remains the highest in the world.

The playing field for the United States entertainment sector in China is not flat, but has been turned nearly upside down. Almost a year ago, the MPAA launched a joint anti-piracy memorandum of understanding with the Chinese government in connection with the most recent JCCT discussions. Disappointed with the results, the MPAA attributed the failure to a lack of political will on the part of the Chinese.

Many members of Congress have reached a similar conclusion and, as all of you are aware, there's a groundswell of sentiment in Congress that the administration must take a harder line on China's trade practices as well as its monetary policies.

So I welcome the fact that the USTR has once again included China on its priority list of countries that are the most egregious violators, and that it has recently conducted a top-to-bottom review of U.S.-China trade relations.

As noted in the USTR's 2006 Special 301 Report, China's IPR laws are often toothless. The government relies heavily on administrative rather than criminal enforcement. When China prosecutes a counterfeiter, the sentence is not commensurate with the offense. The decision to prosecute an offender in an administrative or criminal court is determined by the monetary volume of items seized from the counterfeiter.

A criminal prosecution requires a higher valuation of goods seized than those of an administrative prosecution. Not surprisingly, the courts usually value the counterfeit items at a level that does not meet the threshold for a criminal indictment and trial.

The vast majority of offenders end up paying fines in an administrative court that amount really to a slap on the wrist and are back in business in short order.

The USTR's report also notes that piracy and counterfeiting are products of China's market access restrictions, which artificially limit the availability of foreign content. As a result, consumers are driven to the black market. Demand is present, but supply is kept artificially low. It's a dream scenario for counterfeiters and black marketeers.

Stronger enforcement measures and greater market access are two fundamental keys to heightening China's compliance with its WTO obligations. Another key is the administration's decision to step up consideration of WTO's dispute settlement options. To date, China has faced only one WTO dispute, which I understand was quickly settled by China before it was brought before the World Trade Organization.

It is my understanding that USTR may be in the process of bringing a case for dispute resolution before the WTO that addresses China's failure to comply with its obligations under the TRIPS Agreement. If this is the case, I am supportive of the process and I will be watching any potential developments very closely.

I will be particularly concerned if the government of China seeks to take retaliatory action. It must instead choose the responsible option for complying with its WTO obligations in a straightforward and transparent manner, which includes the sharing of pertinent data.

To use Ambassador Zoellick's turn of phrase: China's compliance with its IPR obligations under the WTO will demonstrate whether or not it chooses to be a responsible stakeholder.

China can no longer take the view that IPR violations are a foreign problem or a victimless offense that have minimum impact on its or the world's economy. IPR enforcement is an issue that must be addressed by every nation of the world for the sake of the health and security of the global economy.

If China wants to be a world leader in technological innovation and not just a manufacturer of other nation's goods and technology, it must first ensure that intellectual property is a valued and respected commodity and that it will vigorously enforce strong and effective laws within its own borders.

I want to thank the Commission very much for this opportunity to explain the circumstances and the factors involved in IP piracy. Thank you for your deliberations today and I look forward to any comments or questions you might have.

[The statement follows:]

Prepared statement of Diane Watson, a U.S. Congresswoman from the State of California

I want to thank Commission Cochairs Richard D' Amato and Kerri Houston for holding this important hearing on China's enforcement of intellectual property rights (IPR) and for inviting me to present testimony. I also want to acknowledge Chairman Larry Wortzel and Vice Chairman Carolyn Bartholomew as well as the other Commissioners here today.

Protection of intellectual property is of central importance to the current and future economic health of the United States as well as to the future of global trade. According to the *2006 Economic Report to the*

President, intellectual property accounts for more than one-third of the value of all U.S. corporations, an amount equal to almost half of the United States' GDP. Chris Israel, Coordinator of IP Enforcement at the US. Department of Commerce is on point in characterizing the U.S. capacity for innovation as one of our nation's greatest comparative advantages. IP protection is the key to our nation's future.
Unfortunately, intellectual property piracy has become the scourge of international trade. It is a disturbing and potentially debilitating by-product of the emerging global economy. By some estimates, counterfeiting now accounts for 5% to 7% of world trade. It shows no signs of abating, is highly lucrative, and represents a growth industry for criminal cartels as well as terrorists. Some now contend that counterfeiting and piracy are as profitable as trading in illegal narcotics and a lot less risky.

China is widely viewed as the model country for intellectual property piracy, and for good reason. U.S. companies lose an estimated $2.5 billion a year due to piracy of copyrighted material. Roughly 95% of all CDs and DVDs manufactured in China are counterfeit. Amazingly, counterfeit products account for 15% to 20% of all products made in China, or approximately 8% of its GNP. Moreover, many of these counterfeit products end up reentering our domestic U.S. market. U.S. Immigration and Customs Enforcement estimates that nearly 70% of all pirate goods it seizes at our borders originate in China. This is a sobering statistic. The adverse impact of pirate goods is directly felt by American producers, consumers, and workers in terms of higher prices and lost revenues, wages, and jobs.

The theft and piracy of software in China is equally staggering. The Business Software Alliance estimates that for every two dollars' worth of software purchased legitimately, one dollars' worth is obtained illegally. The Entertainment Software Industry notes a growing problem with software piracy in the estimated 200,000 to 300,000 Internet cafes in China. On average, each cafe contains 200 computers. Tens of millions of clients use the computers annually. Internet cafe owners typically purchase one piece of legitimate software and then illegally upload the software to their other computers.

As you know, I represent the 33rd Congressional District of Los Angeles and Culver City, California, home to a number of major entertainment companies, including Sony Studios, The Culver Studios, Capitol Records, Raleigh Film and Television Studios, and American Film Institute. According to figures compiled by Americans for the Arts, approximately 30,000 people are employed in creative industries located in my congressional district. More than 18,000 people who work in the 33rd Congressional District make a living from film, radio and television - industries whose profits and future viability are dependent on strong IPR protection and enforcement.

My congressional district also includes parts of Hollywood, the historic home of our nation's movie industry. The Motion Picture Association of American (MP AA) estimates that, in 2005,
its member companies lost approximately $244 million in revenue to Chinese piracy. The cost of Chinese piracy to the entire copyright community was more than $2.3 billion with losses more than $10.6 billion over the last five years.

Also according to the MP AA, piracy has reached almost 100% of the retail market in China, with pirate DVDs of the latest U.S. theatrical release titles available within days of international release. The export and transshipment of pirate optical discs continue to grow. The MPAA reports that there are 1,500 registered cable and television systems that pirate U.S. motion pictures to every comer of the world.
The loss of jobs and revenues in my congressional district from IPR piracy has, to my knowledge, never been calculated. But I would conservatively estimate that the loss of jobs is in at least in the multiples of hundreds, if not thousands, and the loss of revenues is easily in the multiples of millions. When you consider the economic multiplier effect and the number of subordinate workers -caterers, transportation specialists, make-up artists, and extras, for example- that make a living from the entertainment sector, the losses are more staggering. Let me assure you that many of my constituents do not view IPR piracy as an

abstract concept or a victimless crime. It is very real to them. It means the difference between having a job and unemployment.

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Despite the fact that China has strengthened many of its IPR laws since its accession to the WTO in 2001, it has failed, for example, to reduce the level of pirate goods seized at the US. borders or to decrease the incredible level of CDs and American motion pictures illegally reproduced within its borders and distributed worldwide. To date, the Government of China has not prosecuted a single criminal case against software end-user piracy. It has also failed to prosecute one criminal copyright case involving sound recordings. It is therefore not surprising that piracy rates of physical copyright products in China remain the highest in the world.
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political will on the part of the Chinese.

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Stronger enforcement measures and greater market access are two fundamental keys to heightening China's compliance with its WTO obligations. Another key, I believe, is the administration's decision to step up consideration of WTO dispute settlement options. To date, China has faced only one WTO dispute, which, I understand, was quickly settled by China before it was brought before the WTO.

It is my understanding that the USTR may be in the process of bringing a case for dispute resolution before the WTO that addresses China's failure to comply with its obligations under the TRIPS Agreement. If this is the case, I am supportive of the process. I will be watching any potential developments closely. I will be particularly concerned if the Government of China seeks to take retaliatory action. It must instead choose the responsible option of complying with its WTO obligations in a straightforward and transparent manner, which includes the sharing of all pertinent data. To use Ambassador Zoellick's turn of phrase: China's compliance with its IPR obligations under the WTO will demonstrate whether or not it chooses be a responsible stakeholder.

China can no longer take the view that IPR violations are a foreign problem or victimless offense. IPR piracy is an issue that must be addressed by every nation of the world for the sake of the health and security of the global economy. If China wants to be a world leader in technological innovation, and not just a manufacturer of other nation's goods and technology, it must first ensure that intellectual property is a valued and respected commodity and that it will vigorously enforce strong and effective IPR laws within its own borders.

Discussion, Questions and Answers

HEARING COCHAIR D'AMATO: Thank you very much, Congresswoman Watson, for that very detailed, persuasive, and unfortunately disturbing statement about the impact of this situation, and particularly on your constituents and on what we all agree is one of the great American industries.

We've been looking for progress on this matter for years, and unfortunately we haven't seen it. So I think we're all pleased to see your support for the kind of action by the administration to now use the tools that have been available to us in Geneva and the WTO to move this process, move this process into that regime, and see whether we can make some progress there and monitor that very carefully. So we look forward to working with you monitoring that situation and see where it takes us.

But this is a new era. This is an institution that we signed up to and has been used in many cases against us and for us with other countries.

MS. WATSON: Yes.

HEARING COCHAIR D'AMATO: But never in the case of this industry with China at this point. You've made a very persuasive statement that I believe that I'm correctly inferring that you feel that the time is now ripe to pursue this in this way.

MS. WATSON: I might add, too, that on the House side, we have an Entertainment Caucus where this is the key focus and our colleagues--there are about 47 of them--bipartisan--are following this issue and making contributions and we hope to be the conduit between the industries in our districts, particularly mine, and our policy groups, and so we're willing to work with you and supply you with any information that we gather.

So thank you for the opportunity and I think you might have a copy of my statement.

HEARING COCHAIR D'AMATO: We do and it will be included it in the record as written. We understand you're the chairman of that Entertainment Caucus in the House.

MS. WATSON: Yes, I am.

HEARING COCHAIR D'AMATO: I thank you very much for your leadership on this issue.

MS. WATSON: We appreciate your deliberations, too.

HEARING COCHAIR D'AMATO: Thank you. Our next witness will be Senator Levin. We're waiting for Senator Levin. Mr. Chairman, we can go forward.

CHAIRMAN WORTZEL: I can go forward if you want.

HEARING COCHAIR D'AMATO: Let's go forward with our opening statements, pending Senator Levin's arrival. Vice Chairman.

COMMISSION VICE CHAIR BARTHOLOMEW: Thank you very much. I just want to extend my welcome to our witnesses and our audience here today and say, unfortunately, here we are again having to focus on a topic that's been one of the thorniest in the U.S.-China relationship, and one of these years it would be really wonderful to have panelists who are telling us all of the progress that has been made rather than the continuing litany of problems that we have, but the reality is the continuing litany of problems is ongoing.

I think Congresswoman Watson plays an important role recognizing the importance of intellectual property for our economy in the great state of California, of course, and the rest of the nation, and I think our cochairs, Commissioner Houston, Commission D'Amato, have done an excellent job of putting together several days of hearings where we're going to focus on the impact on the U.S. economy as well as the impact on the health and safety for American consumers.

So thank you very much for your work, thank you to your witnesses and I look forward to hearing them. Thank you.

OPENING STATEMENT OF C. RICHARD D'AMATO, HEARING COCHAIR

HEARING COCHAIR D'AMATO: Thank you. Good morning and welcome to today's hearing on Intellectual Property Rights and Imports of Counterfeit Goods. Through this hearing, the Commission is fulfilling its statutory mandate under Public Law No. 109-108 to investigate and report on the "degree of noncompliance" with the People's Republic of China with agreements between the U.S. and the People's Republic of China on intellectual property rights, and United States enforcement policies with

respect to such agreements.

We are fortunate to have with us today members of Congress, key administration officials, industry representatives and legal experts on this very wide-ranging matter.

There is no question that China is a rampant violator of intellectual property rights. Today's hearing will address, among other things, how intellectual property violations reflect the inadequacies of the Chinese rule of law or legal system and, second, perhaps more difficult, whether it is possible to separate IP violations from China's development or whether they are an essential ingredient in this development.

The lack of an effective rule of law in China has resulted in a corrupt domestic legal system and the central government's commitments in the international arena that it knows it cannot or will not enforce. China's Communist Party has perpetrated a corrupt legal system that is at the local level operated by judges under the thumb of administrative officials and in the pockets of criminal elements and other nefarious elements.

As such, the underdeveloped legal system has not provided the necessary protections when rights, particularly intellectual property rights, are violated and is overwhelmed by the economic imperatives of development and employment pressures and provincial political authorities in power.

Annually, the central government commits to improving its protection of intellectual property rights at the U.S.-China Joint Committee on Commerce and Trade--of course, has signed numerous bilateral treaties with us on this matter--and it promulgates laws and appears to want to enforce these agreements knowing that they will not, in fact, we think, be enforced.

Without an enforceable rule of law in China and a restructured, greatly strengthened court system, and legal resources with political clout, intellectual property rights are infringed at levels approaching 90 to 100 percent.

It remains unclear whether the Chinese government is committed to engaging the IPR infringement issue or whether Chinese development is dependent on such infringement. There are very serious questions about the central role of commercial and industrial piracy as a core driver of China's current level of development, innovation and international competitiveness, and whether eliminating the advantages of this extensive industrial piracy would affect the stability of the regime itself.

Whereas rampant piracy should logically limit the level of foreign investment in China, it has not. While it is often reported that foreign companies attempt to protect their most valued IP from Chinese piracy, they continue to invest and expose their IP to such piracy. At the same

time it is clear the Chinese government seeks foreign investment as a means of technology transfer for its own technological development.

Does China's development rely on a certain level of IP infringement? Is the government a party to the infringement? If so, can the United States realistically expect advancement in the protection of intellectual property rights in China?

How the U.S. Congress and the administration choose to view this concern ultimately determines the appropriate actions we will take as a nation to ensure the protection of our IP. In the five years since China has joined the WTO, there has been no tangible improvement in the protection of intellectual property. If China is to be held responsible for adhering to its commitments, it is time to explore the WTO dispute settlement option for a variety of U.S. industries most injured by China's IPR violations.

This hearing examines the questions of IPR losses to China from the perspective of a variety of U.S. industries--entertainment, yes, including recording, publishing, and film industries, but also many key manufacturing sectors such as electronics, automotive, software, chemicals and pharmaceuticals. What progress has been made to bring China into compliance with its commitments to honor the TRIPS Agreements? What tools have worked? What further initiatives by the U.S. government may be needed? What role does Congress play and what further actions should Congress take? In particular, what effect would initiating dispute resolution panels in the WTO actually achieve?

This hearing is intended as a broad-ranging inquiry into the state of IPR protection for U.S. economic interests in China. Determination of what progress has been made; what further steps are needed? At the most fundamental level, is China too dependent on IPR piracy broadly practiced across most industrial sectors for its economic development and technological progress?

The deadline in the WTO for China to fully implement its obligations under the TRIPS Agreement which requires all WTO members to provide minimum standards of intellectual property protection as well as effective IPR enforcement was a key achievement of the Uruguay Round.

The TRIPS Agreement is the first broadly described multilateral intellectual property agreement that is subject to mandatory dispute settlement provisions. What's the scorecard for Chinese compliance with that agreement? How has it improved over the last five years?

In the 2006 USTR Special 301 Report, China is placed on the Priority Watch List which includes countries that deny adequate and effective protection for IPR. This report states, quote:

"Faced with only limited progress by China in addressing certain

deficiencies in IPR protection and enforcement, the U.S. will step up consideration of its WTO dispute settlement option."

In addition, it says we will "conduct a special provincial review in the coming year to examine the adequacy and effectiveness of IPR enforcement and protection at the provincial level." Certainly, this Commission and the Congress are vitally interested in what this stepping up process means in the way of action in Geneva, and second, what the provincial review will yield.

I thank the participants in advance for what we think will be two days of illuminating testimony.

We welcome Senator Levin to our hearing. It's a great honor to have you with us, Senator. Senator Levin is the Chairman of the Auto Caucus and Senate Auto Parts Caucus. He's been a member of the Senate, I believe, since 1979. He's the longest-serving Senator from the great state of Michigan in the United States Senate, has served as Chairman of the Armed Services Committee on several occasions, is the Ranking Democrat on that Committee, as well as the Ranking Democrat on the Permanent Subcommittee on Investigations of the Homeland Security Committee.

He's known as a tireless workhorse and he's a skilled interlocutor, questioner, and a student of these issues. We welcome you, Senator. It's my privilege to have worked with your staff for many years and for you for many years in the Senate. The Commission is delighted that you're taking a great interest in this subject matter.

Senator, if you would like to proceed, and then if you have Time for questions, we would be glad to ask them.

[The statement follows:]

Prepared statement of C. Richard D'Amato, Hearing Cochair

Good Morning and welcome to today's hearing on Intellectual Property Rights and Imports of Counterfeit Goods. Through this hearing the Commission is fulfilling its statutory mandate under Public Law No. 109-108 to investigate and report on "the degree of non-compliance by the People's Republic of China with agreements between the United States and the People's Republic of China on … intellectual property rights, and United States enforcement policies with respect to such agreements." We are fortunate to have with us, Members of Congress, Administration officials, industry representatives, and legal experts.

There is no question that China is a rampant violator of intellectual property rights. Today's hearing will address, among other issues, is 1) how IP violations reflect the inadequacies of a Chinese system lacking rule of law; and 2) whether it is possible to separate IP violations from China's development or whether they are an essential ingredient in this development.

The lack of an effective rule of law in China has resulted in a corrupt domestic legal system and the central government's commitments to the in international arena that it knows it cannot or will not enforce. China's Communist party has perpetrated a corrupt legal system that is at the local level operated by judges

under the thumb of administrative officials and in the pockets of nefarious elements. As such, the underdeveloped legal system has not provided the necessary protections when rights, particularly intellectual property rights are violated, and is overwhelmed by the economic imperatives of development and employment pressures, and provincial political authorities. Annually, the central government commits to improving its protection of intellectual property rights at the U.S.-China Joint Committee on Commerce and Trade, and it promulgates laws that appear to enforce these agreements, knowing that they will not, in fact, be enforced. Without an enforceable rule of law in China, and a restructured, greatly strengthened court system, and legal resources with political clout, intellectual property rights are infringed at levels near 100 percent.

It remains unclear whether the Chinese government is committed to engaging the IPR infringement issue or whether Chinese development is dependent on such infringement. There are very serious questions about the central role of commercial and industrial piracy as a core driver of China's current level of development, innovation and international competitiveness -- and whether eliminating the advantages of this extensive industrial piracy would affect the stability of the regime itself. Whereas rampant piracy should logically limit the level of foreign investment in China, it has not. While it is often reported that foreign companies attempt to protect their most valued IP from Chinese pirates, they continue to invest and expose their IP. At the same time, it is clear that the Chinese government seeks foreign investment as a means of technology transfer for its own technological development. Does China's development rely on a certain level of IP infringement? Is the government a party to the infringement? If so, can the United States, realistically expect advancement in the protection of intellectual property rights in China?

How the U.S. Congress and the Administration choose to view this concern ultimately determines the appropriate actions we will take as a nation to ensure the protection of our IP. In the five years since China has joined the WTO, there has been no tangible improvement in the protection of intellectual property. If China is to be held responsible for adhering to its commitments, it is time to explore the WTO dispute settlement option for a variety of U.S. industries most injured by China's IPR violations.

This hearing examines the questions of IPR losses to China from the perspective of a variety of U.S. industries – entertainment, including the recording, publishing, and film industries, but also in many key manufacturing sectors, such as electronics, automotive, software, chemicals, and pharmaceuticals. What progress has been made to bring China into compliance with its commitments to honor the TRIPS agreement? What tools have worked and what further initiatives by the U.S. Government are needed? What role is Congress playing and what further action should Congress take? In particular, what effect would initiating dispute resolution panels in the WTO achieve?

This hearing is intended as a broad ranging inquiry into the state of IPR protection for U.S. economic interests in China, determination of what progress has been made, and what further steps are needed. At the most fundamental level, is China too dependent on IPR piracy, broadly practiced across most industrial sectors, for its economic development and technological progress? Can, in fact, the Chinese national government control illegal activities now rampant at the provincial level, and the cities of Shanghai and Beijing themselves. Is there sufficient political will in the national government to change the widespread practice of piracy across the economic landscape?

The deadline in the WTO for China to fully implement its obligations under the TRIPS agreement, which requires all WTO members to provide certain minimum standards of intellectual property protection, as well as effective IPR enforcement, was a key achievement of the Uruguay Round. The TRIPS agreement is the first broadly-subscribed multilateral intellectual property agreement that is subject to mandatory dispute settlement provisions. What's the scorecard for Chinese compliance with that agreement, and how has it improved over the last five years.

In the 2006 USTR Special 301 Report, China is placed on the Priority Watch List, which includes countries that deny adequate and effective protection for IPR. This report states, "faced with only limited progress by China in addressing certain deficiencies in IPR protection and enforcement, the U.S. will step up consideration of its WTO dispute settlement option." In addition, we will "conduct a special provincial review in the coming year to examine the adequacy and effectiveness of IPR protection and enforcement at the provincial level." Certainly, this Commission and the Congress are vitally interested in what this stepping up process means in the way of action in Geneva, and, second, how the provincial review is coming?

I thank the participants in advance for what will prove to be two days of illuminating testimony.

STATEMENT OF CARL LEVIN, A U.S. SENATOR FROM THE STATE OF MICHIGAN

SENATOR LEVIN: Thank you very much, Mr. Chairman. It's great to see you back in the Senate always, and I hope you feel very much at home here. You've walked these corridors and sat in these rooms for many, many years and did it with great distinction. It's great to see you back. We want to thank you and the members of the Commission for holding this hearing today and I hope this testimony will contribute to your good work.

I want to talk to you today about counterfeit auto parts, which is a growing problem with major economic implications as well as public health and safety implications. Product counterfeiting is one of the U.S. auto parts industry's greatest concerns with China, along with currency manipulation and the ongoing U.S., European Union and Canadian WTO case challenging Canada's auto parts tariffs.

So the hearing that you're holding this morning is timely and it's critical. Product counterfeiting and piracy have long been associated with knock-off watches and handbags. But counterfeiting has exploded in recent years across many industries. It's become a serious threat to the competitiveness of our economy, and one of the greatest assets of American businesses is the intellectual property that they produce.

But when American innovations can quickly be stolen by competitors around the world, the vitality of our businesses are at risk. The FBI estimates that counterfeiting costs U.S. businesses $200 billion to $250 billion annually, and it's a growing number.

Counterfeiting money is a serious crime and it is treated as such. Counterfeiting auto parts should be treated the same way. China is the worth piracy offender, accounting for 70 percent of all imported counterfeit products seized by U.S. Customs in 2003.

It is estimated that counterfeits constitute an alarming 15 percent to 20 percent of all products made in China and account for about eight

percent of China's total GDP. The U.S. auto parts industry conservatively estimates that it loses $12 billion annually to counterfeit auto parts, $9 billion outside the United States, and $3 billion inside the United States.

China is responsible for three-quarters of those counterfeit auto parts, according to estimates by American automotive suppliers. The auto parts industry estimates millions of counterfeit auto parts enter the United States every year, and only a fraction of them are ever detected at the border by U.S. enforcement officials.

Virtually every automotive part has turned up in the counterfeit trade including windshield glass, brake fluid, headlights, tail lights, emissions components, structural parts, sheet metal parts, suspension parts, tires, belts, hoses and alternators.

The industry has found enough different fake parts being sold in United States' stores to construct an entire car. And the problem is now spreading beyond just auto parts. The theft of intellectual property in China has become so widespread and bold that recently an entire car was copied, manufactured and sold under a different name, sold not as a Chevy, but as a Cherry QQ. The counterfeiter even had plans to export the knockoff to the United States.

Counterfeiting hurts U.S. manufacturers and the unsuspecting public that buys fake parts in many ways. Here are a few of the biggest problems:

Counterfeit and pirated automotive parts means lost revenue and jobs in the United States. The FTC estimates that the auto industry could hire a quarter million additional American workers if the sale of counterfeit parts were eliminated.

Now, this is an industry that's already suffered many layoffs and bankruptcies in recent years. It's intolerable that it has to be faced with these kinds of counterfeit products.

American manufacturers have a difficult enough time to get a foothold in the Chinese market. If that market is permeated by counterfeit products American manufacturers should rightly be making, it is just that much more difficult to penetrate the Chinese market.

Counterfeit parts hurt the legitimate producers brand name and reputation here and abroad because these products are substandard. The Immigration and Customs Enforcement Agency has noticed connections between counterfeiting and organized crime, gang activity and terrorism. Because it is easier, more lucrative and carries fewer penalties than drug smuggling, counterfeiting is becoming the activity of choice of many criminal groups and even terrorists.

Fake parts undermine U.S. safety standards and put customers at risk. For example, components such as brakes have been found that were made of compressed grass and wood. I brought some examples of

counterfeit parts to show you just how sophisticated counterfeiters have become in making fake products that look and feel identical to the original.

These are connecting rods for a Ford automobile. One of these is genuine and one of these is a counterfeit. These are steel structural parts that connect the front-end of the car to the body of the car.

While the products may look identical including the Ford logo, which is cast into the fake product, the quality and the strength of the steel in Ford's product is much higher; the machining of the grooves or the teeth in the circular ring is much better.

If these grooves wear down too quickly with use, the front end of the car could be wobble and become unstable. This, in turn, will put stress on the arm, increasing wear, metal fatigue, and risking failure. In short, this is a safety related issue and the fake product presents a hazard to the unsuspecting driver as well as obviously unfair competition to Ford.

I wonder if somebody could take these up and show these to the panel? I also have another example here. I've got to look at it to tell me which is which here. These two boxes contain a sparkplug wire set. One is genuine Ford; the other one is a counterfeit. Now, the packaging looks identical and the part inside of it looks identical. I won't pull it out to show it to you, but let me just give you an idea what a wire set looks like. That's a wire set. I won't pull the other one out because I may put back in the wrong box and then I'm going to have everyone confused.

But it's the same. They look precisely the same and the boxes look precisely the same. I really tried to find any difference in these boxes and I couldn't. If you look very, very closely at the boxes, I don't think you'll be able to see a difference, except if you happen to come from Michigan, and if you read every single word on this box, you'll notice a misprint on the fake box.

It's the only difference I could find. It says on the counterfeit "Ford Motor Company Dearbond, Michigan." They got a B-O-N-D at the end of Dearborn instead of B-O-R-N. That took a magnifying glass--you can't find a difference in these boxes.

The counterfeit part uses substandard gauge wire, substandard insulation, and substandard connectors, and all that can lead to overheating and to fire. With counterfeit auto parts, the concern goes way beyond the monetary losses like those suffered by a company when a handbag is copied or a high end watch counterfeited.

When the connecting rod on your car is fake or your brakes are made of compressed grass and wood, your life and the lives of your loved ones are at risk as well.

To date, there has been a lack of willingness to initiate criminal

cases against auto parts counterfeiters because it's just not viewed as a serious enough problem by the Department of Justice.

Tens of thousands of sets of counterfeit automobile brakes isn't viewed the same way as a drug case, but when you string these counterfeits together and it adds up to $12 billion lost to industry each year, that should be viewed by the Department of Justice as a major problem, as well obviously as the increasing risk to the health of individuals, the safety of unsuspecting consumers, the loss of jobs in our economy. This is and should be at least a vital national priority.

So we have here a serious and growing crime in counterfeiting. The Justice Department simply is not doing very much about it. We know of only one prosecution for auto parts counterfeiting and the Department of Justice told us that they're unaware of any pending case.

The WTO TRIPS Agreement that China signed requires member countries to have an effectual intellectual property rights enforcement mechanism. China may have these laws, these IPR laws, that appear to be reasonable on the books, but it is not enforcing them. USTR warned China it was considering bringing a case in the WTO against China for failing to enforce its intellectual property rights laws, but nothing has materialized to date.

I'm afraid that the USTR is a paper tiger. On April 29, 2005, the USTR placed China on the Special 301 Priority Watch List because of its failure to improve protections for U.S. intellectual property rights in China. Yet, China continues to fail to do that.

So there China sits while the American government dawdles. We need to stop merely putting China on lists and start taking more effective action. We need an enforcement office. We need a trade prosecutor to pursue trade cases against countries that fail to meet commitments to reduce the IPR infringement levels.

Senator Stabenow and others have introduced a bill which would create such a trade prosecutor in the Department of Commerce. I've joined that bill because I think it's essential that we put a focus on enforcement, not just on meetings, trade negotiations, and discussions.

Because of the lack of government leadership, the auto industry has had to do much of the policing itself and at great expense. The automotive industry through its trade associations is working to educate its suppliers and distributors and to train employees purchasing parts on how to detect counterfeit products.

U.S. parts companies know that they're on the front line. So to coordinate its efforts, the U.S. auto parts industry created the Coalition Against Counterfeiting and Piracy. The Coalition's Detection and Enforcement Task Force issued a report last fall on ways to improve detection and enforcement of counterfeiting and piracy, and I want to just

mention four of the proposals briefly that involve government action.

First is to deploy an intellectual property rights staff at foreign embassies. The second is for the government to share information about intellectual property violators so that companies can avoid becoming victims of known offenders. The third is to address the needs of small and medium-sized enterprises which are particularly vulnerable. And the fourth is to raise standards at foreign trade shows and I would hope this Commission would take a serious look at these proposals and to encourage their implementation.

I would ask, Mr. Chairman, here that the report be included in the hearing record at this time.

HEARING COCHAIR D'AMATO: It will be included.[2]

SENATOR LEVIN: Thank you. we need strong, fast prosecution of auto parts counterfeiters.

To me, this is the most important thing we can do. This is the signal that we can send because if the government won't act, as our government is not acting against currency manipulation by our trading partners, as they should, if our government won't force open export markets for U.S. products that are blocked by tariff and non-tariff barriers, and if our government won't enforce U.S. trade laws, as they should, at least for heaven sakes enforce our anti-counterfeiting laws.

We ought to do all of those four, but our own laws, our counterfeiting laws or our anti-counterfeiting laws surely should be enforced by our Department of Justice even while our trade representatives dawdle when it comes to opening up foreign markets.

Counterfeiting auto parts, in conclusion, is a booming industry. Allowing it to continue unabated would have huge consequences and is having huge consequences already for our country. Counterfeiting presents a grave threat to our auto makers, to auto parts makers, to our economy, to the safety and to the security of all Americans.

China is a particularly grave offender and its violations must be addressed immediately. The U.S.-China Economic and Security Review Commission is uniquely positioned to give this issue the weight it deserves, and I hope you will do so, and I want to thank you for the opportunity to testify here, and I'd be happy to try to answer any questions.

[The statement follows:]

Prepared statement of Carl Levin, a U.S. Senator from the State of Michigan

Thank you for holding this hearing on intellectual property rights issues and the dangers of counterfeited

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[2] Click here to read CACP Final Report

goods imported into the United States. I appreciate the opportunity to testify on the issue of counterfeit auto parts, which is a growing problem with public health, safety as well as economic implications. Product counterfeiting is one of the U.S. auto parts industry's greatest concerns with China – along with currency manipulation and the ongoing U.S., European Union and Canadian WTO case challenging China's auto parts tariffs. So this morning's hearing is both timely and critical.

Today, I'd like to discuss the scope of the auto parts counterfeiting problem; why it matters; and how we can attack it effectively.

Scope of the Problem

Product counterfeiting and piracy has long been associated with knock-off watches and handbags. But counterfeiting has exploded in recent years across many industries to become a serious threat to the competitiveness of the U.S. economy. One of the greatest assets of American businesses is their intellectual property, but when American innovations can quickly be stolen by competitors around the world the vitality of those businesses is at risk. The FBI estimates that counterfeiting costs U.S. businesses $200 billion to $250 billion annually, and growing. Counterfeiting money is a serious crime and treated as such. Counterfeiting auto parts should be treated the same way.

China is one of the worst piracy offenders, accounting for 70 percent of all imported counterfeit products seized by U.S. Customs and Border Protection in 2003. It is estimated that counterfeits constitute an alarming 15 percent to 20 percent of all products made in China and account for about 8 percent of China's total GDP.

The U.S. auto parts industry conservatively estimates it loses $12 billion in annually to counterfeit auto parts: $9 billion outside the United States and $3 billion inside the U.S. China is responsible for about 75 percent of those counterfeit auto parts, according to estimates by American automotive suppliers. The auto parts industry estimates millions of counterfeit auto parts enter the U.S. every year and only a fraction of them are ever detected at the border by U.S. enforcement officials.

Virtually every automotive part has turned up in the counterfeit trade, including windshield glass, brake fluid, headlights, taillights, emissions components, structural parts, sheet metal parts, suspension parts, tires, belts, hoses, and alternators. The industry has found enough different fake parts being sold in U.S. stores to construct an entire car.

And the problem is now spreading beyond just auto parts. The theft of intellectual property in China has become so widespread and bold that recently an entire car was copied, manufactured and sold under a different name – sold not as a "Chevy" but a "Chery QQ". The counterfeiter even had plans to export the knock off to the United States.

Why it Matters

Counterfeiting hurts U.S. manufacturers and the unsuspecting public that buys fake parts in many ways. Here are a few of the biggest problems:

- Counterfeit and pirated automotive parts mean lost revenue and jobs in the United States. The FTC estimates that the auto industry could hire 250,000 additional American workers if the sale of counterfeit parts were eliminated. This is in an industry that has already suffered many layoffs and bankruptcies in recent years.

- American manufacturers have a difficult enough time to get a foothold in the Chinese market: if that market is permeated by counterfeit products American manufacturers should rightly be making, it is that much more difficult.
- Counterfeit parts hurt the legitimate producer's brand name and reputation here and abroad because these products are substandard.
- The U.S. Immigration and Customs Enforcement (ICE), has noticed connections between counterfeiting and organized crime, gang activity and terrorism. Because it is easier, more lucrative, and carries fewer penalties than drug smuggling, counterfeiting is becoming the activity of choice of criminal groups and even terrorists.
- Fake parts also undermine U.S. safety standards and put customers at risk. For example, components such as brakes have been found that were made of compressed grass and wood.

I brought some examples of counterfeit parts to show you how sophisticated counterfeiters have become in making fake products that look and feel identical to the originals.

Here are connecting rods for a Ford car, one genuine and one counterfeit. These are steel structural parts that connect the front end of the car to the body. While the products may look identical, including the Ford logo cast into the fake product, the quality and strength of the steel in Ford's product is much higher and the machining of the grooves, or "teeth" in the circular ring is much better. If those grooves wear down too quickly with use, the front end of the car could wobble and become unstable. This in turn will put stress on the arm, increasing wear, metal fatigue, and risking failure [in a collision or even normal use.] In short, this is a safety-related item, and the fake product presents a hazard to an unsuspecting driver.

I also have a genuine Ford spark plug wire set and a counterfeit set. Again, although these parts and their packaging may look identical to the untrained eye, the counterfeit part uses substandard gauge wire, substandard insulation, and substandard connectors, which can lead to overheating and fire.

With counterfeit auto parts, the concern goes way beyond the monetary losses like those suffered by a company when a handbag is copied or a high end watch counterfeited. When the connecting rod on your car is fake or your brakes are made of compressed grass and wood, your life and the lives of your loved ones are at risk.

What to do about it

To date there has been a lack of willingness to initiate criminal cases against auto parts counterfeiters because it was not viewed as a serious enough problem by the Department of Justice. Ten thousand sets of counterfeit automobile brakes isn't viewed the same way as a drug case but string the counterfeits together and it adds up to $12 billion lost to industry each year. The increasing risk to the health of our economy, loss of jobs, the safety of unsuspecting consumers makes changing that perception a vital national priority. The bottom line is that counterfeiting is a serious and growing crime, and the Justice Department should be doing more to fight it.

To date industry knows of only one prosecution for auto parts counterfeiting. The Department of Justice told us they were unaware of any pending case.

The WTO TRIPS Agreement China signed requires member countries to have an effective intellectual property rights (IPR) enforcement mechanism. China may have IPR laws that appear reasonable on the books, but it is not enforcing them. USTR warned China it was considering bringing a case in the WTO against China for failing to enforce its IPR laws, but nothing has materialized to date.

USTR is a paper tiger, I'm afraid. On April 29, 2005, the USTR placed China on the Special 301 Priority Watch List because of its failure to improve protections for U.S. intellectual property rights there. Yet China continues to fail to do so. There China sits while our government dawdles. We need to stop merely putting China on lists and start taking more effective action. We need an enforcement office to pursue trade cases against countries that fail to meet commitments to reduce IPR infringement levels.

Because of the lack of government leadership, the auto industry has had to do too much of the policing itself and at great expense. The automotive industry through its trade associations is working to educate its suppliers and distributors and to train employees purchasing parts on how to detect counterfeit products. U.S. parts companies know they are on the front line.

So to coordinate its efforts, the U.S. auto parts industry created the Coalition Against Counterfeiting and Piracy (CACP). CACP's detection and Enforcement task force issued a report last fall on ways to improve detection and enforcement of counterfeiting and piracy. I want to mention four of their proposals that involve government action. The first is to deploy Intellectual Property Rights staff at foreign embassies. The second is for the government to share information about intellectual property violators so companies can avoid becoming victims of known offenders. The third is to address the needs of small and medium-sized enterprises, which are particularly vulnerable. And the fourth is to raise standards at foreign trade shows. I urge the Commission take a serious look at these proposals and to encourage their implementation.

I ask that the report and its recommendations be included in the hearing record.

We need strong and fast prosecution of auto parts counterfeiters. If the government won't act against currency manipulation by our trading partners as they should, if it won't force open export markets for U.S. products blocked by tariff and non-tariff barriers and aggressively enforce U.S. trade laws as they should, the least it can do is enforce our anti-counterfeiting laws.

Counterfeiting auto parts is a booming industry, and allowing it to continue unabated would have huge consequences for our country. Counterfeiting presents a grave threat to our automakers, auto parts makers, to our economy and also to the safety and security of all Americans. China is a particularly grave offender, and its violations must be addressed immediately. The U.S.-China Economic and Security Review Commission is uniquely positioned to give this issue the weight it deserves, and I hope you will do so. Thank you for the opportunity to testify before you today.

Discussion, Questions and Answers

HEARING COCHAIR D'AMATO: Thank you very much, Senator, for that very detailed, practical and strong testimony. I think you may be encouraged by the fact that some of the paper tigers that you referred to are in the room, are going to be following this panel, and I notice have been taking notes. So there may be some transfer of information here to administration officials that action is needed across the board by the administration in Geneva.

There was a proposal that the Commission endorsed that Senator Hollings proposed a couple of years ago along the same lines for an enforcement office in Justice. We'll do whatever we can to move your practical suggestions into our recommendations and get the

administration to move on them if we can.

Do we have anybody who would like to ask any questions? Thank you very much, Senator, for your testimony.

SENATOR LEVIN: Thank you again. Really appreciate all your efforts and your energies and you're in a critically important place to make a difference. Thank you.

HEARING COCHAIR D'AMATO: Thank you, Senator.

I think we have Senator Coburn with us. Senator Coburn, thank you for coming to our hearing today.

SENATOR COBURN: Thank you.

HEARING COCHAIR D'AMATO: Senator Coburn was elected to the Senate in November of 2004 and is a member of the Senate Judiciary Committee's Subcommittee on Intellectual Property, which has jurisdiction over copyright, trademark and patent law as well as treaties intended to protect American intellectual property overseas. You have already taken the initiative, Senator, of holding a hearing on this matter in the region, in Beverly Hills, and a member of our Commission, Commissioner Mulloy, testified at that hearing.

SENATOR COBURN: He did.

HEARING COCHAIR D'AMATO: We appreciate your initiative and thank you very much for coming, and you may proceed.

STATEMENT OF TOM COBURN, A U.S. SENATOR FROM THE STATE OF OKLAHOMA

SENATOR COBURN: Thank you very much and I do appreciate Commissioner Mulloy testifying at that the subcommittee hearing last November. I want to speak just very briefly. We have to change expectations when it comes to the Chinese government in terms of our intellectual property rights. The greatest example of that, I visited China about seven weeks ago, nobody messes with the Olympics, nobody, and its promotion. The reason they say they don't is because it's a national pride symbol, but the fact is that they very vigorously enforce the copyright and the rights associated with that symbol and what it means in terms of them economically.

They do have the capability. We should not be surprised given the history of our relationship and human rights records in China that if you don't value and recognize human rights, it's very unlikely that you're going to recognize property rights and copyrights and intellectual property.

So I think we need to walk together with the administration on two fronts. I think we need to be united, the Congress and the administration, on creating the proper expectations. I was glad to see the WTO filing,

but it should be just a beginning.

I believe that they expect us to be consistent and I think that's one of the things that we're going to have to be in the flux and change of our trade representative, but also in terms of what you all can do. The costs are severe for this country. And it's not just in the short term. We will never compete with China in terms of labor costs and we probably will never compete with them in terms of raw material costs, and if we don't enforce the advantage of our intellectual property, what we do is we undermine our future economic base.

The fact is, they're not doing it. What there is, is a lot of talk and very little action. There's action when somebody comes and visits and there's a display, but there is not any action and there won't be any action till the consequences of violating intellectual property and duplicating products has associated with it a cost that is significant. Today it's a cost of doing business in China.

I visited several of the places in China on my recent trip there. Over the front door it says no copies, no fakes, and you walk inside and it's nothing but duplication of American and European products selling for a third to a fifth of what they would normally sell on the world market. That is because there is no expectation on the part of the Chinese citizenry that there is a cost for doing business that violates their commitment, the Chinese government's commitment under WTO.

I was told while I was there that we should expect a developing country to not honor intellectual properties and I quickly reminded them that they had signed an agreement that they would. So I believe the strength of our ability to compete in the future is going to be measured as a reflection of how aggressive we are in protecting our intellectual property--whether that's music and entertainment or whether that's patents--the Zippo lighter case is a great, great case.

Whether that's increased enforcement, both in terms of port security here and there, in terms of pre-inspection and post-inspection, but unless we create the expectation that we're going to aggressively enforce our rights, then I think that we will continue to be taken advantage of.

They're very patient, and if they think they can slide, they will slide, and I believe it's up to us to make sure that we don't allow that in the future, and my hope is that your recommendations as well as what we can do in Congress will change that expectation.

I believe the administration has gotten that message and my hope is over the next few months that we will be aggressive in terms of protecting what is really ours and is our only and last true advantage, other than our freedom, to be able to compete with such a disadvantageous market for us in terms of labor costs and raw material costs.

So I don't have anything else. I'd be happy to answer any questions. I appreciate this commission's hearing, and my hope is that we will start sending a very strong consistent message and look for true marks of how they're enforcing intellectual property because they're not there today. It costs a very small fine if you get caught; you pay the fine and you're back doing it.

The other thing is they don't even destroy the goods. They auction the goods off. There's no destruction of the fake goods. They just auction them off and they come right back into the market. So with your help and your recommendations, hopefully we'll see this change.

Discussion, Questions and Answers

HEARING COCHAIR D'AMATO: Thank you very much, Senator Coburn. I assume that you would be in agreement with the concept of taking more aggressive action in the context of the WTO?

SENATOR COBURN: Absolutely.

HEARING COCHAIR D'AMATO: Would you also think it would be useful to create a special office for trade enforcement in Justice as has been proposed by some?

SENATOR COBURN: I'm not sure I know that we have to do that. What I think we have to do first is use the tools that are at our hand and use them on a timely basis, and I don't believe that's been done up until very recently.

But the fact is, we're undermining the standard of living in this country because we fail to effectively protect our IP and China fails to effectively comply with agreements that they've said they would do. I believe we have to create the expectation on the part of the Chinese that it's going to cost them not to do that, and whether that is making significant trade changes or if that's significant costs in terms of something in some other area that they might be benefiting from us.

But if we continue to say there's no significant cost to this, and if that requires something in the Justice Department, that may be it. I'm not sure we need to do that. I think what we need to do is use the tools that we have right now and effectively do it, and I think when Congressman Portman was put into that position, we started to see some things happen, and that was some of the requirements that we had in terms of confirming him, was that he would aggressively start looking at intellectual property in terms of our trade negotiations and enforcement through the WTO.

HEARING COCHAIR D'AMATO: Thank you very much, Senator. We appreciate your coming and appreciate your testimony. I hope we can make some recommendations along these lines that would be effective and useful in terms of being more aggressive, and communicating our strength

as a nation--instead of weakness--to the Chinese.

Thank you.

HEARING COCHAIR HOUSTON: Senator, I do have one quick question for you, and I'd like to thank you for being here. You have a unique position to look at one issue that we'll be covering today, in the Senate as you are a physician. One of the issues I've followed for years is the importation of drugs and the misconception throughout America and both Houses of Congress that these imported drugs actually are U.S. made, where we know that a lot of them are made in third-world countries, in India and China.

So I'm putting the hearing horse a little bit before the cart here, but my question for you is there's been a lot of legislation, both in the Senate and in the House, aimed at legalizing what is currently illegal, to import drugs from another country.

Do you have any sense that the Senate and/or the House has stopped turning a deaf ear to those concerns, and as talk increases about China and IPR problems and counterfeiting, pharmaceutical counterfeiting in China, do you have any sense at all that the tide will turn at any point and the Senate will sort of look at these dangers of importation as well as the cost factors that people generally associate with them?

SENATOR COBURN: I think really you're asking two questions. Why in the world would the Congress want to pass a bill that says you can allow importation of drugs? My take on that, as a physician, and also as an accountant and businessman prior to that is that there is not a true international market in the pharmaceutical industry because in this country we are essentially subsidizing the research around the world and everybody else's drugs, and that is because you have government purchasers and pharmaceutical companies make a choice. They can compete in those markets where there is only one buyer, and then where do they make the money?

So the real question is, how do we truly get international competition that's fair to Americans as well as to everybody else? Essentially we're in a negative trade balance when it comes to drugs because if you consider the research costs and the financing costs of pharmaceuticals, the American taxpayers are essentially paying for most of that because most of the profits are coming from here, not all of them, but most.

The second question is, why would pharmaceuticals be excluded from trade agreements? But in fact they are, and we ought to ask that question, why are they?

Finally, the third thing is the safety issue. If we can't assure safety and we state that, then the American public ought to ask why can't we,

and that goes back to the question on everything else? Why can't we assure lack of infringement on patents, whether it's pharmaceutical drugs or anything else? Again, it is because you have created an expectation that we're not good at enforcing the agreements and people aren't complying because they know we're not good at it. So they take advantage of it, both in terms of true copies of patented drugs, but also drugs that do nothing that are packaged to look like that.

Both the fakes and the non-fakes, they're both a problem. But the safety question, that's another level of incompetency for us as a government, that we don't control the safety of drugs coming into this country, and we also don't control a lot of other things that are coming into this country.

I believe it's a three-part question, and it's like one of those illnesses that we're treating the symptoms and not the disease. Until we either make a decision, I think one of two or three things is going to happen in the next ten years, and I think most of them are bad for the pharmaceutical industry unless we get a true market, and that is the demand will become such that we'll have single purchase of pharmaceuticals in this country, which I think is terrible for innovation, terrible for research, terrible for health care in the long run.

HEARING COCHAIR HOUSTON: Thank you very much, Senator.

HEARING COCHAIR D'AMATO: Thank you very much for coming, Senator.

SENATOR COBURN: Thank you.

HEARING COCHAIR D'AMATO: That concludes our congressional panel. Next we will have a panel with administration officials. We'll take a very quick five-minute break and then we'll have Messrs. Chris Israel and Tim Stratford.

[Whereupon, a short break was taken.]

PANEL II: ADMINISTRATION PERSPECTIVES

HEARING COCHAIR D'AMATO: We'll proceed with our panel of administration witnesses, but before we do, I think my cochairman for the hearing, Commissioner Houston, has a brief opening statement.

OPENING STATEMENT OF COMMISSIONER KERRI HOUSTON, HEARING COCHAIR

HEARING COCHAIR HOUSTON: Thank you, Commissioner D'Amato. Good morning and welcome to today's hearing. Before we begin this panel, I would like to lay out several issues that will be covered in the Commission's hearing today and tomorrow. Of particular

concern, are the challenges and problems that U.S. companies are forced to address in the face of rampant IP infringement in China and the negative impact that the export of China's counterfeit products has on U.S. consumers, businesses and our overall economy.

First, at the corporate level, American companies and other foreign businesses have invested in China and established operations there for both the domestic and Chinese and international markets. The lack of adequate IPR protection forces changes in corporate strategies in China: focusing only on development in their R&D operations or delaying the launch of certain products in the Chinese market. The latter strategy has proven unsuccessful in many cases.

Where possible, foreign companies have increasingly relied on wholly-owned foreign enterprises in China to maintain as much managerial control over their company's IP as they can. However, limitations on market access and investment behavior constrain the ability of foreign companies to mitigate risks to their IP.

In industries and regions where limitations to market access and investment exist, foreign IP is infringed upon, but foreign companies are unable to diminish such risks with the measures mentioned above. These key factors inhibit a major economic player from contributing to IP protection in China.

Second, while counterfeit DVDs or clothing pose a huge problem for U.S. industry, the criticality of which must in no way be diminished. No one is going to die or be made ill from a Dior knockoff or a bad copy of the "Lion King."

However, the export of counterfeit substandard or even tainted pharmaceuticals pose a major health concern for unsuspecting U.S. consumers. Counterfeit drugs sold through the Internet often involve criminal rings that have manufacturing and export mechanisms in China and distributors in other countries or they may even appear to be in the U.S. or in Canada.

Counterfeit of lifestyle drugs, such as Viagra, and health maintenance drugs, such as Lipitor, are made in China, purchased in the United States via the Internet.

Many of these drugs contain too much, too little or no active ingredient at all. They're often indistinguishable from the legitimate version of the drugs in both appearance of the packaging and the pills themselves. Counterfeiters may be criminals but they are not stupid; they know how to slide gracefully by a quick Customs inspection.

The production of substandard and fake drugs is a worldwide problem, underreported and with very few U.S. patients understanding that the drugs they order from Web sites that appear to be in Canada or claim to be in Canada are actually located in third-world countries or

India and China themselves. The drugs that are their stock and trade are not made in the U.S. and U-turned back out of Canada, but are counterfeit.

Fake drugs are becoming a significant cause of unnecessary illness, mortality and a loss of public confidence in medicines. International security experts repeated warn that the prevalence of off-shore drug counterfeiting creates a potential for the deliberate tainting of drugs by bad actors wanting to harm the U.S.

The prevalence of counterfeit drugs appears to be rising and the World Health Organization estimates that upwards of 15 percent of all drugs sold worldwide are fake. In parts of Africa and Asia, this figure exceeds 50 percent.

Our founding fathers could never have envisioned motion pictures, a car and its associated parts, music downloadable from something called the Internet, the health and longevity that we now enjoy due to pharmaceutical pills and potions, or the $800 required to purchase a genuine Prada purse. The specific notion of 21st century intellectual property was not part of their world view.

Although the intricacy of today's patents, trademarks and copyrights could not have been foreseen 250 years ago, the founders wisely recognized that in addition to the rule of law and individual liberty, the absolute guarantee of property was key to sustaining a free society.

Thomas Jefferson noted that property is the foundation of all civil society, and James Madison stated that the protection of property rights is the first object of government. It is difficult enough for our government and industry to protect property rights on our own shores, but defending America's IPR in a foreign nation that does not view property rights as an underpinning of its government or culture presents us with a Gordian knot of diplomatic, governmental and economic challenges.

Today we will explore these challenges with regard to Chinese counterfeiting in the export of such products and delve into any possible remedies available to cure IPR violations that currently beleaguer our nation.

Perhaps our expert witnesses will help us find a way back to protecting this important aspect of our foundational principles currently under attack in the world market.

[The statement follows:]

Prepared statement of Commissioner Kerri Houston, Hearing Cochair

Good morning and welcome to today's hearing. Before we begin with our first panel, I would like to lay out several issues that will be covered in the Commission's hearing today and tomorrow. Of particular concern are the challenges and problems that U.S. companies are forced to address in the face of rampant

IP infringement in China, and the negative impact that the export of China's counterfeit products has on U.S. consumers, businesses and our overall economy.

First, at the corporate level, American companies and other foreign businesses have invested in China and established operations there for both the domestic Chinese and international markets. The lack of adequate IPR protection forces changes in corporate strategies in China: focusing only on development in their R&D operations, or delaying the launch of certain products in the Chinese market. The latter strategy has proven unsuccessful in many cases. Where possible, foreign companies have increasingly relied on wholly-owned foreign enterprises in China to maintain as much managerial control over their companies' IP as they can. However, limitations on market access and investment behavior limit the ability of foreign companies to mitigate risks to their IP. In industries and regions where limitations to market access and investment exist, foreign IP is infringed, but foreign companies are unable to diminish such risks with the measures mentioned above. These key factors inhibit a major economic player from contributing to IP protection in China.

Second, while counterfeit DVDs or clothing pose a huge problem for U.S. industry, the criticality of which must in no way be diminished, no one is going to die or be made ill from a Dior knockoff or a bad copy of the Lion King. However, the export of counterfeit, substandard or even tainted pharmaceuticals poses a major health concern for unsuspecting U.S. consumers. Counterfeit drugs sold through the Internet often involve criminal rings that have manufacturing and export mechanisms in China and distributors in other countries, or even appear to be the in US or Canada.
Counterfeits of lifestyle drugs, such as Viagra, and health maintenance drugs, such as Lipitor, have been purchased in the United States via the Internet. Many of these drugs contain too much, too little or no active ingredient. They are often indistinguishable from the legitimate version of the drugs in both the appearance of the packaging and the pills, themselves.

The production of substandard and fake drugs is a worldwide problem, underreported, with very few U.S. patients understanding that drugs they order from websites that appear to be in Canada are actually located in third world countries, India or China, and the drugs that are their stock and trade are not made in the US and U-turned back out of Canada, but are counterfeit. Fake drugs are becoming a significant cause of unnecessary illness, mortality, and loss of public confidence in medicines. International security experts repeatedly warn that the prevalence of offshore drug counterfeiting creates a potential for the deliberate tainting of drugs by bad actors wanting to harm the US. The prevalence of counterfeit drugs appears to be rising and the World Health Organization estimates that upwards 15% of all drugs sold worldwide are fake, and in parts of Africa and Asia this figure exceeds 50%, particularly for drugs used to control HIV/AIDS.

Our founding fathers surely never envisioned motion pictures, a car and its associated parts, music downloadable from the internet, the health and longevity that we now enjoy due to pharmaceutical pills and potions or the $800 required to purchase a genuine Prada handbag. The specific notion of 21st Century "intellectual" property was not part of their worldview.

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Thomas Jefferson noted that "property is the foundation of all civilized society" and James Madison stated, "The protection of property rights is the first object of government."

It is difficult enough for our government and industry to protect property rights on our own shores, but

defending America's IPR in a foreign nation that does not view property rights as an underpinning of its government or culture -- in some cases even actively flouting US property rights -- presents us with a Gordian knot of diplomatic, governmental and economic challenges.

Today, we will explore these challenges with regard to Chinese counterfeiting and the export of such products, and delve into any possible remedies available to cure the IPR violations that currently beleaguer our nation.

Perhaps our expert witnesses will help us find a way back to protecting this important aspect of our foundational principles currently under attack in the world market.

HEARING COCHAIR D'AMATO: Thank you very much, Commissioner Houston.

We'll now hear from a distinguished panel including Mr. Chris Israel who was appointed to the new Office of International Intellectual Property Enforcement in 2005.

Mr. Israel works with agencies across the administration to develop policies to address international intellectual property violations and enforcing intellectual property laws overseas.

And Mr. Tim Stratford, Assistant U.S. Trade Representative for China Affairs under the Office of the U.S. Trade Representative.

Mr. Israel works with agencies across the administration, heads the international work of the National IP Law Enforcement Coordination Council, NIPLECC. Is that how you pronounce it?

MR. ISRAEL: Yes. NIPLECC.

HEARING COCHAIR D'AMATO: Previously, Mr. Israel was a Deputy Director of International Trade Policy for AOL and Time Warner.

Mr. Stratford is responsible developing and implementing U.S. trade policy toward Mainland China, Taiwan, Hong Kong, Macao and Mongolia, and prior to September 2005, he was General Counsel for General Motors' China operations. He is fluent in both Mandarin and Chinese, and a very well respected figure in the China arena.

Each of you can give your opening statements and then we'll go to questions. So would you like to start, Mr. Israel?

STATEMENT OF CHRIS ISRAEL, U.S. COORDINATOR FOR INTERNATIONAL INTELLECTUAL PROPERTY ENFORCEMENT, U.S. DEPARTMENT OF COMMERCE

MR. ISRAEL: Thank you, Commissioner D'Amato and Commissioner Houston and other commissioners for the opportunity to join you today to discuss the challenge of IP enforcement in China. I certainly thank the Commission for its continued support and leadership on issues concerning the protection of American intellectual property

rights. Few things indeed are as critical to our ongoing economic strength and vitality and the sustainability of our competitive advantages around the world as our ability to protect our intellectual property.

Before I begin my prepared remarks, I would like to stress the significance of this issue, the prioritization of this issue, within the administration. Commissioner D'Amato, you noted my appointment by President Bush in July of last year to head a newly created office inside the administration tasked with ensuring that we are leveraging and utilizing all the capabilities, the many impressive capabilities of the U.S. federal government to make sure that we are doing everything we can to enforce the intellectual property of American rights holders, creators, entrepreneurs and inventors.

I report directly to Secretary of Commerce Gutierrez who has made this a very high priority of his. I work daily with senior officials at the Department of Justice, the U.S. Trade Representative's Office, State Department, the Department of Homeland Security within their Customs infrastructure, and of course the Department of Commerce as well.

In October of 2004, the administration announced its STOP Initiative, Strategy Targeting Organized Piracy, a comprehensive approach to the challenge of intellectual property protection that brings on board all the federal agencies that I noted previously and set forth a series of strategic priorities for all of us to remain focused on that include working very closely with industry, with the private sector, making sure that our criminal enforcement capabilities are as robust and strong as they possibly can be, making sure that in terms of Customs and Border Protection, we are doing everything we can to ensure that we are seizing counterfeit and fake goods at our borders.

And finally, a major piece of that overall strategy and what we'll probably spend most of our time this morning speaking about, the work that we're doing with our trading partners to build a robust infrastructure around the world and certainly no trading partner ranks higher on the list of interests and work in this field of IP protection as China.

We certainly know that the rising tide of counterfeiting and piracy in China has created enormous challenges for U.S. businesses. According to the U.S. Chamber of Commerce, worldwide IP theft costs U.S. industry approximately $250 billion annually.

In a 2005 survey of the U.S.-China Business Council, members listed IP enforcement as their greatest single concern. Our industry reports that infringement levels in China range from 85 to 95 percent for all copyrighted works, and in 2005, the value of copyrighted works that were pirated exceeded $2.3 billion.

In 2005, U.S. Customs reported that China was by far the leading source of counterfeit products that were seized at our borders, accounting

for 69 percent of their seizures. We certainly recognize that China has expanded their efforts. There are still critical deficiencies in IPR protection and enforcement. We appreciate the recent statements made by Chinese President Hu, Vice Premier Wu Yi, and others on improving IP protection in China.

These are definitely steps in the right direction, but we need to see more than just statements. It is critical that China deliver on their commitments. The U.S. government is working on many fronts to engage China on IP enforcement and under President Bush's leadership, we have developed a proactive strategy being coordinated among a number of agencies.

The Bush administration's China IP strategy is built on four key pillars: first, bilateral engagement; second, effective use of our trade tools; third, expanding law enforcement cooperation; and fourth, working with our private sector.

We are utilizing all of our resources to effectively implement this approach. First, we are working through the U.S.-China Joint Commission on Commerce and Trade, the JCCT, to secure strong bilateral IP commitments. In 2005 and during the last JCCT this past April, we negotiated a comprehensive set of commitments from the Chinese government to reduce counterfeiting and piracy.

These include increasing criminal IP prosecutions and Customs enforcement, using only legal software in government offices. A significant note from the 2006 JCCT is the commitment from China to allow only computers preloaded with legitimate software to be either produced or imported into the country.

We extracted additional commitments regarding the shutting down of illegal consumer markets in major cities and markets around China, and also furthered our work towards promoting China's joining the World's Intellectual Property Organization Internet Treaties.

The second item we're focused on is making effective use of all of our trade tools. Earlier this year, U.S. Trade Representative Portman announced the China Top-to-Bottom Review, which I know this Commission with the help of Assistant U.S. Trade Representative Stratford has reviewed and studied in the past.

The Top-to-Bottom Review assessed the benefits and challenges of U.S. trade following China's first four years of membership in the WTO.

Also, the placement of China on the Special 301 Priority Watch List articulates our specific concerns and indicates the significance we place on them. We are using every trade tool at every disposal in the WTO and we consider all options to be on the table.

We are waiting for China's final response to our TRIPS Article 63.3 request and are considering whether to file a complaint under the WTO

dispute settlement process for inadequate protection of IPR. I know both the items of bilateral cooperation and use of our trade tools are things we'll discuss this morning, particularly with the insight of Tim Stratford.

Another point to make in terms of use of our trade tools that bears noting, I think, to this Commission is the work that we've done and I think the cooperation we've gained working with our trade partners around the world to focus on China. I would note in particular the participation of Japan and Switzerland in joining us in filing the Article 63.3 request for information to China.

I would also note the increased level of cooperation that we have gained working with the European Union. I would note that the European Commission Trade Minister, Peter Mandelson, is in Beijing with the European delegation this week, raising IP as one of the more prominent items on his personal agenda, and we've seen a good level of cooperation over the last year or so working with the Europeans on this issue.

The third primary area we are highly focused on is the expansion of our law enforcement cooperation capabilities with the Chinese government. Attorney General Gonzales has laid the groundwork for this effort. He was in China last fall and spoke to his counterparts directly on the issue of IP enforcement and cooperation, and our law enforcement agencies are working with their counterparts in China to share information, expertise and investigation techniques.

There is actually a Department of Justice delegation in China right now this week following up on the groundwork laid by the Attorney General focused on expanding our cooperation at the law enforcement level.

We hope Congress in addition will move forward on the Bush administration's proposed legislative package entitled "The Intellectual Property Protection Act of 2005." This is a comprehensive reform package that would toughen penalties for IP crimes, expand criminal IP prosecutions, and add investigative tools for criminal and civil IP enforcement.

The final sector of our work is what we are doing actively to engage the private sector to address their concerns and learn from their experience.

We are also expanding the tools and remedies that we offer to industry from significant tools such as their ability to record their trademarks directly with Customs and Border Protection, allowing CBP agents to have better expertise, better information as they do their work at the border.

Educating small businesses. I know this is a point Senator Levin raised, and we are ramping up our efforts. USPTO and Justice are leading the way on this. We've got a Website that provides a significant amount

of information to small businesses about what we can offer them from the federal government to protect their IP and the steps they should be taking themselves and can be taking themselves to protect their IP.

This Website has received almost two million hits over the last 18 months. We have a 1-800 number that companies can call. It's received almost a thousand calls. And through outreach efforts led by the U.S. Patent and Trademark Office, we've reached almost 1,000 small businesses through a series of forums around the nation over the last year to discuss the protection of intellectual property and what small businesses can do.

We are expanding our IP attaché program in China and around the world, adding attaches in countries such as India, Russia and Brazil.

Members of the Commission, the Bush administration is committed to stopping intellectual property theft in China and providing businesses the tools they need to flourish in the global economy. China must deliver on their commitments and achieve measurable results as they look to take their place among the world's leading economies.

As we work to continue to coordinate the U.S. government's IP enforcement efforts and with your continued support and the partnership of this Commission, we will be able to do even more to provide American businesses and innovators with the protection they need.

America's intellectual property is indeed one of our most critical competitive advantages and it is essential to our continued economic growth and technological leadership. We must take advantage of the opportunity to work together to better protect the knowledge industries of today so that we may continue to see the innovations of tomorrow.

Thank you very much for the opportunity to be here and I look forward to your questions.[3]

HEARING COCHAIR D'AMATO: Thank you very much, Mr. Israel. Mr. Stratford, you can go ahead with your statement.

STATEMENT OF TIMOTHY P. STRATFORD, ASSISTANT U.S. TRADE REPRESENTATIVE

MR. STRATFORD: Thank you. Cochairmen D'Amato and Houston and other members of the Commission, I'm pleased to join you today to speak about China's compliance with its World Trade Organization commitments regarding intellectual property rights and the actions the Office of the U.S. Trade Representative is taking to improve intellectual property right protection and enforcement in China.

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[3] Click here to read the prepared statement of Chris Israel

In my last appearance before this Commission two months ago, I focused my remarks broadly on China's economic development, its record on WTO compliance, and the steps the U.S. government is taking to ensure China lives up to its WTO commitments for the benefit of American companies, farmers and workers.

At that time, USTR had just released its Top to Bottom Review of U.S.-China trade policy and I was able to outline our view that U.S-China trade relations are entering a new phase in which greater accountability on China's part and greater enforcement on the administration's part are needed.

As I mentioned at that time, the area of intellectual property rights is especially significant among the enforcement challenges we are facing in our bilateral trade relationship with China. While China has made noticeable improvements to its framework of laws and regulations, the lack of effective IPR protection and enforcement continues to damage U.S. businesses.

Today, I would like to offer an update on the U.S. government's efforts to deal with the problem of IPR enforcement in China based on events that have taken place since I last appeared before you, specifically addressing the IPR-related results of the April 11 U.S.-China Joint Commission on Commerce and Trade and the release of USTR's 2006 Special 301 Report on April 28.

I will also review USTR initiatives developed to strengthen IPR protection and enforcement in China. Our overall priority is to see China achieve the significant reduction in piracy and counterfeiting that it committed to in 2004.

First, let me say something about the JCCT and the visit of President Hu. Protection of intellectual property topped the list of issues that we raised with Vice Premier Wu Yi on April 11 at the annual meeting of the U.S.-China Joint Commission on Commerce and Trade, or JCCT.

The elevated JCCT co-hosted by the U.S. Trade Representative and Secretary of Commerce has proven to be a successful vehicle for resolving trade issues with China. This year, before the visit to Washington of President of Hu Jintao on April 20, the JCCT gave China a timely opportunity to demonstrate in concrete terms to the American people its commitment to following the rules of international trade and to mutually beneficial trade relations with United States.

Our approach yielded measured progress. With regard to IPR, some of the key results from our recent JCCT meeting, as Mr. Israel indicated, included: enforcement actions by China against plants that produce pirated optical disks; new rules that require computers to be preinstalled with licensed operating system software; an agreement to cooperate to combat pirated goods displayed at trade fairs in China; a commitment to

intensify efforts to eliminate infringing products at major consumer markets in China, such as the Silk Street Market in Beijing; and a commitment to ensure the legalization of software used in Chinese enterprises and to take up issues of government and enterprise software asset management in the JCCT IPR Working Group.

However, as the administration has repeated stressed, the value of the JCCT is not only in the commitments that China makes, but most importantly in the actions that it subsequently takes to implement these commitments.

During his remarks on the South Lawn on April 20, President Hu restated his commitment to take new steps to strengthen the protection of intellectual property rights.

We are working aggressively to follow up with our Chinese counterparts to ensure that we have full and timely implementation of the commitments made at this year's JCCT and that concrete actions are taken to implement President Hu's pledge.

I traveled two weeks ago to Beijing along with my Department of Commerce counterparts to discuss next steps to fulfill China's JCCT commitments. My discussions with Chinese agencies yielded positive results including discussion of cooperation on optical disk piracy and software asset management for government offices and state-owned enterprises.

Our primary sub-Cabinet level forum for exchange on IPR issues is the JCCT IPR Working Group which was established at the 2004 JCCT. This forum provides opportunities to discuss in a detailed and full manner, including at the expert-to-expert level, specific IPR issues with our Chinese counterparts including China's implementation of its JCCT commitments on IPR.

The United States is looking to China for full and timely implementation of its commitments to stamp out optical disk piracy and completely eliminate the use of pirated software in government and large enterprise offices and both of these topics will be discussed in the next meeting of the JCCT IPR Working Group.

Let me turn next to the 2006 Special 301 Report. On April 28, USTR released its Special 301 Annual Report on the adequacy and effectiveness of IPR protection provided by trading partners around the world.

Concerns regarding China featured prominently throughout the report. While USTR recognizes and appreciates the incremental steps China's leaders have taken at the JCCT and through China's recently adopted 2006 IPR action plan, the report concludes that China's infringement levels remain unacceptably high and its enforcement efforts inadequate.

As a result, USTR announced that China will remain on the Priority Watch List and the United States will step up consideration of WTO dispute settlement options.

The report also emphasizes the need for authorities at the sub-national level in China to more effectively establish and sustain proactive deterrent IPR enforcement.

To address these challenges, USTR announced that it will scrutinize IPR protection and enforcement at China's provincial level through an unprecedented special provincial review to be conducted during the coming year.

The report identifies inadequate IPR enforcement as one of China's greatest shortcomings as a trading partner. China suffers from chronic over-reliance on toothless administrative enforcement and under-utilization of criminal remedies.

This is in part because China maintains volume and value thresholds that allow commercial scale violations to escape criminal procedures and penalties.

China's own 2004 data showed that it channeled more than 99 percent of copyright and trademark cases into its administrative systems and turned less than one percent of cases over to the police.

In 2005, the United States pressed China to address its over reliance on administrative enforcement and at the July 11, 2005 JCCT, China agreed to increase the number of criminal prosecutions for IPR violations relative to the total number of IPR administrative cases. Unfortunately, there has been no sign yet of a significant shift in emphasis towards criminal enforcement.

The 2006 Special 301 Report also singles out four Chinese hot spots, Guangdong Province, Beijing City, Zhejiang Province and Fujian Province, where there appears to be an acute need for authorities to begin and sustain proactive deterrent IPR enforcement.

USTR believes that focusing on the need for improvement at the provincial and major city level will shine a spotlight on specific problem areas and create a basis for improvement. This is the objective of the special provincial review that will be taking place over the coming year.

In terms of next steps, an important priority of the administration is to assist U.S. businesses to ensure they are competing on a level playing field with China. According to a 2006 survey conducted by the American Chamber of Commerce in China, 41 percent of U.S. companies in China believe counterfeiting of their profits increased in 2005 and 55 percent were hurt by violations of IPR.

As to next steps, we will continue expanded outreach to the business community to ensure that their China related concerns are addressed.

For example, through the Top-to-Bottom Review, USTR recently established a China Task Force under the Advisory Committee for Trade Policy and Negotiations to receive regular strategic advice on U.S. trade relations from U.S. industry.

The special provincial review announced in the 301 Report will inform USTR Special 301 Report next year as we continue to monitor China's actions to meet its commitment to significantly reduce IPR infringement levels. Results are what matter to us, and this will entail continued dialogue and enhanced cooperation through the JCCT and other mechanisms.

USTR is establishing a senior trade position at the U.S. Embassy in Beijing to foster enhanced dialogue and pursue U.S. trade policy interests in China. While dialogue and cooperation are our preferred means of dealing with China on trade issues, we will not shy away from using dispute settlement at the WTO when we feel that China is not living up to its commitments.

As we have repeatedly told China's leaders, we see WTO settlement as a tool utilized to avoid politicizing trade issues and we will continue to consider WTO cases as appropriate to bring China into compliance with its obligations.

Having two separate tracks, dialogue and dispute settlement, help to create a favorable environment for a successful JCCT and Hu visit this year. By pursuing WTO dispute settlement on China's treatment of imported auto parts, it took a very contentious issue out of the JCCT mix allowing us to achieve more success on the remaining JCCT issues.

With respect to IPR, we have stepped up consideration of our WTO dispute settlement options and intend to fight our work within the U.S. government and with the affected industries to compile data and lay other necessary groundwork for a possible case.

Within USTR, we now have established a China Enforcement Task Force to develop enforcement initiatives including potential WTO cases and this is co-led by our acting Chief Counsel for China Enforcement and our Deputy Assistant U.S. Trade Representative for China Enforcement.

We are determined to hold China accountable just like any other WTO member. We have two criteria for assessing whether to bring a case: it must be winnable and it must be the most effective way for addressing the underlying concern.

In conclusion, the administration is working its two-track approach of dialogue and enforcement to ensure that China becomes a responsible stakeholder in the international economic community commensurate with the benefits it derives from international trade and with its own economic weight.

On IPR issues, China has a long way to go and the stakes are high,

but this is not an issue that the United States faces alone. The first WTO trade policy review of China in April made clear that the multilateral community is also concerned about the lack of effective IPR enforcement in China.

We will continue to work with our trading partners and U.S. industry to ensure China addresses this problem and ensure that China meets its WTO and bilateral commitments. Thank you for inviting me to join this hearing today and for your continued attention to this pressing issue.

[The statement follows:]

Prepared Statement of Timothy P. Stratford, Assistant U.S. Trade Representative

INTRODUCTION

Cochairmen D'Amato and Houston and additional Commission members, I am pleased to join you today to speak about China's compliance with its World Trade Organization commitments regarding intellectual property rights and the actions the Office of the U.S. Trade Representative is taking to improve intellectual property rights (IPR) protection and enforcement in China.

In my last appearance before this Commission two months ago, I focused my remarks broadly on China's economic development, its record on WTO compliance, and the steps the U.S. Government is taking to ensure China lives up to its WTO commitments for the benefit of American companies, farmers, and workers. Having just released the USTR "Top to Bottom Review of U.S.-China Trade Policy" in February, I was able to outline our view that U.S.-China trade relations are entering a new phase in which greater accountability on China's part and greater enforcement on the Administration's part are needed.

As I mentioned at that time, the area of intellectual property rights is especially significant among the enforcement challenges we are facing in our bilateral trade relationship with China. While China has made noticeable improvements to its framework of laws and regulations, the general lack of effective IPR protection and enforcement continues to damage U.S. businesses. For example, industry sources estimate that 2005 piracy levels in China across all lines of copyright business are 85 to 93 percent, indicating little to no improvement. Internet piracy is increasing and end-user piracy of business software and other copyright materials, such as books and journals, are key concerns. The share of IPR infringing products of Chinese origin seized at the U.S. border increased to 69 percent in 2005 from 63 percent in 2004, while the total value of the IPR infringing goods from China decreased to $63.9 million in 2005 from $87.2 million in 2004. China's share of infringing goods seized at the border is more than ten times greater than that of any other U.S. trading partner.

Today I would like to offer an update on the U.S. Government's efforts to deal with the problem of IPR enforcement in China based on events that have taken place since I last appeared before you, specifically addressing the IPR-related results of the April 11, 2006 U.S.-China Joint Commission on Commerce and Trade, and the release of USTR's *2006 Special 301 Report* on April 28. I will also review USTR initiatives developed to strengthen IPR protection and enforcement in China. Our overall priority is to see China achieve the "significant reduction in piracy and counterfeiting" that it committed to in 2004. Through our initiatives, we seek to achieve the dual objectives of solving specific, immediate problems and encouraging the long term transformation of China into a more rules-based, open economy. As I stated two months ago when I last made a statement to this Commission, I believe that the key to achieving those

objectives is treating China as a fully accountable stakeholder in the international trading system and insisting that China play a constructive role commensurate with its economic heft and responsibilities as a WTO Member.

1. 2006 JCCT and Visit of President Hu

Protection of intellectual property topped the list of issues that we raised with Vice Premier Wu Yi on April 11 at the annual meeting of the U.S.-China Joint Commission on Commerce and Trade (JCCT). The elevated JCCT, co-hosted by the U.S. Trade Representative and Secretary of Commerce, has proven to be a successful vehicle for resolving trade issues with China. For example, during the last two JCCT meetings in 2004 and 2005, China postponed its software procurement regulations after we expressed WTO concerns, it suspended its proposed mandatory encryption standard for wireless computer networks, and accelerated U.S. companies ability to import, export, distribute and sell their products in China without going through Chinese state trading companies.

This year, a great deal was at stake. Our trade imbalance is worse, and many of China's IPR problems are too. Holding the JCCT on April 11, before the visit to Washington, DC of President Hu Jintao on April 20, gave China a timely opportunity to demonstrate in concrete terms to the American people its commitment to following the rules of international trade and to mutually beneficial trade relations with the United States. Our approach yielded measured progress. At the JCCT, China committed to addressing a number of U.S. trade concerns in three areas: enhancing access of U.S. companies and farmers and ranchers to the Chinese market; improving protection of intellectual property rights in China; and moving toward a transparent and market-oriented system of government procurement in China.

With regard to IPR, some of the key results from our recent JCCT meetings included:

- enforcement actions by China against plants that produce pirated optical discs;
- new rules that require computers to be pre-installed with licensed operating system software;
- agreement to cooperate to combat pirated goods displayed at trade fairs in China;
- a commitment to intensify efforts to eliminate infringing products at major consumer markets in China, such as Silk Street Market in Beijing; and
- a commitment to ensure the legalization of software used in Chinese enterprises and to take up issues of government and enterprise software asset management in the JCCT IPR Working Group.

However, as the Administration has repeatedly stressed, the value of the JCCT is not only in the commitments that China makes, but in the actions that it subsequently takes to implement these commitments. During his remarks on the South Lawn on April 20, President Hu restated his commitment to take new steps to strengthen the protection of intellectual property rights.

We take President Hu at his word, and we are working aggressively to follow up with our Chinese counterparts to ensure that we have full and timely implementation of the commitments made at this year's JCCT and that concrete actions are taken to implement President Hu's pledge. I traveled to Beijing late last month, along with Department of Commerce counterparts, to discuss next steps to fulfill China's JCCT commitments. My discussions with Chinese agencies yielded positive results, including discussion of

cooperation on optical disk piracy and software asset management for government offices and state-owned enterprises. Our primary sub-cabinet level forum for exchange on IPR issues is the JCCT IPR Working Group, established at the 2004 JCCT. This forum provides opportunities to discuss in a detailed and full manner, including at the expert-to-expert level, specific IPR issues with our Chinese counterparts, including China's implementation of its JCCT commitments on IPR. The United States is looking to China, e.g., for full and timely implementation of its commitments to stamp out optical disk piracy and completely eliminate the use of pirated software in government and large enterprise offices, and both of these topics will be discussed in the next meeting of the JCCT IPR Working Group. The United States also uses the JCCT IPR Working Group to discuss customs and border protection issues with China, in order to address the influx into the United States of Chinese IPR infringing products.

2. 2006 Special 301 Report

On April 28, USTR released its Special 301 annual report on the adequacy and effectiveness of IPR protection provided by trading partners around the world. Concerns regarding China feature prominently throughout the report.

While USTR recognizes and appreciates the incremental steps China's leaders have taken at the JCCT and through China's recently adopted 2006 IPR Action Plan, the report concludes that China's infringement levels remain unacceptably high and its enforcement efforts inadequate. As a result, USTR announced that China will remain on the Priority Watch List, and the United States will step up consideration of WTO dispute settlement options. The report also emphasizes the need for authorities at the sub-national level in China to more effectively establish and sustain proactive, deterrent IPR enforcement. To address these challenges, USTR announced that it will scrutinize IPR protection and enforcement at China's provincial level through an unprecedented special provincial review to be conducted in the coming year.

The Report identifies inadequate IPR enforcement as one of China's greatest shortcomings as a trading partner. Rights holders report that enforcement efforts, particularly at the local level, are hampered by poor coordination among Chinese Government ministries and agencies, local protectionism and corruption, high thresholds for initiating investigations and prosecuting criminal cases, lack of training, and inadequate and non-transparent processes.

Most of all, China suffers from chronic over-reliance on toothless administrative enforcement and underutilization of criminal remedies. This is in part because China maintains volume and value thresholds that allow commercial scale violations to escape criminal procedures and penalties. China's own 2004 data showed that it channeled more than 99 percent of copyright and trademark cases into its administrative systems and turned less than one percent of cases over to the police. In 2005, the United States pressed China to address its over-reliance on administrative enforcement, and at the July 11, 2005 JCCT, China agreed to increase the number of criminal prosecutions for IPR violations relative to the total number of IPR administrative cases. Unfortunately, there has been no sign yet of a significant shift in emphasis toward criminal enforcement.

As the title of this hearing makes clear, the export of infringing products from China is of grave concern worldwide. The U.S. Customs statistics cited above make clear that an increasing share of infringing goods seized at U.S. borders are being exported from China, and these counterfeits include many products that pose a direct threat to the health and safety of consumers in the United States, China and elsewhere, such as pharmaceuticals, batteries, auto parts, industrial equipment, and toys. The Report calls on China to aggressively prosecute exporters of infringing products.

USTR also remains concerned about various aspects of China's 2004 customs regulations and

implementing rules, which were intended to strengthen border enforcement and to make it easier for rights holders to secure effective enforcement at the border. For example, disposal of confiscated goods remains a problem under the implementing rules, which appear to mandate auction, rather than destruction, of infringing goods not purchased by the right holder or used for public welfare.

The *2006 Special 301 Report* singles out four Chinese "hot spots" – Guangdong Province, Beijing City, Zhejiang Province, and Fujian Province – where there appears to be an acute need for authorities to begin and sustain proactive, deterrent IPR enforcement. USTR believes that focusing on the need for improvement at the provincial and major city level will shine a spotlight on specific problem areas and create a basis for improvement; this is the objective of the special provincial review that will be taking place over the coming year. This year's report also includes a new section that highlights notorious markets, including both on-line websites, such as Baidu.com, and traditional marketplaces, such as Silk Street Market in Beijing and Xiangyang Market in Shanghai.

III. Next Steps

An important priority of the Administration is to assist U.S. businesses to ensure they are competing on a level playing field with China. According to a 2006 survey conducted by the American Chamber of Commerce in China, 41 percent of U.S. companies in China believe counterfeiting of their products increased in 2005 and 55 percent were hurt by violations of intellectual property rights. We will continue expanded outreach to the business community to ensure that their China-related concerns are addressed. For example, through the "Top to Bottom Review," USTR recently established a China Task Force under the Advisory Committee for Trade Policy and Negotiations to receive regular, strategic advice on U.S. trade relations from U.S. industry.

The special provincial review announced in the *2006 Special 301 Report* will inform USTR's Special 301 report next year, as we continue to monitor China's actions to meet its commitment to significantly reduce IPR infringement levels, including actions China takes under its 2006 IPR Action Plan. Results are what matter to us, and this will entail continued dialogue and enhanced cooperation through the JCCT and other mechanisms. We will continue to utilize the JCCT IPR Working Group mechanism to bring experts from China and the U.S. together to discuss specific IPR issues, and will promote deepened law enforcement cooperation. USTR is also establishing a senior trade position at the U.S. Embassy to foster enhanced dialogue and pursue U.S. trade policy interests in China.

While dialogue and cooperation are our preferred means of dealing with China on trade issues, we will not shy away from using dispute settlement at the WTO when we feel China is not living up to its commitments. As we have repeatedly told China's leaders, we see WTO dispute settlement as a tool utilized to avoid politicizing trade issues, and we will continue to consider WTO cases as appropriate to bring China into compliance with its trade-related obligations when dialogue proves not to be an effective means for resolving our concerns. Having two separate tracks − dialogue and dispute settlement − helped to create a favorable environment for a successful JCCT and Hu visit this year. By pursuing WTO dispute settlement on China's treatment of imported auto parts, it took a very contentious issue out of the JCCT mix, allowing us to achieve more success on the remaining JCCT issues.

With respect to IPR, we have stepped up consideration of our WTO dispute settlement options by intensifying our work within the U.S. Government and with the affected industries to compile data and lay other necessary groundwork for a possible case. Within USTR, we have now established a China Enforcement Task force to develop enforcement initiatives, including potential WTO cases, co-led by our Acting Chief Counsel for China Enforcement and our Deputy Assistant U.S. Trade Representative for China Enforcement. We are determined to hold China accountable just like any other WTO Member. We

have two criteria for assessing whether to bring a case. It must be winnable, and it must be the most effective means for addressing the underlying concern.

CONCLUSION

The Administration is working its two-track approach of dialogue and enforcement to ensure China becomes a "responsible stakeholder" in the international economic community commensurate with its economic weight. On IPR issues, China has a long way to go, and the stakes are high. But this is not an issue that the United States faces alone. The first WTO Trade Policy Review of China in April made clear that the multilateral community is also concerned about the lack of effective IPR enforcement in China. We will continue to work with our trading partners and U.S. industry to ensure China addresses this problem and ensure that China meets its WTO and bilateral commitments. Thank you for inviting me to join this hearing today and for your continued attention to this pressing issue.

PANEL II: Discussion, Questions and Answers

HEARING COCHAIR D'AMATO: Thank you very much, Mr. Stratford. We certainly look forward to monitoring and discussing with you potential cases as they may be brought in Geneva and the WTO on some of these particular issues. Of course, we're quite interested in the future of the potential case on entertainment. We had Congresswoman Watson here today discussing that in some detail.

I have one specific question on the so-called "special provincial review." How you would go about this? We have the case of Zhejiang Province, city of Yiwu. I don't know how you get at this, but this is a city which is one of the four hot spots where counterfeiting supports the entire local economy.

In fact, Yiwu has become a byword for "fake" in China. The wholesale market there serves as one of China's largest wholesale centers, an important distribution center for small commercial goods, 410,000 different items reportedly sold in the market including fake Gillette razor blades. 8,000 distributors purchase 2,000 tons of goods everyday, all fakes of various kinds. So you have an entire city that is really quite centrally dependent on it.

Now, is it possible to get the Chinese government's cooperation in reviewing this situation in your special provincial review and how would you go about something like this?

MR. STRATFORD: Thank you for the question. With respect to the provincial review, the first step that we will have is that we will have a notice in the Federal Register in the near future that invites a comment by industry, by other affected persons about particular areas where they have seen either notable progress or else significant problems.

And then we will have delegations that will be visiting some of the most important areas and talking with them. With respect to Zhejiang in particular, the Party Secretary of Zhejiang Province actually visited Washington within the last month.

I had an opportunity to meet with him. I pointed out that his province is becoming very well known for things that he probably would rather it not be well-known. We specifically talked about Yiwu. We also talked about the city of Cixi in Zhejiang Province, which is known as being a global source for counterfeit sparkplugs, to refer back to Senator Levin's testimony, and he pledged that he would be happy to work together with us to look at how we can address the issues in his province, but we will be visiting and following up with that discussion, and our first goal will be shine a spotlight on problem areas, so that the real nature of the problem can be identified, and also to shine a spotlight on provinces that take strong positive actions on IPR enforcement.

We think this will be a first step and it will also lay the groundwork for further enforcement action.

HEARING COCHAIR D'AMATO: Thank you very much. Commissioner Wessel.

COMMISSIONER WESSEL: Thank you to both our witnesses for their appearance today and all their hard work on this issue.

I'd like to follow up on this area of questioning on the provincial review and, Mr. Stratford, your last comments because I think we have potentially an additional tool here that could be of tremendous value here as you do your provincial reviews.

Clearly, as U.S. companies look to invest in China, as do other nation's companies, they will seek guidance often from our government as to how to go about doing that, whether it's U.S. and FCS, whether it's going through other Commerce Department entities, the embassy, et cetera. It appears to me that we could have additional leverage here if we would urge our companies to reward those provinces that do the right thing, which ultimately their investment, of course, could aid in job creation, economic growth, and be a model for those other provinces that are not doing the right thing, and potentially accelerate the movement towards implementation of the rule of law at the provincial and local level.

Have you looked at that, as to how our infrastructure of advice for our companies, our multinationals, et cetera, to help urge them to invest if they're going to be over there in areas where the best climate exists for their activities?

MR. ISRAEL: Sure. I appreciate the question and am happy to give some thoughts, particularly on what the U.S. government can do to maybe focus those investments or target those investments a little bit, probably not the right two words to use, what the government can or should be doing when it comes to private investment in a foreign country, but certainly we take every opportunity we can, whether it's through FCS, through staff at embassies or consulates throughout China and other

countries, to provide the best possible information that we can to U.S. investors, to U.S. companies operating there.

We work with them very closely with the local chambers of commerce and other entities to provide them visibility and transparency into the investment and business climate that they're either thinking about getting into or are already involved in, and I think you coupled that obviously with a tremendous amount of information and due diligence that's done by the companies themselves. They obviously do much more analysis than even the government does regarding where their investment dollars are going, and I do think it's an investment or it's an indicator and it's a sign that companies look for. The capital will go where it's most welcome, particularly if it's a company thinking about making an investment that's going to be R&D based or that's going to have some type of a technological focus to it. We talked quite a bit at length with our European counterparts who are, as we are, quite concerned about issues such as technology transfer and what it entails for major manufacturing, particularly R&D based manufacturing entities, to work in China, where there is issues of technology transfer that are at play and on the table, and those are decisions companies need to make and make on a daily basis.

But certainly through the FCS, through our consulates, we do, and we can work to provide even better information I'm sure to companies about the investment climate that exists at the provincial level and the city level within China. It's important information for us to be aware of and for us to interact with our companies about.

COMMISSIONER WESSEL: Are you using any of this--we have a whole network of tools, TDA, all the various other government infrastructure that can be used--is this being raised in the interagency process as you look towards doing the provincial review?

MR. STRATFORD: Maybe I could just say that I think the first step is to do the review. The 2006 301, Special 301 Report, was the first time that we really highlighted hot spot areas, and that's a start. We did that because those problems are very well known, but we wanted to get more information on it, which is why we wanted to have this provincial level review for the coming year.

Our intention is very much along the lines of what you're suggesting. That is, we think that if there is more information out there, that it certainly will guide decision-making with respect to investment, with respect to other types of economic areas and, in addition, hopefully, it will create a sense amongst provincial governors and other leaders that they would rather have a reputation as a province for being one that upholds intellectual property rather than for one that disregards it or fails to enforce it.

So we very much hope that by generating this information and making it public, that it will help inform decision-makers in ways that will naturally reward those who are doing a good job and penalize those who are not.

COMMISSIONER WESSEL: This is a, I think, a very important effort you're engaged in. I would assume that ultimately that if the effort bears fruit, you could see financing authorities gauging capital costs and capital returns based on where siting is occurring, et cetera, and help ultimately leverage our resources to get action in China, which could be very important.

Thank you.

HEARING COCHAIR D'AMATO: Thank you. One other comment that may not be completely on point, but there are a lot of counties and cities in the United States that have a so-called sister city relationships with Chinese counties and cities and hopefully we can enlist their support in these provincial hot spot investigations. That might be helpful.

Commissioner Reinsch.

COMMISSIONER REINSCH: Thank you. I can barely see you, but I'm here. If you hear this disembodied voice, it's me.

I want to commend you both for, I think, demonstrating the extent to which you're on top of the issue. I think critics, some of whom are up here, would probably say that you may be late, but nevertheless I think clearly you've demonstrated a command of the subject which is important.

While there's a lot of issues with China where there's disagreement within the United States on the best approach, I think this is one where there is no disagreement. All segments of the economic community that I'm aware of are all on the same page here, and that's one of the reasons why I'm happy we're doing this, I think, to demonstrate that kind of unity.

I have a couple of questions. Mr. Stratford, what do companies tell you about why they are reluctant or have difficulty providing you with the information you need to file complaints?

MR. STRATFORD: I think the biggest problem is that if you are seen as being a major critic of specific agencies or local authorities, and yet you still have to continue to work with those authorities to do your business. Your efforts are not appreciated by the local authorities and your ability to work effectively within the future could be compromised.

If you look at local police authorities or something like that, you have to be able to work well with them and they have to be able to trust one another and communicate back and forth in order to get the job done, and if police have the sense that you're going back to the U.S. government and letting them know the good points and the bad points of that cooperation, then they won't be so open and forthcoming. So I think that's a major part of the problem.

COMMISSIONER REINSCH: So that makes it sound like as much a pressure problem more than an evidentiary problem?

MR. STRATFORD: Yes. Our problem, the United States government does not need to have the consent or even the support of U.S. companies necessarily to bring WTO cases. At the end of the day, it's the decision of the U.S. government itself whether or not to bring the cases.

COMMISSIONER REINSCH: Exactly.

MR. STRATFORD: But we need to have, we need to have the evidence, and also we don't want to do things that will result in great harm to our companies, and we try to make sure that we do things, or even if we go a different path from what the companies would like to do, we like to do it in a way that won't hurt our companies.

COMMISSIONER REINSCH: It seems to me that working with some of the sectoral associations might be able to solve the problem of particular companies being identified.

MR. STRATFORD: That's right. You want to go from an individual company to an industry association, and you want to go from one industry association to several industry associations, and then you want to expand it so that you're in cooperation with Europeans and with Japanese and with other trade partners, and certainly when it comes to intellectual property, all of China's trade partners have raised significant concerns about the level of enforcement.

COMMISSIONER REINSCH: Right. Then let me ask you both to make an observation if you will. My sense on this issue has often been that countries get really interested in solving this problem when they have intellectual property of their own to protect and have a domestic pressure from their own inventors, copyright holders, whatever, to do the same thing.

Can you comment, either or both of you, on the development of intellectual property inside China and the extent to which this is becoming an issue there that might help your efforts?

MR. ISRAEL: Sure. Happy to answer that question because I do think it's probably one of the more central long-term questions to ponder and to think about and to address, and I think we need to ask it and assess it and analyze it now in order to get it right in the future.

My last trip to China, I was there in late April, on what WIPO had dubbed as World Intellectual Property Day, April 26. And there were a number of conferences and seminars and events in Beijing that day focused on innovation and IPR. It seemed to be kind of the buzzword of the day.

The Chinese are very much focused on building a world-class innovation-led economic model. They look at the science and technology infrastructure in the United States with great admiration. They want to

develop their own infrastructure that can compete with that, and there were a number of presentations and a number of discussions I've had with Chinese officials who were very focused on ways in which they can build and measure the innovative capacity and growth of their economy.

They're looking at things like the production of domestic Chinese patents, comparing them with the rest of the world. How do they stand up? There's a big push within China to create, generate more patents, investments, more investment in research and development, discussing, getting their universities engaged, some of the real critical things we do here in the United States that have led to what we've created in so many different industries in areas around the country.

So I think there's a very acute focus on this issue in China. You're right. I think it's a net positive in a lot of ways because it will compel and incentivize them to protect the intellectual property they themselves are creating as they look to create and commercialize it and move it into the global market. I think one question we certainly have to ask ourselves and be very aware of is how does this, what are the tools and the policies that are being utilized by China to create this type of innovation-led growth and to generate these technologies and these world-class competitive companies.

In addition to IPR, there's standards issues, there's government procurement issues, there's technology transfer issues that I think we need to keep an equal eye on that can be utilized as tools to propel this type of growth in China which don't always or usually fit with international norms or the way that we, certainly in the United States, view the utilization of things like that.

So I think it's a big issue in China. I think we've moved past to some extent the question of or the need at a government level to convince the Chinese that intellectual property rights enforcement is a good thing to do and it's a necessary thing to do.

I think they very much see it as something that in the long term they have to do to benefit their own economy, and I think what that means in the future and how they go about doing that are, as you point out, very critical things to keep an eye on.

COMMISSIONER REINSCH: Yes. Your last couple comments about standards are probably a good subject for another whole hearing, but not something I can pursue right now because my time is up.

Thank you very much.

HEARING COCHAIR D'AMATO: Thank you, Commissioner. Commissioner Bartholomew.

COMMISSION VICE CHAIR BARTHOLOMEW: Thank you very much, gentlemen. Thank you for your testimony today and thank you also for taking time out of what is undoubtedly quite lucrative careers to do

public service, so we appreciate it.

Sometimes I feel particularly on this issue that we're a broken record and when I look at the history of U.S. intellectual property rights agreements with China, I think it's a broken record there, too.

So I just want to review very quickly a couple of things we've already learned today. Senator Levin mentioned 250,000 lost jobs in the auto parts industry alone because of counterfeiting. Mr. Stratford, you mentioned that U.S. business says that things got worse in 2005 when it came to counterfeiting and copyright violation, and we've already heard about increased concern about health and safety consequences.

Carla Hills, this is where I become the broken record, because I keep going back to this, Carla Hills signed an MOU with the Chinese on intellectual property rights protection 14 years ago. Since then, I don't know, I feel like I'm beginning to lose count of how many of these agreements have been signed.

What evidence is there that any of these agreements have made any difference when we look at the facts on the ground and why should we believe that the dialogue that you have taking place now is going to turn things around? First question.

Then on a completely separate kind of question, I note also that Senator Levin was saying it's estimated that counterfeits constitute an alarming 15 to 20 percent of all products made in China and account for about eight percent of China's total GDP.

This issue of the phenomenon of the China price, where U.S. corporate presence in China is focused on driving down costs, when other U.S. businesses have to compete with people who are counterfeiting, is that having some impact? In other words, are U.S. corporate interests ultimately encouraging counterfeiting?

How does a legitimate U.S. company compete for U.S. production business even on the ground in China if what they're bidding against is a company that's counterfeiting with reduced costs?

Two completely different sets of questions. Thanks.

MR. STRATFORD: You've raised a lot of important questions in your question there. Let me talk first of all about Chinese commitments. I think one of the reasons that we see an increase in problems with counterfeiting and piracy in China is that the overall level of economic activity in China has increased.

Back when Carla Hills was the U.S. Trade Representative, the level of trade between the U.S. and China was greatly reduced, I mean much smaller than it is today. And as China's economic development has grown, the piracy industry has had a robust growth together with everything else, so that's part of the phenomenon that we're dealing with.

In terms of whether the agreements that China has made in the past

have made any difference, if you talk about agreements, for example, in the mid-'90s to deal with the counterfeit movies or pirated movies and so on, I think the industry noted at the time a significant improvement in the situation, and then after the passage of a period of time, the old problem came back again, and since that time, that industry like other industries has grown.

So I think at the time of the agreement there was some progress and then things slipped out of hand again. We're focusing on agreements and measures that will take account of China's circumstances so that they can have more durable positive benefit.

If you take the example of software, the commitment that China made that computers leaving the plant or imported would have preloaded operating system software on them, that's a very measurable practical measure to take that will significantly improve the software situation in China. And that's something that we can monitor pretty easily to see whether there's slippage or whether they continue in that direction.

If you look at pirated movies, an initiative that we're discussing with the Chinese government right now has to do with creating or having China participate in an international library where you would have exemplar optical disks so that when pirated movies are discovered anyplace in the world, the industry can take that pirated movie to this international library, they can examine the disk and they can figure out which plant it came from by certain tell-tale signs on the disk, and then they can trace it back.

This is a sort of library that's really necessary to have effective enforcement against pirated movies and we're discussing with the Chinese government how they can participate in this program.

When you put these types of things in place, you create long-lasting durable mechanisms for improving enforcement over the long run, and so we're trying to focus on those types of measures.

MR. ISRAEL: Just to maybe add a couple of thoughts to that and maybe focus a bit on the pricing question, the competitiveness question that you raise.

I think there's some additional things to look at that, as Tim Stratford mentioned, just the mechanisms you put in place and the infrastructure in addition to some of the things he noted in the progress on software. Over the last two or three years, PTO has trained about 300 Chinese officials, law enforcement officials, judiciary officials, on patent and trademark issues, on IP issues.

As China seeks to become a member of the WIPO Internet treaties, we are actively in a very substantive, very detail-oriented way consulting with them as they attempt to put the legislation in place domestically that they need to join those treaties and protect digital copyright primarily.

So, I think you can look and you can see, you can see the overall infrastructure that we're trying to build that, as Tim Stratford mentioned, just kind of gives you a systemic ability to work on issues of IP enforcement, and then hopefully we're able to pull out of that some individual indicators such as our ability to work with and conduct training in China to see specific cases. Pfizer, for example, had its patent for Viagra upheld on Friday in Chinese court. Starbucks had a trademark case resolved favorably in December of last year.

I'm not saying there's always one to ones, but you've got to be in the game, you've got to be there actively engaged, and it takes the type of agreements and infrastructures that you lay in place at a government level to get the type of incremental progress made that we all want to see.

On the issue, you raise the issue of price and competitiveness, and I think certainly that as a premise, we can't vary from the principle that U.S. companies, no company should have to compete against counterfeiters on a global stage. That's a principle that we seek to adhere to everyday, and certainly when China joined the WTO, it's a principle, it's a commitment that they made.

It's clearly they committed to put in place a deterrent infrastructure to piracy and counterfeiting, and to the extent to which they're falling short of that, we, as we've discussed here, work everyday to consider with them and consider all of our trade tools to address.

COMMISSION VICE CHAIR BARTHOLOMEW: Mr. Chairman, just one final comment in mind, which is mentioning Senator Coburn acknowledging the protection that the Beijing Olympics logo is getting. Of course, the Chinese movies have some protection that U.S. movies don't have, and always one of our issues is the fact that they've got what are reported 30,000 people monitoring the Internet.

I think one of the biggest challenges you all face is getting the political will on the part of the Chinese government to actually engage in these practices. We can train all of the patent and trademark officials that we want over there, but unless there is will coming from the top, I don't know how it makes a difference.

Thank you.

HEARING COCHAIR D'AMATO: Thank you. Commissioner Houston.

HEARING COCHAIR HOUSTON: Thank you, Commissioner D'Amato, and thanks to both of you for being here. I have a question for each of you. My question for Mr. Stratford follows up on what Commissioner Bartholomew just said.

I think we're all operating here under the assumption, or perhaps fantasy, that the Chinese government actually wants to police IPR violations. It is not a government that is structured or based on property

rights, as ours is here, and I've seen numbers, eight percent, ten percent, of GDP and growing, based on counterfeiting. So a country that wants to be an economic player, I can't see it throwing away ten percent of its growth.

My question is, it seems that any real solution to this problem is going to have to be on the delivery end of the counterfeit or pirated goods.

From some of the testimony today, I'm a little bit unclear and, Mr. Stratford, if you could clarify for us, who owns the problem? Sometimes nobody owns the problem and sometimes it's made worse by everybody owning the problem.

I've heard three comments from testimony today. One, that you go to WTO with these violations. Two, that our own government, our own Justice Department should pursue litigation on IP violations. And three, what you spoke to a little while ago, what America's companies can do, and certainly I appreciate the position that they're in and not trying to irritate the Chinese government.

However, that doesn't apply to companies who aren't operating in China but are simply having their goods counterfeited there. So that is my question for you. Who owns the problem and where do you go?

For Mr. Israel, I wonder if you have a sense of percentages, and we certainly wouldn't hold you to any real numbers. But when you look in the aggregate of pirated goods, whether it be pharmaceuticals or auto parts or motion pictures produced in China, are most of those counterfeited goods sold inside China? Is it a larger percentage that is sold back here in the U.S.?

Or is there a larger percentage sold in Europe and other parts of the world, which would tie into my question for Mr. Stratford --who owns the problem? And how on the delivery end do you solve it if a great number of the counterfeited goods are staying in China versus coming over here?

MR. STRATFORD: Yes, thank you, Commissioner Houston. I think your question is an important one, who owns the problem? I think in order to solve a problem, one needs to understand precisely what the nature of the problem is, and when you talk about intellectual property rights, that's a label that covers a very large number of different types of problems, and therefore there is not one solution fits all.

You have different types of intellectual property. You have patents. You have copyrights. You have trademarks. You have trade secrets. You have different types of industries, and the nature of the IPR problem for different industries and different types of IPR really is quite different.

If you talk about the pharmaceutical industry, you talk about the auto industry, two examples that have been raised today, where there are

clear health and safety concerns, you'll find that the Chinese public, to be sure, and Chinese leaders are very concerned about that problem.

There are newspaper reports all the time in China about deaths or other safety incidents where pirated or counterfeit products have been involved, and government officials in that case have a real desire to stamp out that sort of activity because they get very negative feedback from their public when these sorts of things happen.

If you talk about counterfeit luxury goods, watches or handbags or things like that, there are different concerns there. But there really is not an interest on the part of the Chinese government overall to protect those types of industries, but then again you have to look at different actors.

If you're at the central government level, the central government is not particularly interested in helping a local government protect someone that's producing fake handbags or something like this, but then they have to make the judgment of how much resource are they going to spend to go down and get a local official who may be benefiting personally to stop that sort of activity in his jurisdiction?

But there are other types of IPR where there may be some people in the central government that they're not as interested in protecting it. For example, if they want to see China develop a globally competitive company in a particular industry, they may believe that if that company can somehow get its hands on foreign technology, that that would give that company an advantage and allow them to compete better.

In that case, there may be some individuals in the central government who would be trying to find ways to help that company get that technology. So there are different motivations and different inclinations at different levels of the government, in different cases, depending on the specific circumstances.

So that's part of what you have to consider if you're a company whose rights are being violated. You consider whether to sue the violator in China, whether to try to use political means by getting the U.S. government or other governments involved in discussing the particular concern with the Chinese government, and then the U.S. government needs to decide what's the best tool that it has available to it.

Is there grounds for a WTO case? Are there other actions that could be taken? Is the product being exported from China into the U.S. market in which case there are U.S. trade remedies that might be available as well?

So there are a lot of different sorts of things that you can do depending on the very specific problem you're talking about.

MR. ISRAEL: On the question of the intention, I guess, of the counterfeited goods produced in China, where they want to go, I don't have a specific percentage for you, but I can give you a few thoughts.

As I mentioned, 69 percent of the seized goods, counterfeit seized goods that we catch at our borders, come from China, and you get to 75 percent if you add Hong Kong to that, which I think most Customs officials would read as a flow-through port of departure for counterfeit goods coming from China.

The European numbers are very similar. We've talked about this issue with the Europeans and right now we have a customs to customs cooperation infrastructure established with Europe to share intelligence, to share information, and to share personnel in some instances to address the issue.

I think we agree. One statement I'd feel pretty comfortable making is that I think most of the counterfeit goods produced in China either want to get to the United States or to major European markets.

The demand is here. The ability to purchase is certainly here so I would say the vast majority of the counterfeit goods produced in China are either destined for the United States or Europe at some point in their life cycle.

The demand question is a one to tackle as well. I mean there is a demand in the United States for counterfeit and fake products, and as long as that demand exists, the supply will rise up to meet it, so that's something we're trying to address as well, but to answer your question, I think it's the vast majorities.

HEARING COCHAIR HOUSTON: Let me ask you one quick follow-up. With all the interagency liaison that you do, especially with ICE, I can walk down the corner of 20th and L and buy a Kate Spade bag for $20.

MR. ISRAEL: Right.

HEARING COCHAIR HOUSTON: I know I can't buy a Kate Spade bag for $20. The guy is sitting right on the corner of 20th and L. Where are the D.C. police?

So I guess my question is we're here in the bubble and we're looking at all these IP issues, piracy, counterfeiting. Is there any mechanism within the federal government to work with local law enforcement to send down briefs or memorandums or any kind of information where the local cop on the beat down at 20th and L can shut down what is clearly pirated handbags, sunglasses, all those kinds of things?

MR. ISRAEL: Yes, there are those things going on. DOJ is leading an effort to work directly, and they've set up two projects specifically in New York and Los Angeles to really bring together local, state and federal law enforcement entities in those two major jurisdictions and also work with the Chamber of Commerce on this to address issues at the local level, particularly on behalf of small businesses.

The city of New York under the leadership of Mayor Bloomberg has done quite a bit getting the local police involved. Rights holders have a lot of civil remedies that they can bring as well and are pretty active in doing that.

So, yes, to answer the question, DOJ at a federal level is trying to push information down, push resources down, and where there are appropriate cases for federal prosecutors to bring, bring those cases, they tend to be large, more organized type of cases that rise up to the attention of federal prosecutors, but the overall caseload for federal prosecutions of IP crimes went up 45 percent in 2005 versus 2004, so they're bringing significantly more cases to the federal level of IP related crimes and trying to cooperate with local enforcement officials to address markets in Georgetown and other places which we're all--

HEARING COCHAIR HOUSTON: On the front end, they're giving these people permits probably knowing that (a) they like the revenue and (b) that they're going to be selling pirated goods. So, okay, thank you very much, I appreciate your answers.

HEARING COCHAIR D'AMATO: Thank you, Commissioner. Commissioner Mulloy.

COMMISSIONER MULLOY: Thank you both for being here. Mr. Myron Brilliant, who is going to be on the next panel, said this on page two of his opening testimony of his prepared testimony:

"Anecdotal reports from industry further indicate that IPR violations, including those emanating from China, are not just impacting large corporations. Increasingly counterfeiters are targeting American small and medium-sized enterprises"--and listen to this--"and thereby seriously undermining their ability to compete in global markets"--seriously undermining their ability to compete in global markets.

On Sunday night there was a show on TV that my wife was watching while I was trying to prepare for this hearing. It was "Dateline" about all of these counterfeit drugs coming into this country and being a health and safety threat to the American people.

I'm telling you when I watch what's going on, I think the whole consensus for international trade is unwinding in this country. And this is part of it. We may have made a major mistake in bringing a country that didn't have the rule of law and ability to live up to its WTO commitments into this organization, into the international trading system, before it had the institutions to live up to its obligations.

I have a couple quick questions, and need to understand how this works. Mr. Israel, you say you're working under the leadership of the White House and you're now the U.S. Coordinator for Intellectual Property Enforcement across the government. Who in the White House do you work under?

MR. ISRAEL: I work probably most closely with the National Security Council.

Under the International Economic and Trade--

COMMISSIONER MULLOY: Who would make the decision on whether to bring a WTO case on China's IPR violations?

MR. ISRAEL: I will give you my answer, and I would defer to the expertise of Tim Stratford. I think it would be a joint decision made by the U.S. Trade Representative and the President.

COMMISSIONER MULLOY: Would your office be involved in that or the NSC would be involved?

MR. ISRAEL: The NSC would obviously be involved. Both the USTR and NSC are part of the Executive Office of the President so there is clear involvement there and we would offer whatever.

COMMISSIONER MULLOY: You're involved with the NSC because this is not just an economic issue? It's looked at as a political economic issue?

MR. ISRAEL: Political economic issue and a trade issue, and probably should defer to Tim for more detail analysis.

COMMISSIONER MULLOY: I'm going to refer to Tim because I needed to get that understanding. Tim, you say on page five of your testimony, "We will not shy away from using dispute settlement at the WTO when we feel China is not living up to its commitments."

From everything I hear, China is not living up to its commitments. So what are we doing in the WTO? Now here's another thing I hear, that there's intimidation, that our companies won't come forward with the evidence because--Commissioner Reinsch raised this issue--because there's intimidation going on.

Secondly, I was on a panel with Victoria Espinel—and I've heard we have to be very careful about bringing a WTO case because if we don't win it, then it really sets us back, but I don't believe that.

I think bring the WTO case. If you can't win it, and that tool doesn't work, then you got to develop some other tools because this system is intolerable and we can't continue to let it go on.

So, one, do you think we're now at the point where China is not living up to its WTO commitments and we ought to bring a case on IPR?

MR. STRATFORD: Let me describe the process. When USTR or before USTR files a request for consultations at the WTO in Geneva which initiates a dispute settlement process, we run through a standard interagency clearance process. We prepare a memorandum that advocates raising a particular case. It's sent out to the Trade Policy Staff Committee which consists of 20 different federal agencies. USTR leads the meeting, and a decision is taken.

If there is not a consensus, or if there's a feeling that the case is

important enough that it needs to be reviewed at a higher level, and the TPSC, by the way, is led at the Assistant USTR level, so if there's not a decision taken at that level, then a Trade Policy Review Group meeting is held. That's convened at the deputy USTR and undersecretary level. And then if there's not a consensus at that level or if it needs to go higher, then a principals meeting would conduct the issue.

So that's the formal process whereby a decision to take WTO cases is taken. With respect to an IPR case, we have been discussing IPR case strategy formally in this process, and we have already begun detailed discussions with the Chinese government about possible IPR claims that we may take against them in the WTO.

I had follow-on discussions specifically on this matter related to a specific potential WTO case on IPR with the Chinese government when I was there two weeks ago, and we are laying the groundwork for a case by first formally raising our concerns with them on a bilateral basis, giving them a chance to react to address the problem and then on a very short time frame, if we don't think that their reaction to that particular claim is satisfactory, then we're prepared to take the next step. So we are very much advanced in that process.

Let me just add that when you talk about WTO cases, when you talk about IPR, you can't just go in and say you don't enforce IPR well enough, we're suing you at the WTO. You have to have a very specific claim, and then you have to have the sort of evidence that would allow you to support the claim and win the case.

So if you think for a moment, well, what sort of evidence would it take to say that a country or a WTO member is not carrying out its TRIPS obligations, you have to frame very carefully what is it that you're alleging, what is it that you're claiming, and then what sort of evidence would be necessary in order persuasively to prove that claim?

That's the challenge we have. What we look at is very discrete, specific obligations, and whether China is meeting those discrete obligations. We have identified some, and again we are discussing those particular concerns with the Chinese government right now.

I guess I would add that with respect to industry's involvement, as WTO settlement becomes a more routine method for resolving trade disputes between the U.S. and China, the hesitation of American companies to participate I think will decline over time, and as we have more countries involved with us on raising particular WTO claims, I think companies will feel less vulnerable as well.

COMMISSIONER MULLOY: Mr. Chairman, may I have one follow-up? The WTO itself just reviewed China's WTO participation as part of their--

MR. STRATFORD: Trade policy review.

COMMISSIONER MULLOY: --review process of trade policy. And they cited them on IPR. Are you ready, do you think you'll have a case brought by this fall?

MR. STRATFORD: If the particular concerns that we have been discussing with them are not resolved, I think it's very possible that we would have a case filed by this fall.

COMMISSIONER MULLOY: Thank you very much.

HEARING COCHAIR D'AMATO: Thank you, Commissioner. Let me just follow up very quickly. You heard here the very riveting testimony that Senator Levin gave about the state of the counterfeiting problem in the auto industry. Is the auto industry counterfeiting issue, which is a huge safety issue for us and very large economic impact, the kind of situation that's appropriate for what you call in your Special 301 Reports stepped up consideration of our dispute settlement options?

In other words, dispute settlement options, is that one option for us in the auto case? Is that the type of case that would be appropriate for the dispute settlement process or is there another tool that's better for that particular problem?

MR. STRATFORD: Again, you have to point out a particular WTO obligation that China is arguably not fulfilling. If you just say there are a lot of counterfeit auto parts that come from China, that in and of itself is not a claim that's put in terms that you could raise in the WTO because the question is, well, who is producing them? Are companies trying to sue the particular counterfeiters?

Are criminal actions being taken against them? You have to go and see, okay, where is the system breaking down. If, for example, there are counterfeiters and they're not being sued, then China's response is, well, if you think there's a company that's producing counterfeit parts, we have a court system, we have laws, go sue them. And if you don't even try to use the local system, it's very difficult for you to claim that the local system is not doing its job or that China is falling down on any particular obligation.

So if you wanted to allege, for example, that China's court system was inadequate to protect IPR, you'd need to show that a lot of companies have tried it and you'd need to show fairly persuasively that for some reason the court was not doing a proper job. But you can't just say, well, there seem to be a lot of counterfeit auto parts coming from China, therefore China has violated its TRIPS obligations.

HEARING COCHAIR D'AMATO: Well, thank you very much for your participation in the hearing this morning, both of you. We appreciate your commitment on the wide range of efforts that we're engaged in in trying to bring this situation to some sane resolve of this situation.

COMMISSIONER MULLOY: Mr. Chairman.

HEARING COCHAIR D'AMATO: Yes.

COMMISSIONER MULLOY: Maybe you could ask the court at the WTO to take judicial notice because sometimes you can ask a court to do that, and based on what the WTO itself has said about China, I don't understand why there is this enormous rock to lift up this hill when everybody knows and will say it's going on.

HEARING COCHAIR D'AMATO: Thank you, Commissioner, and thank you both for your testimony. We look forward to working with you on this matter as we go along. We'll take a quick five minute break before our next panel. Thank you.

[Whereupon, a short break was taken.]

PANEL III: OVERVIEW: PROTECTING U.S. IP IN CHINA

HEARING COCHAIR D'AMATO: The hearing will come to order. Our third panel this morning, we will hear an overview of the major U.S. industry concerns regarding China's failure to protect international property rights.

First, we have Myron Brilliant, Vice President, East Asia, for the U.S. Chamber of Commerce. Mr. Brilliant is responsible for developing, promoting and executing U.S. Chamber programs and policies relating to U.S. trade and investment in the Asia trade arena.

In 2001, he formed the U.S. Chamber's China WTO Implementation Working Group to follow China's efforts to open is market to foreign goods and services.

Next we have Mr. Edward Jung, co-founder and managing director of Intellectual Ventures in Bellevue, Washington.

Mr. Jung is dedicated to the funding, creation and commercialization of inventions and responsible for several development projects in Asia. He's a strategic advisor to the Harvard Medical Group where he advised the dean of research on issues related to intellectual property.

Before Intellectual Ventures, Mr. Jung was chief architect and advisor to executive staff at the Microsoft Corporation. He holds more than 60 patents and more than 200 patents pending.

STATEMENT OF MYRON BRILLIANT, VICE PRESIDENT, EAST ASIA UNITED STATES CHAMBER OF COMMERCE

MR. BRILLIANT: Thank you, Mr. Chairman. As you can hear

from my voice, I'm suffering from a cold so I apologize up-front and I seek the mercy of this Commission in light of that.

HEARING COCHAIR HOUSTON: Make sure you take American pills.

MR. BRILLIANT: We'll talk about that in a minute. On behalf of the American U.S. Chamber of Commerce, we are very pleased today to have this opportunity to testify before the U.S.-China Economic Security Review Commission.

Fighting this global problem of intellectual property theft is now, and has been for a number of years, one of our top priorities. We have talked about this before this Commission I guess in December this past year, and what I will say today will really focus on what's going on now and what our Chamber actions are in response to the problems in China.

We have at least 35 staff at the U.S. Chamber of Commerce focused on the issue of counterfeiting and piracy. I don't care how you call it, whether it's counterfeiting, piracy, knockoffs, imitations, it's a global challenge, and the U.S. Chamber is responding.

This is the largest business federation in the world and we count as our members not just large multinational companies but small and medium-sized enterprises. I was pleased that one of the commissioners noted already that this issue of intellectual property theft does not just impact large companies but also impacts small businesses, and it's clearly an issue of global dimensions hitting a wide variety of industries and not all companies are able to protect themselves.

They don't have the resources, they're limited, and the issue with China in particular is not just what's being manufactured and distributed in China, but obviously the export of product to the United States and into third markets where our companies compete as well.

So we're fully aware of the scope of the problem. We know it's costing Americans billions of dollars a year, and we are committed to working with the U.S. government and to working with others to fight this issue and to make sure it remains a top priority not just of this U.S. government but of other governments around the globe.

The threats to the economic side are clear. They've been documented already. There are in our testimony as well, but they're obviously threats to the public and health side as well, risks to public safety and human health. And I would note that just last week, nine patients at a hospital in Guangzhou, China died after receiving fake medicines that proved to be toxic.

The problems are not limited to China. They exist in the United States. They exist in Europe. They exist all around the globe. But certainly as you've heard already this morning, a significant challenge exists in China, and certainly China represents a significant percentage of

the overall exports. Somewhere between 65 to 69 percent of the exports coming into the United States, counterfeit product that is, is coming from China.

So we recognize as the Chamber takes this on it's a global challenge and we are focused here in the United States and around the world in critical markets like Russia and elsewhere that we need to pay a lot of attention to China, and we are. We have already seven or eight people working on this issue here, and we've established a presence in China to work on this issue and we're expanding that presence this year.

Let me talk now about China in particular. We do believe that China remains an opportunity for U.S. companies. There is growth in exports. There is profit to be made in the China market. But there are a lot of risks, and at the high end of this is, of course, the issue of intellectual property theft.

We don't feel that China has adequately lived up to its obligations under the WTO, and it clearly has not done enough on the enforcement side. This calls into question its overall obligations. While China has made progress on tariffs and some non-tariff areas, improved regulatory transparency in some measures, not living up to its obligations on the intellectual property front seriously undermines U.S. competitiveness in that market and frankly undermines China's own interests in not just the short term, but clearly in the long term.

It's already been noted today about the scope of the problem in China. I've made a quick reference to it. We talked about the American Chamber's survey in China that was conducted recently that said that China's enforcement of IPR deteriorated or failed to improve over the last year.

According to the survey, 41 percent of U.S. companies said that counterfeits of their products increased in 2005. Our own indications are that this problem continues as well to be a priority issue for American business, and we'll talk about some of the efforts we have underway including working with the American chambers in China in benchmarking where the issues are and in assessing, going forward our strategy.

I'll say that skipping through some of the testimony that there are a lot of organizations, some of whom will testify in these coming two days that can tell you that piracy rates in the software area remain in the high 80s or low 90s, and that in other areas as well, the piracy or counterfeiting rates are very high, and that this is depriving us of market opportunities and of course creating all kinds of challenges going forward in terms of our not only development of our China businesses, but also, of course, here in the United States and in third markets.

The news is not entirely negative. I think there has been some progress in terms of cooperation and transparency, particularly for the

Ministry of Commerce. We've also seen increase in tension at the senior government level. President Hu Jintao reinforced his commitments publicly when he was in Washington. Vice Premier Wu Yi has made similar statements.

I do not want to suggest before this Commission, and in light of some of your questioning, that that's enough. But I think there have been some very positive statements. I also think that the Business Software Alliance, which can speak for themselves, has said that they've seen a slight decline since 2004 in the piracy rates. They're still very high. We are still not seeing enough done on the enforcement side, and I could point to other efforts including the recent announcement on Viagra. So I think we've got some positive things to point to.

Let me jump right now to where we think progress needs to be made. Clearly, we need to see deeper legal reforms. We need to see additional police resources. I think that criminal convictions need to be much more robust than they are today. We know that in March the China government issued new action plan and IPR protection. I would say just in quick reference, there are five points I would like to make here.

The action plan is intended to amend all of China's main IP legislation by 2008, but it leaves out the criminal code, which is a critical component of China's enforcement regime. We're working hard with other groups to make sure that we eliminate holes in the criminal code. We're providing some analysis on that in the weeks ahead. We'd be happy to share that with the Commission.

Second, the plan did call for impact analysis of the December 2004 judicial interpretation of the Supreme People's Court to see how it's handling the adoption of lower thresholds. We believe that there still are issues with regard to the local police and authorities about how they interpret those requirements, and how they eventually go and investigate cases.

We don't think there's enough criteria specificity and so we're looking at that issue as well. The action plan also refers to new measures to be introduced to facilitate the transfer of administrative cases to police for criminal investigation. We think there are again loopholes in the language of these regulations.

There are certainly questions about how the police have discretion in these cases to investigate and we want to make sure that the regulations that are implemented at the local level provide enough clarity and clarification so that we have some accountability.

Finally I just would mention that the plan notes that they plan to issue new regulations to strengthen the deterrent impact of administrative enforcement measures including fines, but for some reason they've not yet been issued. We're pushing hard this year for those regulations to be

issued.

Tim Stratford and Chris Israel outlined some of the successes of the April JCCT. I won't get into that, and I'll be happy to respond in the Q&A.

Let me just lay out, first, the Chamber's bottom line of what we want to see in a very clear sense going forward in the near term rather than the long term and then tell you what we're trying to do in the market.

We want to see first a demonstrated significant increase in the number of criminal IPR investigations, prosecutions, convictions and deterrent sentencing. We talk about this in our testimony, our written testimony.

Second, we want to see an implementation of administrative IPR enforcement actions that are deterrent.

Third, we want to see a demonstration of specific steps to combat copyright and trade infringing activities including Internet piracy.

Fourth, we want to see the Chinese make publicly available case rulings and IPR-related statistical data.

Fifth, we want to see demonstrated steps that Chinese customs authorities are undertaking, steps that are leading to significant declines of exports of infringing products.

Sixth, we want to ensure that the Chinese remove administrative and other market access impediments that support illegal infringing activities and prevent the sales of legitimate foreign products.

Finally, we want to see the Chinese resolve high profile cases. They've done that recently with Pfizer's Viagra product, but we want to see them do that more with other infringements of foreign IP owners, thus establish the primacy of the rule of law.

So that's our sort of action plan. Now, we're working closely with our government. We're collaborating very closely with them. We were very pleased that in their Special 301 Report, they provided not only analysis of what's going on in the market and assessment, but also said that they're going to put a lot more focus on the provincial side.

This is something the Chamber has been doing for the last two years, so we welcome collaboration from the U.S. government on that.

Our four-point plan is very clear. We're going to continue our high level dialogues. The Chamber has become a forum to meeting with not just the central government leaders but also the authorities on IP. We just recently held a meeting with the National Intellectual Property Strategy Office. They had their Deputy Commissioner here who did not meet with USTR but met with private sector.

We're very pleased that they're engaging us. We're not going to say that engagement in itself leads to results, but it's certainly clear that over the past year, we've seen central government authorities and we've seen

provincial leaders as well. We just hosted the Jiangsu Party Secretary in Washington for a meeting with our companies in which we talked about IP issues.

Second, we're going to engage not only in Washington local and provincial leaders, but we're going to engage them in their provinces on best practices, work on training, and related educational programs, and hold their feet to the fire.

We've talked a little bit this morning, or you have, the Commission has, about this issue of education and training. It is a priority for us. Clearly, it's not enough, but it is a priority for us.

We've done some provincial programs in China already. We'll do two more in June in Guangdong as well as Jiangsu Province, and we'd be happy to report on our findings there.

Third, we're going to do benchmarking. We need to assess what's going on in China. We're working with the AmCham in China already on a benchmarking exercise. We'd be happy to share the results with you on that. It will be ongoing. It won't be a one-time study.

Second, we want to get the provincial governments also engaged in benchmarking so we can take assessments of what's going on there. We're working very closely with Guangdong in particular on this, and I think we're close to announcing their commitment to a benchmarking exercise. Since Guangdong is the capital of manufacturing in China, this is a significant breakthrough.

Finally, we're going to continue to implement not only a public policy campaign but a public awareness campaign to focus on Chinese stakeholders and to make sure that they play a role in the marketplace because while multinational companies and American small manufacturers have a stake in this, we need to have the Chinese stakeholders also out there publicly, and we want to work on that issue.

I'm going to end on just two other points, which is we look forward to working with the Commission. We recognize this is a top priority of yours. We also recognize this is a top priority of the U.S. government. We cannot expect to see significant progress overnight, but we need to continue to see incremental progress, and we need to see change in China take place and we respect our government in taking all kinds of actions to ensure that.

But we're going to continue to push them, prod them along on the policy front, and continue to constructively engage the Chinese when it comes to capacity building and to making sure that the police have the right resources and making sure that provincial leaders are committed to these issues.

Thank you for your time today

[The statement follows:]

Prepared Statement of Myron Brilliant, Vice President, East Asia United States Chamber of Commerce .

On behalf of the US Chamber of Commerce, I am delighted to have this opportunity to offer our organization's views on the importance of intellectual property (IP) protection in China.

As the world's largest business federation representing more than three million members, the U.S. Chamber of Commerce is keenly aware of the threats posed by counterfeiting and piracy to the well-being of American firms and workers. In today's Information Age, intellectual property rights (IPR) constitute the new "gold standard." Strengthening IP protection is essential to achieving economic prosperity in this new era.

A Global Challenge

IPR theft goes by many names: counterfeiting, piracy, knockoffs, imitations.

Copies of brand names and copyright works are taking increasing market share away from lawful businesses in an ever-widening range of industries. In earlier times, the problem was mostly associated with luxury goods; but today, it impacts almost every industry, including both consumer and industrial goods. The list of items targeted by counterfeiters is almost endless, ranging from pharmaceuticals to auto parts, food, beverages, cosmetics, electronic appliances, batteries, and computer peripherals. Copyright piracy meanwhile remains at extreme levels for entertainment and business software, movies, music, and books. And the problem will get worse before it gets better, particularly as more and more illegal business is promoted and conducted through the Internet.

Anecdotal reports from industry further indicate that IPR violations—including those emanating in China—are not just impacting large corporations. Increasingly, counterfeiters are targeting American small and medium-sized enterprises (SMEs) and thereby seriously undermining their ability to compete in global markets. Many SME victims do not have operations in China, and have fewer resources to pursue investigations and legal actions against pirates in China and their middlemen in other countries.

IPR infringement is clearly a world-wide problem, and any solutions require a global perspective. They also require more concerted efforts among business and governments in a number of key countries—including particularly China and the United States.

Hidden Harm

Counterfeiting and piracy are clearly costing American companies billions of dollars annually by stealing away market share and reducing overall demand for legitimate products.

It has been estimated by U.S. Customs and Border Protection that counterfeiting and piracy cost the U.S. economy between $200-$250 billion in global sales annually, consequently displacing 750,000 American jobs.

But while this harm by itself is a serious concern, it is essential to consider the other types of damage that are inflicted upon society by counterfeiting and piracy.

The most obvious threats include the risks to public safety and human health. Just last week, nine patients at a hospital in Guangzhou, China died after receiving fake medicines that proved to be toxic. These

problems are not limited to China's borders, as there have been increasing reports of fake drugs—including many emanating from China—finding their way to U.S. shores.

In fact, in a highly publicized case, the U.S. Federal Drug Administration recently seized 51 shipments of so-called "generic Tamiflu" that was on its way to U.S. consumers from China. And in another frightening example of how counterfeit pharmaceuticals from China are now affecting average Americans, a licensed pharmacist in Houston, James George, was convicted earlier this month of conspiracy to introduce into the U.S. market counterfeit and misbranded pharmaceutical drugs as well as trafficking in counterfeit drugs from China.

The World Health Organization (WHO) recently estimated that counterfeit drugs account for 10% of all pharmaceuticals sold globally. Incredibly, in some developing countries, the WHO believes that this number is as high as 60%.

Counterfeiting and piracy also deprive governments of enormous tax revenues. In New York City alone, it has been estimated that tax losses caused by counterfeiting exceed US$1 billion annually. The diversion of legitimate trade denies government at all levels badly-needed revenues. Meanwhile, it is extremely rare to find counterfeiters and copyright pirates paying any taxes whatsoever.

Then there is the impact of fakes on corporate investment and innovation. The U.S. Chamber has found American SME's particularly vulnerable in this regard.

Last but not least is the cost of investigating and prosecuting infringers. Some companies spend millions of dollars annually in tracking down infringers, mostly with results that are far from cost-effective.

And with increasing reports of counterfeiting and piracy, law enforcement agencies are being called upon to do more, often with fewer resources than they had a few years ago. Since government resources are limited, counterfeiting and piracy must compete with other types of crime, presenting local and federal government agencies with extremely difficult choices.

On top of all this is the link between IPR theft, terrorism, and organized crime. National and intergovernmental agencies such as INTERPOL have observed that counterfeiting and copyright piracy are now among the preferred sources of income for terrorists and organized criminal networks, both in the U.S. and abroad.

The U.S. Chamber: Making a Difference

The scope and scale of harm caused by the rising tide of IPR theft has motivated the U.S. Chamber to embark on a wide range of initiatives to deal with the problem—initiatives that are intended to make a real difference.

The U.S. Chamber is aggressively implementing a three-part IPR strategy.

First, we are educating businesses, media, and lawmakers on the growing threats posed by counterfeiting and piracy in the United States.

As part of our efforts, the U.S. Chamber established the Coalition against Counterfeiting and Piracy (CACP) with the National Association of Manufacturers (NAM) to coordinate the efforts of the business community to stop counterfeiting and piracy. CACP is committed to increasing the understanding of the negative impact of counterfeiting and piracy by working with Congress and the administration to drive

government-wide efforts to address this threat.

Second, we are securing the supply chain by toughening existing laws and increasing detection and enforcement efforts.

The Chamber is creating a framework to strengthen links between federal, state, and municipal enforcement officials such as Department of Justice prosecutors, Customs and Border Protection agents, the FBI, police, state prosecutors and district attorneys, and INTERPOL. We have hired investigators to assist law enforcement officials by detecting and investigating trafficking, particularly with respect to goods that impact health and safety.

The Chamber is also working with Congress to strengthen U.S. IPR laws, thereby closing loopholes in existing legislation and ensuring that resources expended by both industry and government enforcement agencies are more effective, as well as cost-effective. Most recently, the Chamber helped to secure congressional support for the Stop Counterfeiting in Manufactured Goods Act, which was signed into law by the President on March 16, 2006. This legislation closes loopholes that previously allowed counterfeiters to avoid prosecution entirely by importing products and infringing labels separately. It also strengthens the ability of the government and IP owners to seize the illegal proceeds of counterfeiters and copyright pirates—thereby hurting them where it counts most—their wallets.

Third, we are engaging internationally in China, Brazil, India, Russia, and Korea to strengthen global IP protection and enforcement by working with key stakeholders on policy advocacy and education, capacity building, data collection, coalition development, and consumer awareness campaigns.

CHINA: An Opportunity and Challenge

Our bilateral relationship with the People's Republic of China (PRC) is of immense and increasing importance to both the U.S. and Chinese economies and business communities. U.S.-China trade has boomed in recent years, and the trend is only growing. The United States ranked second among China's global trading partners in 2005, and China was again the 3rd largest trading partner for the United States. U.S. exports to China have grown by 150% since 2000, making China the United States' fourth largest export market in 2005, compared to the fifth largest in 2004.

Exports of U.S.-made goods have clearly been increasing. For example, from 2004 to 2005, exports of U.S. aerospace products and components increased by 115%, electrical equipment exports increased by 13%, and optics and medical equipment exports increased by more than 15%. These statistics underscore the opportunities that China offers to U.S. exporters, to investors, and, more broadly, to U.S. economic development—particularly in high-technology sectors.

China's growing middle class is also an engine for the sale of American-made consumer goods. McKinsey estimates that the number of middle-class households in China will jump to 105 million in 2009, up from just 36 million in 2004. In 2025, middle-class Chinese will likely constitute one of the largest consumer markets in the world, spending about RMB 20 trillion (US$2.5 trillion at today's exchange rate) or almost as much as all Japanese households currently spend. China's urban population has demonstrated a liking for imported goods and American brands. As consumer spending increases and China's tariffs decrease, exports from the U.S. will certainly rise, as will sales of goods incorporating American technology.

Notwithstanding the importance today and future promise to American business of the commercial relationship, the Chamber recognizes the escalating concerns in many quarters over the growth and

direction of China trade…the ballooning bilateral trade deficit, rising competition from Chinese-made imports, consternation over China's currency practices, and clearly inadequate enforcement of American IPR.

Let me be perfectly clear. The Chamber believes China has failed to adequately enforce its own laws against counterfeiting and copyright piracy, thereby putting into question China's compliance with its obligations under the World Trade Organization (WTO) and various other bilateral agreements and accords. We believe not only that enforcement is lax, but that relevant laws, regulations, and policies relating to IPR enforcement are ambiguous and contain too many loopholes—all of which need to be addressed as soon as possible.

Given the enormous harm that is being inflicted, the U.S. Chamber feels strongly that China must do significantly more to comply fully with both the spirit and the letter of its World Trade Organization (WTO) commitments to respect IPR.

Scope of the IP Problem

Upon joining the WTO over four years ago, China agreed to fully comply immediately upon its accession with the provisions of the Agreement on the Trade-Related Aspects of Intellectual Property Rights—the so-called "TRIPS Agreement". While a number of legislative changes and enforcement campaigns have been introduced since 2001, it is clear to most in U.S. industry that the level of infringement in the market has not improved significantly and that enforcement measures introduced by the government have been inadequate. China is generally obligated under the TRIPS Agreement to provide access to enforcement of foreign IPR which is "effective" and creates "deterrence". Yet China continues to fall short in adhering to these obligations as well as some IP undertakings set out in accords reached during the Joint Commission on Commerce and Trade (JCCT) meetings held in 2004 and 2005.

According to the American Chamber of Commerce in China (AmCham) 2006 annual survey of its members, China's enforcement of IPR deteriorated or failed to improve over the last year. According to the survey, 41% of U.S. companies said that counterfeits of their products increased in 2005. Other industry surveys similarly suggest that counterfeiting has likewise worsened or remained the same for the vast majority of companies polled and that exports of Chinese-made fakes pose a serious business challenge in markets outside the PRC.

Alarmingly, counterfeits of many of the more widely-used pharmaceuticals in China are said to occupy 30% or more of the market.

There is now little doubt, based on hard data from government and industry, that China is the single largest source of counterfeit and pirated products exported worldwide. The U.S. Department of Homeland Security estimates that from 2004 to 2005, China's share of total IPR infringing product seized at the U.S. border increased from 63 to 69 percent. China's share of border seizures is more than ten times greater than that of any other U.S. trading partner.

Meanwhile, losses in China for U.S.-based copyright industries in 2005 were estimated by the International Intellectual Property Alliance (IIPA) to amount to about $2.69 billion—thereby imposing a severe drain on the U.S. economy. IIPA and its member associations estimate that the market share of pirated movies, music, and business and entertainment software continues to hover around 90%, much as it has for years. And this is notwithstanding the remarkable increase in buying-power of Chinese consumers and their demonstrated preference for American copyright works.

As suggested above, the lack of more adequate protection for American copyright works stems in part from loopholes in Chinese laws and regulations. But government policies are clearly tilted against greater resource allocation for copyright enforcement—particularly criminal enforcement.

Adding insult to injury, the Chinese government continues to maintain severe market access restrictions on entertainment industries, generally—barriers which are more severe than for virtually any other sector of the U.S. economy. These limits on market access significantly hamper the fight against piracy inside China by depriving American copyright owners of a more solid presence in the market, including distributors, licensees, and other allies within local industry that might help in combating piracy.

The use of the Internet in China is growing dramatically and is now estimated at over 111 million users. Consequently, copyright piracy through the Internet is quickly becoming a grave threat—one which reminds us that losses in American jobs and business revenues will only be higher in years to come if the problem is not addressed more effectively. Relevant Chinese authorities recently conducted a very tardy and non-transparent consultation process with foreign industry in bringing forward China's new Internet Law. Although U.S. industry is still assessing the new Law, it appears to contain many flaws and loopholes that pirates could exploit.

But the news is not entirely negative. According to the Business Software Alliance, China's software piracy rate last year declined four percentage points—from 90 percent in 2004 to 86 percent in 2005. At the same time, the estimated market value of the pirated software in use in China increased from $3.6 billion in 2004 to at $3.9 billion in 2005, due to increased sales of computer hardware. Thus, while the respect for copyright in software is increasing somewhat, the actual losses being suffered by American industry remain among the highest in the world.

As the U.S. Chamber stated in its fall 2005 report on China's WTO implementation record, effective enforcement of IPR, in particular criminal enforcement, will require the national government in China to look carefully at the flaws and loopholes in their laws. Of equal, if not greater importance, is the need for substantially stronger commitments from provincial, municipal, and county-level governments to increase proactive intervention, enforcement resources, and the political priority accorded to IPR protection, as well as to deal more resolutely with protectionism.

Constructive Engagement

China needs to continue to hear the consistent, open and honest views of foreign governments on concerns over IPR protection. The Chamber believes IPR should remain one of the top, if not the top, economic and commercial policy concern of developed countries in their bilateral relations with China.

Industry will continue doing its part to support bilateral engagement on IPR. The U.S. Chamber is committed now for the long-haul in promoting constructive engagement with the Chinese government, not only at the national level, but also at the provincial and municipal levels. We know from experience that there are demonstrable benefits to be generated from organizing enforcement training seminars, dialogue with government and other stakeholders, and expert exchanges.

While the challenges appear vast, there is clearly a basis for optimism, as China is now awakening to the need for stronger IPR protection not only to satisfy the needs of foreign investors, but for the development of domestic industry.

Indeed, IPR violations could pose a greater threat to China's own economic development and security than

they do to foreign rights holders. This stems, in part, from direct infringements (i.e., Chinese infringing Chinese); this also results from the displacement of domestic sales that occurs when pirates target foreign brands and copyright works. Therefore, it is very much in China's own interest to take significantly bolder measures that crack down on IPR infringements and achieve real reductions in the current levels of counterfeiting and piracy.

Increasing Cooperation and Transparency

In the last year, the U.S. Chamber has observed new levels of openness and cooperation on IPR within the Chinese government authorities as well as an increased commitment among various levels of the government to address IP issues. These are positive signs that should be encouraged in every way possible.

During his visit to the U.S. in April, President Hu Jintao stated that the protection of IPR is "essential" for China's economic development. In February, Vice Premier Wu Yi announced that China would "continue to consolidate IPR enforcement, rigorously clamp down on IPR-infringing activities in accordance with law,…outline an action plan on IPR protection, and…subject criminals and infringers to applicable punishments."

These commitments by China's leaders, along with statements made at the March National People's Congress meeting by Supreme People's Court President Xiao Yang and Procurator-General Jia Chunwang about the need to combat piracy, appear to signal an increased commitment by the central government to improve IPR protection and enforcement.

China's leadership, thus, is now saying the right things on a regular basis about IP creation, protection, and enforcement. Discussions on IP matters between U.S. and Chinese government officials and between the US and Chinese private sectors are increasingly robust. The U.S. Chamber believes China's growing interest in developing its own IP is a noteworthy trend; a country is much more likely to protect and enforce the IP rights of US companies once it has its own IP to protect.

In this regard, the U.S. Chamber welcomes the recent judgment by the Beijing No. 1 Intermediate People's Court to uphold the Viagra patent. As China's economy continues to grow and develop into a more knowledge-based economy, businesses, both foreign and domestic, will require a dependable patent system. This decision should help significantly to promote investment by knowledge-based industries, including the pharmaceutical sector.

We are also seeing what we regard as some important process-oriented changes at the central level that could, over time, lead to measurable improvements in enforcement. For example, in the past, the many ministries responsible for IP protection and enforcement in China had little, if any, coordination. Following the establishment in 2004 of a National Working Group for IPR Protection under Vice Premier Wu Yi, there are clearly indications of greater coordination across the Ministry of Commerce (MOFCOM), the Procuratorate, the Ministry of Public Security, the State Administration of Industry and Commerce (SAIC), the National Copyright Administration, and the General Administration of Customs.

However, even as we appreciate the government's increased level of awareness of the importance of IP protection, we are cognizant that China's desire to ascend the value chain and develop an economy based on innovation rather than low-cost manufacturing are driving its new focus on IP.

In this regard, the Chamber is monitoring closely China's post-WTO accession use of industrial policies—

including antitrust law, standard setting, and patent reform—to foster the development of strategic sectors and reduce the value of foreign-held IPR. Although this topic is not the focus of today's hearing, we are closely tracking several different draft laws and regulations that could substantially weaken legal protection for U.S. rights' holders, and I would be happy to take any questions on this subject.

Need for Deeper Legal Reforms and Additional Police Resources

The Chamber is working closely with Chinese authorities to outline the existing structural and legal problems as well as successful strategies that can be applied to reduce the level of counterfeiting and piracy.

In our regular meetings with high-level IP officials, we stress the critical need for China to create an enforcement system that effectively deters IP violators and, most importantly, that addresses its continuing over-reliance on administrative enforcement.

Less than one percent of the total copyright and trademark cases handled by administrative enforcement authorities were turned over to the police for prosecution in 2005. To illustrate, out of almost 40,000 cases in 2005, local Administrations for Industry and Commerce (AICs) transferred only 230 cases for criminal investigation.

Criminal convictions of IPR offenders in China in 2005 increased 24%. While this statistic is encouraging, it is woefully insufficient compared to the current needs. Indeed, even if the number of arrests and convictions continue to increase annually by 50%, the number of criminal actions would still remain far too low in relative terms for some time to come.

Boosting criminal enforcement of IP will clearly require dramatically greater resources and training for Chinese police—who are already notoriously under-resourced for IP enforcement. IP owners—particularly SMEs—need Chinese police to be user-friendly. Proactive investigations by Chinese police are particularly needed in cases which are difficult to investigate privately, e.g., cases involving large syndicates and those that operate in the shadows of cyberspace.

Progress in criminal enforcement will also require amendments to judicial interpretations and (we believe) China's Criminal Code itself to create a more credible and effective framework for criminal action against more egregious IPR offenders.

The American government and industry will need to maintain focus on these obvious structural problems in China's IPR enforcement system in ongoing dialogues with the central government. Given the scope and seriousness of the challenge, particularly at the provincial and local levels, China's heightened awareness of the commercial benefits of IP, its discussions with foreign governments and business representatives, and process-oriented changes, alone, will not lead to tangible improvements in the IP environment for U.S. companies.

China's IP Action Plan

In earlier congressional hearings, the Chamber has voiced our concerns over the need for a wide range of legal and policy reforms to boost IPR enforcement, as well as for a comprehensive action plan to ensure proper implementation and coordination of these reforms. In an encouraging sign, on March 8, 2006, the Chinese government issued a new Action Plan on IPR Protection which provides the most comprehensive blueprint ever issued by the Chinese government to promote respect for IPR.

Regrettably, some of the core concerns of American industry are not adequately addressed in the Action Plan. However, the contents of the plan provide a clearer basis for engagement with China over the implementation of promised reforms.

The U.S. Chamber will continue to engage MOFCOM and other enforcement agencies in the Chinese government to remain focused on implementing the Action Plan, and also expanding its scope to cover important problems not addressed therein. We will in particular be focusing priority attention on the following:

- First, the Action Plan indicates the intention to amend all of China's main IP legislation by 2008. However, the plan makes no mention of the intention to amend the IP provisions in China's Criminal Code. The Chamber and others in industry have made clear the need for China to eliminate gaping loopholes in the Criminal Code and provide more detailed provisions for dealing with infringements in the internet era. The Chamber is therefore working with the US business community to push for a commitment by the National People's Congress to amend the Criminal Code no later than 2008.

- Second, we are pleased that the Plan calls for an impact analysis of the December 2004 Judicial Interpretation (JI) of the Supreme People's Court and Supreme People's Procuratorate, which lowered the numerical thresholds for IPR crimes. As we have stated in the past, the Criminal Code and JI, together, lack clear standards for the calculation of case values. Currently, local police and other authorities use widely divergent methods of valuing fake products—some by reference to the infringer's declared price, normally without evidentiary support. The JI also fails to provide enough non-numerical criteria for criminalization of cases. To illustrate, there are currently no provisions in the JI for criminal enforcement against repeat offenders, or criteria that would facilitate easier prosecution of cases involving underground factories, pharmaceuticals, food, and auto parts.

- Third, the Action Plan refers to new measures to be introduced to facilitate the transfer of administrative cases to the police for criminal investigation. The promotion of criminal transfers was a key commitment of the Chinese government set out in the 2005 JCCT accord. The Chamber has been pleased to note the issuance between January and March of four regulations by the Ministry of Public Security together with other authorities that have a role in criminal transfers (including the Supreme People's Procuratorate, the General Administration of Customs, the State Administration for Industry and Commerce and the National Copyright Administration). Each of the regulations clarify the responsibility, procedures, and deadlines for administrative authorities to evaluate and transfer suspected criminal cases to the Public Security Bureaus (PSBs).

  While it is yet unclear what impact these regulations will have on contributing to effective deterrence, this action shows a desire by the central government to help overcome institutional barriers to increasing criminal enforcement. That said, the Chamber has noted language in three of these regulations which seems to give discretion to police to reject cases which meet the numerical thresholds for criminalization on the basis that they are "inconsequential" or otherwise do not warrant criminal action. The Chamber will be seeking clarification from relevant authorities on this language, which to date remains undefined. The Chamber also remains concerned as to whether these rules will be implemented in a manner that promotes on-the-spot referrals from administrative to criminal authorities where there is a "reasonable suspicion" that the infringer has committed acts which, upon further investigation, would meet the criminal threshold.

- Fourth, the Chamber was pleased to note plans to issue new regulations that appear intended to strengthen the deterrent impact of administrative enforcement measures, including fines. The Trademark Office of the State Administration for Industry and Commerce has indicated since 2002 plans to issue such regulations, but for reasons which are not entirely clear, they have not yet been issued. Consequently, fines imposed in administrative enforcement cases are normally so low as to constitute a mere cost of doing business for most infringers, let alone a deterrent to further infringement.

The Chamber was also heartened by China's commitment at the April 2006 JCCT to require the pre-loading of legal operation system software on all computers produced or imported into China as well as its issuance of a notice requiring government agencies to purchase computers with pre-loaded software. If the new notices are effectively implemented, this new requirement could make a significant contribution to curbing software piracy in China.

As the dust settles on the April 2006 JCCT meeting, we hope that additional progress will be forthcoming soon in cracking down on optical disc piracy, creating a software asset management system, and increasing transparency in rule-making and statistical reporting of cases and criminal penalties.

However, even as we note these examples of progress, these steps taken by the Chinese government and judiciary over the last year have achieved very little, if any, reduction in the level of infringement in the market.

As we indicated at the outset, the problem remains as serious today as it was a year ago. Administrative penalties—still the mainstay of the current trademark and copyright enforcement system in China—remain grossly inadequate and in most cases create no deterrent to further infringements. Moreover, serious obstacles still remain in the transfer of most administrative cases to the police.

One such obstacle is the lack of police resources and training to ensure that officials at the local level have the capability to support the regulatory and infrastructure changes in China's IPR enforcement regime. Without the allocation of additional police resources targeted at IP hotspots, China's provincial and local security bureaus will be unable to bring rampant counterfeiting and piracy under control.

U.S. Chamber Action Plan

The U.S. Chamber is supporting the Chinese government in its efforts to extend greater protection to foreign and Chinese IP owners. We have embarked on a targeted program offering on the ground capacity-building efforts in the provinces, fostering public awareness of the importance of IPR protection among the Chinese public, and advising on policy changes to better strengthen the legal framework.

The four main components of the U.S. Chamber action plan include:

(1) Spearheading high level dialogues with Chinese business and government leaders including here in Washington DC in 2005 with State Administration of Industry and Commerce (SAIC) Vice Minister Li Dongsheng and Guangdong Vice Governor Song, and in San Francisco with Guangdong Governor Huang; in 2006 with State Intellectual Property Office Commissioner Tian Lipu, Vice Minister Ma Xiuhong of MOCOM, National IP Strategy Office Deputy Commissioner Zhang Qin, and other ministries on IPR;

(2) Engaging local and provincial Chinese leaders on best practices, judicial and administrative

training or related educational programs;

(3) Benchmarking progress with AmCham-China and with provincial authorities in Guangdong province;

(4) Promoting public awareness in China by implementing a media strategy for re-branding IPR as not a "victimless crime."

To achieve these goals, the U.S. Chamber is working closely with U.S. and Chinese governments, our corporate members, and counterpart associations, including with the AmCham network in China.

As I noted earlier, the root of China's IP problem resides in the provinces. It is, therefore, absolutely critical that we cultivate the support of the provincial/local officials, as well as local industry, if IP enforcement is to be addressed in a truly meaningful way.

At the end of June, I will travel to China for our second installment of provincial IP enforcement seminars in Guangdong and Jiangsu—two IP theft hot spots. Together with U.S. government and corporate representatives, we will exchange enforcement best practices and illustrate to provincial and local officials the steps they can take to solve their persistent IP enforcement problems.

Our programs this year will also allow us to gauge progress on some of the indicators we discussed with provincial and local authorities last July. We are exploring the possibility of developing a benchmarking initiative with the Guangdong Provincial government to improve transparency, demonstrate progress, and highlight enforcement bottlenecks in the province. The Chamber looks forward to expanding our provincial efforts to Fujian and Zhejiang provinces—two additional "hot spots"—in the fall of this year.

Separately, the U.S. Chamber is working with AmCham China to benchmark China's problems and progress administrative and criminal enforcement. Our initiative with AmCham aims to measure the effectiveness of enforcement over time by administrative authorities, including administrative fines, confiscations of production equipment, export enforcement, and the success of the government in transferring cases from administrative enforcers to the police for criminal prosecution. And with respect to criminal enforcement, we are also tracking the number of judicial prosecutions, convictions, and jail sentences for IP crimes on a periodic basis.

U.S. Chamber –U.S. Government Collaboration

The U.S. Chamber supports the Administration's ongoing efforts to address and improve the inadequacy of China's IP protection and enforcement regime. In particular, we appreciated the Administration's increased focus in its 2006 Special 301 Report on assessing enforcement progress—or the absence thereof—in China's provinces.

We also see as essential the Administration's efforts to foster increased transparency in the way China gathers and presents its IPR enforcement data to the world. In this regard, the U.S. Chamber viewed USTR's October 2005 formal request that China transparently document its actions under Article 63.3 of the TRIPS Agreement to enforce IPR as a constructive action.

Only through increased transparency will the Chinese authorities be able to document that the IPR climate is improving, and specifically, that regulatory reforms and enforcement efforts are creating a climate of deterrence. We look forward to receiving conclusive data from the Chinese government that confirms a more substantial increase in proactive government investigations into cases, and substantial increases in

case transfers, prosecutions, convictions, and incarcerations of counterfeiters and copyright pirates. U.S. government efforts to address inadequate transparency, the absence of criminal deterrence, and other regulatory and enforcement shortcomings in China's IP regime through the JCCT, other bilateral forums, and multilateral policy mechanisms are complimentary to ongoing private sector work. The U.S. Chamber strongly supports our government's efforts in this regard.

Looking Ahead

In short, we are seeking continued and more rapid progress from China in seven key areas. We hope that China in the near-term will use recent and encouraging advances in the areas of IP process, regulation, and awareness to:

(a) Demonstrate a significant increase in the number of criminal IPR investigations, prosecutions, convictions and deterrent sentencing;

(b) Implement administrative IPR enforcement actions that are deterrent;

(c) Demonstrate specific steps to combat copyright and trade infringing activities, including internet piracy;

(d) Make public available case rulings and IPR-related statistical data;

(e) Demonstrate steps Chinese customs authorities are undertaking that are leading to significant declines of exports of infringing products;

(f) Ensure that China removes administrative and other market access impediments that support illegal infringing activities and prevent the sales of legitimate foreign products; and

(g) Resolve high profile cases involving infringements of foreign IP owners thus establishing the primacy of the rule of law.

If China were to take such actions, tangible results could be achieved.

In our view, the burden of ensuring a reduction in China's piracy and counterfeiting levels in 2006 will ultimately hinge on the political will of local Chinese authorities as much as the national government. Police investigations into new cases need to be proactive and adequately resourced in order to send a proper message to criminal networks that are increasingly behind the problem.

Full protection under PRC law and enforcement of IPR in China as set forth in China's TRIPS obligations are critical to the interests of foreign and PRC companies in China, as well as to China's public health and safety, the integrity and attractiveness of China's investment regime, and its broader economic development goals. We hope that the PRC government will accelerate IP enforcement in 2006 by further enhancing national leadership and dedicating additional capital and resources. Only through aggressive measures will China's IPR protection and enforcement regime be effective and respected.

China's accession to the WTO afforded it an opportunity to sell increasing quantities of products where it has a comparative advantage to the United States. But by tolerating massive counterfeiting and piracy, China is denying U.S. companies the chance to do the same in China. Moreover, by tolerating the export of such counterfeits, China strips our companies of the opportunity to use their comparative advantage—and thus WTO benefits—in third countries as well.

Ultimately, it is essential that China purchase the foreign IP-based products it is illegally using. That would translate into billions of dollars of sales and exports by U.S. and other foreign companies and more accurately reflect the balance of trade between the U.S. and China.

HEARING COCHAIR D'AMATO: Thank you, Mr. Brilliant. Mr. Jung, you want to go ahead and make your statement and then we'll go to some questions.

STATEMENT OF EDWARD JUNG
FOUNDER, INTELLECTUAL VENTURES, BELLEVUE, WA

MR. JUNG: Members of the Commission, I appreciate your inviting me here to talk to you. I am an entrepreneur and an inventor and have done so as an individual, a scientist, a small business owner, and a large company executive. As such, I actually feel a little bit like mismatched sock here, and I'm going to try to bring a somewhat different perspective on this IPR issue, which is a very big issue, than I think many of the other people who are here.

Inventors in America have invented most of the key technologies that drive the world economy today. It's actually a fantastic thing if you look at the last hundred years to see how much of the world economy has been driven by technologies that came out of the United States. From the days of electricity and the automobile and light bulb, all the way to the Internet, many wireless protocols and software.

It's a tremendous track record. No other country comes even close to the United States' ability to set the key technologies in the world. And all over the world companies go and follow our lead and manufacture the products that are based on the technologies that we invented, and one of the interesting questions is why is it that the United States has done that for so long?

It's not like other countries haven't noticed and it's not like they haven't tried to do it themselves. Part of the reason is that we embrace this generation of new and disruptive technology. More so than any other country, an inventor who comes up with a new idea plays on a level playing field in the United States and has the ability to promote that idea even against large entrenched companies.

This has given us actually tremendous leverage in the global economy because even if a product is created in some other country, it is really built to the specifications of the technology that we invented, and it gives us a fundamental advantage in, first of all, being the first manufacturer but also having the choice of where we want products manufactured.

That's given us a very sustainable world of prosperity, economic security, and very importantly, a tremendous amount of economic

stability, and sometimes it doesn't look like it's stable. The top technology companies change from time to time, but it's quite amazing that they're almost always coming from the United States.

And that gives us that economic stability that we can adjust to the market as it changes. I think this is really good news. I want to make sure that we focus on this larger perspective that the United States is really at the top of the food chain of most of the global economy in this way.

If you're in China and you make a DVD player, some majority of your profits actually have to go to foreign stakeholders in the form of royalties and license fees. If you're Lenovo, you wrote $3 billion in checks to U.S. companies for royalties and license fees, right, and that's even before they sign this agreement to ensure that there's a certified software on everyone of those computers.

If you do a handset in China, 30 percent of the cost of that handset and most of the profits go to overseas holders. So that's a very good system that we have in place, that we continue to innovate and thereby be skimming the cream, so to speak, of the profits of all of these products.

Now, China is not unaware of this. In fact, it's something they're completely envious of. If you're in China and you're trying to triple your GDP, you cannot do it by continuing to be a low cost manufacturer. And you get no stability by knowing that what you manufacture is being dictated by somebody else; right.

So that's why when they shifted this past year from their Tenth Five Year Plan to their 11th Five Year Plan, a huge portion of it, across the board, from education to manufacturing to policy was about something they call independent innovation and you see it everywhere in China.

That's their big tag line. It's independent innovation. And they are trying to build a knowledge economy in China to rival ours so that the next generation standards that are created, the next generation new technologies and key technologies that are created will come out of China.

That's something I want to make sure that we're very mindful of because no matter, as someone else pointed out, we can't compete on costs in manufacturing in the long run. And, in fact, China doesn't even want to stay there themselves, but if we lose the ability to be the leaders in creating the next generation key technologies, we will really lose the only thing we've got.

China is very, very committed to doing this. They see some advantages that they have; they have a very large population. They're graduating and, depending on who you talk to, four times or ten times the number of science and technology people that we do, they have sort of central control so they can go pour a whole lot of funding in their IPO

and pour a whole lot of development funding into regions, into manufacturing, into education and so on.

And they've even gone so far, if we talk particularly about technology, because they have this huge interest in developing technology, as making the property rights for technology, for their technology holders inside of China very, very strong. The number of litigations on the patent side, technology patent side, has gone up by a factor of 20 in the last four years.

It's a lot of court load that here in the United States would actually be very difficult for us to bear. So, again, it's very important that we defend the interests of U.S. companies in terms of infringement in China, but we should not lose sight of this bigger picture, that if we do at the risk of losing our technological lead in the future, we have lost the game.

Today, in the United States, the system that has allowed us to create these disruptive innovations, I believe, is under threat. There are a lot of interests in the United States who find disruptive innovations threatening and therefore will try to dilute the property rights of inventors and also try to slow their progress.

They use reasoning that goes from the fact that, gee, some innovations are actually bad or we think they're bad all the way to reasoning having to do with global trade. So again, it's important to protect the interests of our large companies, but not at the expense of not being able to produce the next generation key technologies.

One of the things that I think is the goal that we all would like to see is that ten years from now, we the United States are still producing the key technologies of the world. But there are two or three billion additional customers added to the world markets. That's a good situation. That gives us a lot of growth.

What we don't want to necessarily see, and I think we're willing to sacrifice the notion that the top companies, 20 years from now, may be different companies than the ones that are here today. We may not know them.

By maintaining our domestic incentives to continue to innovate, I think we can continue to lead because there are many advantages that we have in the United States that China does not enjoy. We do have an entrepreneurial culture. We do have the ability to not rely on a central authority to decide what is good and bad technology.

We have a lot of people who are willing to take huge amount of risk on new ideas, and we have a culture that rewards it. It's not embarrassing to be in a start-up company. It's not embarrassing to have a crazy idea. These are systematic advantages we have in the United States that we should not lose so that we can maintain our leadership.

When I was in China, it was an immensely interesting experience

because they are actually fairly entrepreneurial and frankly I went there with sort of maybe a high school educated '80s view of what communism is. I talked to a lot of ministry officials and director of the IPO there and Chinese Science Academy and so on, and I talked about innovation. The level of interest expressed was truly amazing. In many of these conferences that I would go to, I would get mobbed like a rock star. I mean people would ask me for my autograph and all this.

I found it a sharp contrast, this desire for them to try to promote individual success in innovation inside of China to what I was seeing in the United States where we are defending the individual's right to assert, to maintain their property rights on intellectual property in the United States.

So I just want to make sure, speaking to the Commission, that we keep in mind that our true advantage is that we can stay ahead and adapt, we can out-innovate any other country, and we have to maintain that advantage and not lose it.

Thank you.[4]

PANEL III: Discussion, Questions and Answers

HEARING COCHAIR D'AMATO: Thank you very much, Mr. Jung. Have you got your copy of Hot Property by Pat Choate?

MR. JUNG: Yes, I've read that.

HEARING COCHAIR D'AMATO: You're singing off the same sheet of music. He'll be testifying tomorrow, I think, some of the same lines that you're talking about in terms of the threat to the small inventor in the United States currently which we think is rather important question.

Commissioner Wessel.

COMMISSIONER WESSEL: Thank you both for your testimony. I appreciate it. Mr. Jung, I have to admit I'm a little confused, and I hope you can clear that up for me. You seem to indicate that in part that aggressive enforcement of our intellectual property protections in China would reduce innovation here. Is that what--

MR. JUNG: No, not at all. In fact, I believe there are many people today and tomorrow that will hammer in the point that aggressive enforcement is important, and I also agree it's important. I was actually talking to a related issue that I want to make sure that it's considered in the context, that when we do things, we shouldn't damage our ability to innovate. So, yes, I actually believe that.

COMMISSIONER WESSEL: And how does aggressive enforcement

[4] Click here to read the prepared statement of Edward Jung.

damage, what areas do you see the damage coming from in terms of aggressive enforcement?

MR. JUNG: No, no. Like I said, I'm not against aggressive enforcement. I was talking about a different issue which is making sure that we protect ourselves in the United States so we continue to produce the innovations that need to be enforced in the future.

COMMISSIONER WESSEL: So we are all singing off the same sheet is what you're telling?

MR. JUNG: Yes, I believe we are.

COMMISSIONER WESSEL: Okay. Again, I was somewhat confused because I want to make sure we're not getting into the entrepreneurial economy where we turn into coupon clippers here. Because you indicated, I think, in part that China is going to manufacture all these products, and certainly when you look at certain cost advantages, they are there. There are a lot of I would think artificial cost advantages to producing in China. Where our last hearing, I believe, was on subsidies and a number of other issues that have created an unlevel playing field, we've seen in the 11th Five Year Plan, as you talked about, the individual innovation approach is supported by billions of dollars of capital going into nanotech, biotech, optical electronics and some of the industries we want to be the, continue to be the innovators because those really are many of the industries of the future.

Mr. Brilliant, I'd like to follow up on the line of questioning that Commissioner Mulloy engaged in last and get some of your thoughts because the response to that, which I found very important, was the administration's indication that their frustration level has risen to the point where they may be prepared to file a case as early as this fall.

What interaction is the Chamber having and the rest of the business community on the preparation of those filings and can we assume that the Chamber will be four square behind the administration if they were to bring a case?

MR. BRILLIANT: Commissioner, I'd be pleased to answer your question, all facets of it. But first I just would go back to your other question, which is I think it's an important question as well. I just want to make sure, based on what you are saying, that we articulate, I think, that we need to be competitive here, and that while we pursue courses of action in markets like China, we must not forget about the innovation that's taking place in here and nurture and develop it.

I think one of the responses I would give to you is that there are things that we can continue to do in our own house here in the United States and focus on to nurture and develop innovation, not just at the multinational level, but at the small and medium-sized level, which is really I think the heart of the American economy.

So I think there are--

COMMISSIONER WESSEL: I think we would all--

MR. BRILLIANT: We can walk and chew gum in other words.

COMMISSIONER WESSEL: I think we have to chew probably several packs of gum at the same time.

MR. BRILLIANT: Right. Exactly.

COMMISSIONER WESSEL: I think we all agree on that.

MR. BRILLIANT: On your question directly to me, Commissioner, I'd say a couple things. We are in consultations with USTR. We regularly meet with them. As you know, I chair or, if you don't know, I chair a coalition of associations focused on these issues, not just broad-based organizations but sector-specific associations. We meet regularly with the USTR. We meet regularly with Department of Commerce. We are fully aware of where they are in the process.

I think they are right to take the approach that they need to make sure if they move towards a case, if they have a winnable case, that they have the facts to support it. There have been times when they've issued questionnaires to industry. We've been supportive of those endeavors.

I think bringing a WTO case is only one of your arsenals. I know one of the commissioners has already raised that. You're raising it as well. I think we have to look at other vehicles to make sure the Chinese move forward not just in our bilateral dialogues but also making sure that the Europeans and the Japanese and others are on board as well to strengthen our hand and to make sure we're going forward.

So we will likely support USTR in whatever course of action they take, so long as the action is consistent with China's WTO obligations. I'd just add one thing. One focus that we're going to give a lot of attention to this year, and I think the Commission should put some attention to it, is what happens with the criminal code. I'm sorry? What?

COMMISSIONER MULLOY: Criminal code?

MR. BRILLIANT: Yes, the criminal code. There's not enough attention on that issue. We want to see not just a much more robust administrative fine system put in place, and of course, we want to see the police have the resources to come into these cases earlier. That's critical as well. But we want to make sure that there's a lot of attention, and we're going to work with the NPC in China and other authorities to make sure that that criminal code deals with some of the gaping holes, and we have that in our testimony.

We're going to put a report together on that. You will find that's going to be one of the issues that USTR tackles as they assess what to do on the WTO front.

COMMISSIONER WESSEL: Thank you. Let me also just quickly indicate your members, many of the Chamber affiliates that come over

from China and elsewhere, meet with members of the Commission. It's extremely helpful. We want to continue that dialogue and as you work further on the provincial reviews that your organization has been involved with, to the extent it's appropriate to share that information, we'd appreciate it.

MR. BRILLIANT: Thank you.

HEARING COCHAIR D'AMATO: Thank you, commissioner. Commissioner Mulloy.

COMMISSIONER MULLOY: Thank you both very much for being here. I read both your testimonies. Quite interesting. Mr. Brilliant, you always have a way of really capturing things. I remember last year, there was a press quote: "China is Public Enemy Number One on IPR." That was a great quote. Now, in your testimony today, you really capture it again. On page 14:

China's accession to the WTO afforded it an opportunity to sell increasing quantities of products where it has a comparative advantage to the United States. But by tolerating massive counterfeiting, China is denying U.S. companies the chance to do the same in China.

Let me understand what I think. In other words, China is in the WTO and instead of facing a 40 percent tariff for its goods coming into the United States, they get MFN, which gives them a 2.5 percent tariff, which everyday we give to China, and all their goods come in here with that very low tariff.

We asked and they signed on to protect our intellectual property rights. Everyday we hear there are massive violations, and we're not getting what we bargained for. See, the deal is a two-way deal. One part of it is being upheld; the other part isn't.

Now, Ted Fishman, who wrote the book China, Inc., testified before this Commission last year, and he said this isn't just happenstance. China has an industrial policy. Getting IPR free helps their companies compete better. They don't have to do the R&D. They get the technology and they can compete better.

Now, what I was struck by is Mr. Jung, in your testimony on page 15, you say, and this important to catch how this works, China is delaying 3G license awards to American companies. The belief is that will allow time to have their competing domestic standards, their companies, so that they can have this new standard to become commercially viable and to give their local vendors development and deployment experience.

In other words, they have an industrial strategy. Is that what you're saying here?

MR. JUNG: Yes.

COMMISSIONER MULLOY: Yes. So they have an industrial strategy, and all this is tied together to make them move up the food

chain and be able to be the one that sets the standards and that is the leading economy. And this IPR, allowing this to go on year after year, I think is part and parcel of that strategy and that we ought to be, we have to be, we have to understand the inner relation and be much more aggressive in going at--do you accept that, Mr. Jung, and then Mr. Brilliant, do you have any comment on that observation?

MR. JUNG: Every country in the world wants to have a Qualcomm; right? I mean they extract tremendous amounts of revenue from all over the world through having a set of wireless standards. So it's smart for them to have an industrial, for China to have an industrial policy like that, yes, so I agree it's important for us to be mindful of what they're doing and have the right measures in effect for us to make sure that they're not ripping us off; right.

COMMISSIONER MULLOY: Yes.

MR. JUNG: At the same time, I just wanted to make sure that we also are mindful that we continue to allow our new QUALCOMMS to occur.

COMMISSIONER MULLOY: No, I caught the different point. That was our own system at home that we're letting--

MR. JUNG: Right.

COMMISSIONER MULLOY: --yes, deteriorate. Myron.

MR. BRILLIANT: Well, I'd make two points, Mr. Commissioner. Point one is that every country should have an industrial policy. I mean we need to protect and nurture our own industries and we need to find ways to make them competitive and viable. We need to look at our tax regimes. We need to look at our tort reform structures. There are a lot of things we can do in the United States to ensure our companies can compete and prosper and to invest in R&D and, of course, great jobs here in the United States.

The second part of it is China does have an industrial policy. It's something that we're following very closely. It's something that we testified to in our WTO report, our annual report, and by the way, it does touch on IP issues, but it's more than that. It's competition policy, it's standard development, it's patent reform.

These are very important issues and issues that we're following very carefully. I would say that China has improved its transparency in how it's adopting its anti-monopoly law. We're working with them. The American Bar Association is working with them. We're pleased that they're engaging us more.

But we have significant concerns about patent reform in China. We have significant concerns about standards development because it does, it does, as you suggest, have a direct impact about how our companies can compete in that marketplace and around the globe, and so we're following

these issues very closely. We're giving a lot of attention to it, and we welcome talking to the Commission on a different day about those issues, but certainly we do see a nexus between our competitive position and industrial policy in China and how they may be supporting domestic industries, and we are following that very carefully and we're working with the Chinese as constructively as we can.

COMMISSIONER MULLOY: Thank you, Mr. Brilliant, for your testimony and that helpful offer to help us understand that industrial policy a little better at some point. Thank you again.

HEARING COCHAIR D'AMATO: Thank you, Commissioner Wessel. Mr. Brilliant, what's the Chamber's position on the viability and utility of using the WTO process and dispute settlement mechanism as a mechanism, at least at this juncture, to try and bring some light on the situation and some, let's say, victories with regard to some of the egregious behavior we see in IPR?

MR. BRILLIANT: Mr. Chairman, your question is just to the IPR side of it as opposed to using the WTO system more broadly?

HEARING COCHAIR D'AMATO: Well, the WTO system more broadly, but at the moment, the question on the table seems to be whether or not we're going to be able to bring some successful dispute settlement cases as a mechanism that has not been used in IPR yet--

MR. BRILLIANT: Right.

HEARING COCHAIR D'AMATO: --with regard to WTO?

MR. BRILLIANT: I'd probably make three points here. First, wherever disputes rise in a bilateral fashion, and they can be taken to a multilateral system and their rules and protections, it helps all parties concerned.

HEARING COCHAIR D'AMATO: Right.

MR. BRILLIANT: So there is a reason we wanted China in the WTO. There's a reason the United States should be a member of the WTO, and we welcome that process.

The second point I'd make is that there are a lot of consultations that lead to a WTO process, and often you don't have to take a case all the way. You get resolution of disputes along the way, and that's very possible with the Chinese in some cases.

Tim Stratford earlier talked about the auto case that's pending, auto parts and some other issues in that regard. That's part of the process with China which is to engage them, to make them realize that we're going to take it all the way, and hopefully resolve it along the way, and that's to the mutual benefit.

There are issues that may require WTO attention on the IP front. One of the challenges, as you know, is the TRIPS Agreement is somewhat vague in defining deterrence. One of the reasons we wanted the United

States to be careful in how it engages the WTO process is we don't want the United States to bring a case before the WTO on IP issues that we don't win.

That wouldn't help America. That wouldn't help frankly our friends in China who support the United States' pressure on that. There are people in China who believe it's in their own self-interests that the United States keep this pressure up. There are also now Chinese stakeholders, entrepreneurs there, private entrepreneurs, who have a stake just as large as we do in seeing innovation protected in China.

So if we're going to bring a WTO case on a specific issue, whether it's trademarks or copyrights, we better make sure we have the facts to win those cases, and I know that's something that Tim Stratford and USTR more broadly is looking at very carefully with other parts of the government. So when they get to a point where they're ready to move and they share with us the case, we will then at that point make an assessment.

HEARING COCHAIR D'AMATO: Thank you. I think there's a possibility of being too cautious in this area as well because when you take a look at the entertainment business, there is very little that you can see in there that would say this is a gray area that there is not a huge problem that hasn't been solved.

So it seems to me at some point, we've got to take--there's always risk in life. You've got to take risk and go forward, particularly if the situation has had such an egregious impact as that was identified by Congresswoman Watson here in terms of employment in California and her industry and business over time.

It seems to me that there has been an abundance of caution in this area over time, and there's a time when you have to go for it as well.

MR. BRILLIANT: I don't disagree with that at all. I think we can't keep talking about WTO cases forever. We have to decide what our strategy is in the U.S. government and the private sector as well and go forward.

I will say this though. There are things going on in China that have to be recognized. There are some campaigns--we don't like the word "campaigns" because it suggests a short time frame--but there are some crackdowns that are going forward right now dealing with a range of industries, and you probably heard about some of that this morning. The work that's being done in Beijing with landlords, the work that's been done around the country to crack down on optical disk piracy. So there is some work being done.

Some of these campaigns are effective, but to be really effective, they need not to be viewed as campaigns but an ongoing process. So some of the industries want to see whether these initiatives that China has

launched are going to go forward and that is part of the calculus that USTR has to factor in its assessments.

HEARING COCHAIR D'AMATO: Commissioner Reinsch.

COMMISSIONER REINSCH: Thank you. Going back for just a second to the dialogue between Mr. Wessel and Mr. Jung, it seems to me that I think the point you're making is, and when you're talking about technological competitiveness, it's really more about us than it is about them in many respects, and I'm inclined to agree with that.

Am I misunderstanding?

MR. JUNG: I'm sorry. I missed part of your question.

COMMISSIONER REINSCH: I think the point you're making about competitiveness is that it's as much or more about us than it is about them?

MR. JUNG: That's right. It's as much about us as it's about them.

COMMISSIONER REINSCH: Good. Well, I certainly agree with that. Mr. Brilliant, going back to something that the previous panel alluded to, which is the JCCT, can you comment on whether or not you believe it's a useful problem-resolving device or structure and if so, why?

MR. BRILLIANT: Thank you for that question, Mr. Commissioner. I think it is a useful vehicle. Without it, some of the actions that have been taken by China might not be possible, and I say that because high level dialogue is important still in the U.S.-China relationship.

It has fostered change. It has required the Chinese to be accountable in some areas and we recognize it's always done in a political context and that's one of the challenges.

I was widely quoted around that time as saying we shouldn't expect home runs. We should expect singles, maybe because it was baseball season, but basically I was saying that we need to expect incremental change from China and not look for home runs overnight. That's one of the challenges that we all face because there is a lot of ground for improvement in China, and I think the JCCT dialogue creates an opportunity for incremental change and for accountability, and so I'm one that supports the dialogue very much, and I think by elevating it to Wu Yi's level with our Secretary of Commerce and our USTR Trade Representative, I think that's a very important thing.

We need to keep that dialogue in place. We need to ensure there's always incremental progress and we need to always ensure there's accountability. It's a long answer, but, Mr. Commissioner, you didn't hear that I have a cold today, so I have to apologize for my wordy answers.

COMMISSIONER REINSCH: It's a lot less wordy than some other ones that we've gotten, I can assure you of that. Thank you.

A lot of the discussion has been about pirated products in the

Chinese market and by extension third markets. Are we seeing the entry of phony Chinese products into the U.S. market in substantial numbers? I know Senator Levin had an example of that. Can you comment on that, too? Is that becoming a serious problem?

MR. BRILLIANT: I didn't hear it.

COMMISSIONER REINSCH: The entry of counterfeit Chinese products into the United States market directly.

MR. BRILLIANT: Well, I stated that in my opening remarks that somewhere between 65 percent and 69 percent of product that's seized at the Customs border is--of illegal IP product, counterfeit or piracy, is coming in from China. And obviously the Internet presents more challenges as well because there's a distribution mechanism that we can't always fully account for.

So we know that China represents a significant body. The U.S. Chamber is trying to work with some other groups now on getting better facts and figures and, as you know as well, the OECD is looking at this issue, too.

One of the challenges we have collectively is we don't have good data. We have estimates, and we have some assessments of a worldwide problem that could be anywhere from 500 billion to 750 billion, and so we know it's sizable. We can't give you as precise data today as we'd like to give you, but we do cite some statistics in our written submission that suggests that the China problem is by far the largest one and dwarfs all other countries by maybe tenfold in terms of size and scope.

COMMISSIONER REINSCH: Thank you. Mr. Chairman, I've got another one, but I think it would take me way beyond the time, so I'll yield back my time and tackle that one on another occasion.

HEARING COCHAIR D'AMATO: Thank you very much, Commissioner. Commissioner Bartholomew.

COMMISSION VICE CHAIR BARTHOLOMEW: Thank you very much. Thank you to our witnesses. Mr. Jung, it's always interesting to have innovators here in front us. We take to heart your comments. We have, of course, been concerned about maintaining our own competitive advantage and the importance. I think it's really the reason that intellectual property is such a topic, which is it is about our economic present but it is also about our economic future.

And it's interesting because I think that people probably innovate for a number of reasons. Inventors invent partly because it's in their nature and they have all these ideas, but there are also people who invent because they see economic returns for their invention, and one of the things I am concerned about is as more and more things are being ripped off, there is less economic incentive for inventors to invent. Do you see this as a problem?

MR. JUNG: I am an inventor, and I've also had to go through a lot of business in my life, and it's always useful to have a stick when you're going off and trying to make sure you're treated fairly.

So it's very important. I don't want to under-accentuate everything that's been talked about today of making sure that we use the sticks appropriately.

But on the other hand, having a carrot is really useful too. And one of the things that Commissioner Reinsch had said--I maybe mangled his name--earlier--

COMMISSIONER REINSCH: I probably mangled yours, so turn about is fair play.

MR. JUNG: It's actually amazing how many times people think I'm Austrian, but it's one of the wonders of the Internet, they never see me. So but it's important to keep in mind that the greatest incentive for China to build respect for intellectual property is for them to actually build a stake in it, and so part of what I like to talk about is, yes, we have to be willing to use the stick, just like in any property law, we have to be able to use lawsuits to evict tenants or what have you, squatters.

But we also have to think about how we can get them really behind developing intellectual property of their own, so that they will truly, truly believe in it, and one of the things that Mr. Brilliant said, which I think is a very important point, is there are people in China who are trying very hard. I've met very senior government officials who really want things like mandatory injunctions and criminal liability and so on, but they don't feel empowered at the moment in their own government to do it.

And helping support them and giving them the means and mechanism to advance that over time, I think that is also an important approach, not to say we shouldn't, I say, use a stick. But I think that's a very important part.

Having said that, there are many companies out there and even some individuals out there trying to assert their intellectual property rights. I've put in my testimony some kind of figures around how much of that is getting done. It is an increasing amount. There is progress there. They have a long way to go.

But I'm actually generally encouraged, having lived there and kind of seen how people are looking at this problem and how it's been evolving in the last just two years, I'm actually encouraged that they will take it very seriously.

Now, having said that, I'm lumping all of IP, I'm guilty of lumping all these IP things together. I'm really talking about technology and patents. In the area of copyrighted material, there's a much lower incentive for China domestically to protect that and so that is a viable issue.

COMMISSION VICE CHAIR BARTHOLOMEW: Thank you.

MR. BRILLIANT: Am I allowed to add to that?

COMMISSION VICE CHAIR BARTHOLOMEW: You are, Mr. Brilliant.

MR. BRILLIANT: Thank you. Because there's a couple points that I think are important to highlight. First of all, we do need to have both carrots and sticks in our approach to China. Just having sticks won't work, and a lot of us feel that's a critical point.

The other thing is, if you look at consumer attitudes in the United States, they are probably not very different than they are in China about this issue. People don't have a great amount of awareness here. I'd argue there's probably more awareness campaigns going on in China than there are in the United States on IP theft and the harm it does to companies and therefore to people who work in companies.

So when we look at solutions, part of the solution is continuing to work in this market. Public and health safety issues like the one I raised with regard to fake medicine in Guangzhou will help, I think, the Chinese political system go forward, and you mentioned political will.

Political will means a lot of different things. In the United States, there has been political will in Washington to deal with tort reform. There was a bill that was passed, but guess what, there are problems around the United States in individual states that have to be addressed, and the federal government doesn't have a mandate necessarily to deal with that.

We have to go into each state and try to address tort reform. Similarly, you can say the central government has increased its political will. I would argue it has, but it needs to put into place a system at the provincial level and the provinces, the leadership in these provinces are now independent in some respects, and they need to put in place their own political will to address these issues.

So we just need to be careful how we define and describe the issue, so I meant to put that back to you.

COMMISSION VICE CHAIR BARTHOLOMEW: Mr. Brilliant, it always seems that you and I have sometimes contentious discussions when you testify in front of us, and I just want to make sure that you know that I appreciate the fact that you come and that we have an opportunity to have a dialogue.

I'm just going to do a dangerous thing, which is to take you to task on your sports metaphor, dangerous only because I seem to mess them up frequently myself, but you don't win a game if all you do is to get to first base repeatedly, so singles don't work unless you go from first to second to third to--

MR. BRILLIANT: Well, lots of singles.

COMMISSION VICE CHAIR BARTHOLOMEW: So that's my only comment on your sports metaphor. In the context of political will, I think the reason it becomes such a huge issue is both I think the American public and I want to always make sure that our government officials remember some of the vested interest that China's leaders have in the status quo.

I think the other thing is it is frequently touted as success when the Chinese leadership, the central leadership, has signed an agreement, and I think we have to ask if there is not the political will or the ability for those agreements to be binding on people below the central leadership, why should we believe that yet another agreement signed is progress on the issue?

You and I could go back and forth on that for hours. I want to move to a different topic. I want to take two minutes on this. I'm going to take two minutes on this.

MR. BRILLIANT: Fair enough.

COMMISSION VICE CHAIR BARTHOLOMEW: I'm trying to understand something in terms of this China price issue that I raised before, and what I'm trying to understand is what happens on the ground? When a U.S. company is manufacturing, a big company--let's say Wal-Mart or one of our major auto makers, something like that--there is pressure on small and medium-sized producers in this country to transfer production overseas in order for them to be able to compete. Let's just say transfer to China in order for them to be able to compete.

In the bidding process, is there any legal requirement, code of conduct, anything like that, that when a contractor for Wal-Mart writ large, I mean the person who is doing, putting the bids out, that the bids that come in are from companies that are not counterfeiting?

In other words, how do we know, if I'm a small or medium-sized business, how do I know that the price that I am giving is being judged against a legitimate producer's price or am I being gamed so that a counterfeiter is coming in with a lower bid which forces me to have to go down and then, for example, shift production overseas?

Is there any business code of conduct, any legal requirement that the bidders be not using counterfeited goods?

MR. BRILLIANT: You're putting me in dangerous territory here.

COMMISSION VICE CHAIR BARTHOLOMEW: I'm really trying to understand how this works.

MR. BRILLIANT: I think it's safe to say that some companies have in place a check and balance system, but it's also safe to say that there isn't a universal way to assess that, and that that presents a unique set of challenges for all of us who are working on this issue.

In other words, there are a lot of companies that are providing

goods in China to, as you said, Wal-Mart or Target or other retail stores, and I'm sure those stores feel they have some checks and balances in place, but I'm also sure it's hard because some enterprises are doing both legitimate and counterfeit product at the same time.

We know that in China there are enterprises conducting legitimate enterprise as well as conducting illegal activities, and that becomes a difficult issue for us. That's why some companies are going into investigations. Pfizer is one of them, but there are a lot of U.S. companies that are investigating these issues to try to address that because there are enterprises that are doing dual.

In effect, there are enterprises that are working with U.S. companies, that have legitimate enterprise with U.S. companies, and then go off and steal that IP and end up creating product that they also sell, and that undermines our competitiveness as well, a host of these issues that make it difficult to give you a single answer.

COMMISSION VICE CHAIR BARTHOLOMEW: And I'm not saying that Wal-Mart--I have no evidence that Wal-Mart is doing this. I'm just using them because they're such a major factor in all of this, but it is to their competitive advantage to drive the price of their producers down by using whatever lowest bid that they can get, and I'm a little concerned that the bidding process might essentially be rigged on behalf of the counterfeiters because of that. If it is a voluntary check-and-balance, and yet the incentive is to get the lowest price possible, how do we deal with that?

It might be something we need to have a further conversation on. I really don't want to put you on the spot. I'm just trying to understand how this is working.

COMMISSIONER MULLOY: Could I offer--

COMMISSIONER WESSEL: Mr. Chairman, could I respond just quickly because I met briefly recently with a CEO of a U.S. manufacturer dealing with one of these "Big Box" retailers, who in his last line review to fill the Big Box retailer's shelves was told that they had to send their products to Hong Kong for the review and their Chinese competitors were invited to review their products to see whether they could produce them at a lower cost, copying, molds, pirating, et cetera, counterfeiting.

So are they driving not only the price, but are they facilitating the counterfeiting and the piracy, yes, they are.

COMMISSIONER MULLOY: I think that was a really helpful issue you raised, Commissioner Bartholomew. One thought is that if we had a criminal penalty for companies that know or have reason to know that they're bringing in counterfeit products, then that would put the burden on them to maybe not be doing that. But I think that's something we could talk about.

COMMISSION VICE CHAIR BARTHOLOMEW: Well, I think it's twofold. It's not that they're necessarily going to use the counterfeited products as a component of whatever it is they're manufacturing, but they might be using bids from companies that are counterfeiting to drive the price down.

MR. BRILLIANT: I fully understood your question, yes.

COMMISSION VICE CHAIR BARTHOLOMEW: Yes. Yes. I would like to talk to you more just in terms of understanding.

MR. BRILLIANT: Yes.

COMMISSION VICE CHAIR BARTHOLOMEW: Thank you.

HEARING COCHAIR D'AMATO: Thank you, Commissioner.

COMMISSIONER BROOKES: Thank you very much. Since we have Mr. Jung in all the way in from beautiful Bellevue, Washington, where I actually was last week to give a speech in Seattle and passed through Bellevue, but I did--sometimes we feel like we have answers to fundamental questions and you get group-think and assumptions, but since we have you here, I just wanted to ask you two kind of basic questions. A lot of my other questions have been asked already.

For the record, just so we have your thoughts, since we have the advantage of having you all way in from the West Coast, what is your view, or maybe you could just tick it off because we're getting to the end of the session here, but what is your view of the cost to U.S. interests in losing our technological edge to China or any other country?

And then what do you believe is the likelihood of U.S. losing its technological superiority?

MR. JUNG: Okay. So those two questions, let me address them in the opposite order.

COMMISSIONER BROOKES: Okay.

MR. JUNG: I actually think it's ours to lose, so if we don't make missteps, I think it's a kind of "Chicken-Little" syndrome that runs around every decade, it could be the EU or Japan or somebody else is going to come and eat our lunch.

It doesn't happen, and it tends not to happen because most of the other countries tend to take centrally managed approaches to a system that really just inherently has to be distributed and chaotic. That's the beauty of the American system is that really anyone can succeed. It doesn't matter if they're connected or the central government thinks they have a good idea or what have you; it just works out.

It's a very hard system to compete against, and the odd thing is it's a complete mystery to most governments to figure that out. So I think if we don't misstep and we don't end up taking away the incentives and rights that innovators have that allow them to do that, we will continue to produce the lion's share of the intellectual property of the world,

certainly the key intellectual property of the world.

The cost of losing that, though, is huge because, as many people have pointed out, we are so prosperous an economy, there are a lot of areas in which we are no longer competitive. And the edge we have, whether it's there or in financial services or any number of the sectors where we do well, has to do with creativity. It has to do with things like our agility and ability to adapt to new situations.

And those are almost cultural things. Right. Those are ones that hard for another country to replicate. It's hard for them to mandate: okay, guys, just start being entrepreneurial. It's very hard to do that.

So I am generally fairly confident that if we keep the protections in place that encourages this behavior, we'll continue to do quite well. Again, it's almost a kind of Armageddon kind of scenario for me that we would lose that. It's very hard for me to kind of put that and the United States sort of in the same bucket. So I can't answer that first question really.

COMMISSIONER BROOKES: Okay. Thank you.

HEARING COCHAIR D'AMATO: Thank you, Commissioner Brookes. Commissioner Mulloy.

COMMISSIONER MULLOY: Mr. Jung, on page eight and nine of your testimony, prepared testimony, you point out that China does have a vision and a strategy how to replace the U.S. as the technological leader and are pursuing that; don't you kind of lay that out? They have a vision?

MR. JUNG: Yes, they have a vision.

COMMISSIONER MULLOY: And they're pursuing it at the highest levels of their government. So they're not just letting it to the marketplace. They have a vision and a plan on how to replace us?

MR. JUNG: Yes.

COMMISSIONER MULLOY: Is that correct?

MR. JUNG: That's right.

COMMISSIONER MULLOY: Yes.

MR. JUNG: I mean industrial development, going back to the point that Mr. Brilliant was making, industrial development is done by every country.

COMMISSIONER MULLOY: Yes.

MR. JUNG: And the United States had an industrial development plan very much like this, that, in fact, involved intellectual property theft back in the 18th century, early 19th century. The difference, I think, is just culturally it's very hard for these kind of governments with these kind of plans. It looks really scary because they have this allegedly centralized government. As I think Mr. Brilliant also pointed out, they're not really as central as you think. In fact, they're sort of the weakest they've been since World War II.

There's a lot of social/political issues they have to deal with. There's a lot of just problems that's going to make it difficult for them to really execute on this in a way that is likely to be very successful.

COMMISSIONER MULLOY: Do we have such a plan?

MR. JUNG: No, we don't have as much industrial policy in the United States, but we have a lot of entrepreneurs.

HEARING COCHAIR D'AMATO: Thank you.

MR. BRILLIANT: May I respond to the commissioner?

HEARING COCHAIR D'AMATO: Yes, go ahead.

MR. BRILLIANT: The only thing I would say is that it was a somewhat leading question. I think China has an industrial policy for sure, and China's policy is geared towards nurturing certain industries to be world-class, and that presents challenges to the United States as it does to the European Community.

I don't want to take it to the point that it's about the United States. I think it's about China. I think a lot of their industrial policy is about putting China on the map on a higher end, not just a low-wage manufacturing economy but a higher end, and that's going to be competitive against not just the United States but Europe and Japan and other developed countries.

So I think a lot of what China is doing does have ramifications for us and we do have to watch it carefully, but it's not about beating the United States. It's about their own economic development.

What we have to do here is to focus on our own economic development, take China, challenge them where we need to challenge them, but also focus domestically on our competitive challenges.

COMMISSIONER MULLOY: Thank you very much. I agree with that.

HEARING COCHAIR D'AMATO: Thank you. Commissioner Houston.

HEARING COCHAIR HOUSTON: Yes, thanks to both of you for being here, and I will ask a brief question. If you organize a Neighborhood Watch program because your houses are getting broken into, it's unlikely that the burglars are going to show up at the meetings.

Both of you have mentioned that you go to China, and you meet with stakeholders, business leaders, I assume that the bad guys are not in the room. My question is for Mr. Brilliant sort of on the widget side and for Mr. Jung on the pirating of software and those kinds of issues.

When you go over to China and you meet with these folks, what is the dynamic there? Is the dynamic that you're meeting with government leaders or you're working with private sector leaders who get it, as we would say over here?

And is there a dynamic between the two? The business leaders that

you both mentioned, who are interested in sort of honestly brokering IP, do they put pressure on the government? Does the government then put pressure on people who are misbehaving? What is that dynamic there? Do you see it at all?

MR. BRILLIANT: Actually, I had a cockroach analogy that I used on TV, which was that you can terminate cockroaches in one room of your house, but fail to look at the rest of the house, you're not going to have a very good strategy.

Look, I think in China, I think the reality is that we deal with a whole range of people. We deal with people who get it, who want to make sure that China is at the technological edge, is innovating and they need to protect intellectual property, and that can be in the government, that can be in the private sector, it can be at the provincial level.

We get people who also recognize the job issues. There's a lot of jobs created through illegal activity in China, and so in some provinces, one of the issues is to deal with that as a legitimate issue for all of us to address, which is if you've having double-digit growth and you've got unemployment pretty low, or you're creating jobs, and some of this is through illegal activity, there is an element of corruption, and so when we deal with provincial leaders or we deal with state-owned enterprises, that's one of the challenges that we all deal with.

And in our job, we, of course, have to deal with all facets of society. The Chamber is a broad-based organization--the American Chamber is there--deal with all segments of society. You have to obviously engage those who are on board with you. Those who perhaps are not moving as fast as you want, you've got to engage them, so that they move more rapidly towards the same goals and objectives that you have. And then you have to deal with other elements of society which perhaps are behind the curve or perhaps working against your interests. You have to try to neutralize them.

Obviously, you have the most success with those who want to engage you and who share your goals and aspirations. We just need to widen that base in China.

MR. JUNG: Well, I'm guessing, just looking at Mr. Brilliant's card, that he probably--it's harder for him to meet a certain element of people carrying this card than for me.

MR. BRILLIANT: Well, you flip it over, it's in Chinese.

MR. JUNG: I see. Well, does it say the same thing? That's the interesting question. I started businesses in five countries in Asia, and when you do that, you actually do meet a wide variety of elements, some of which expose you to the kind of corruption that's necessary to actually get a business going in some cases.

So I think I got a fairly wide view and a very varied view in terms

of the kind of interests that are there. It does range from people who are making good money and continue to want to make good money off of illegal activities all the way to people who actually really do see it necessary to clean it up.

However, I have met nobody who believes that China can triple their GDP by pirating. It just won't work. No one is believing that's going to happen. Now, there's a question of, if it's ten percent of their GDP, do they want to lose it, you know, take that kind of bet to increase the GDP somewhere else? And that's something that we have to apply pressure to make them believe that that's a bet they have to take. I mean that's a tradeoff they have to make because obviously if they didn't have to make that tradeoff, they wouldn't. Right.

But at the same time, I just want to go back to the point is there are a lot of people there who truly believe in this system which is all about creating intellectual property and protecting intellectual property. I was actually quite surprised how much support there is there for it. Like I said, I came there maybe with a bias that the communist countries don't believe in any kind of property.

To hear senior officials and many business people there talking very aggressively about how they want to defend property of this type, at least, was quite astonishing to me, so I just want to make sure we keep that in mind, the carrot/the stick, and also our own domestic support for it.

HEARING COCHAIR D'AMATO: Thank you. Thank you, commissioners, and thank you both for your excellent testimony, for giving your time so freely to the Commission this morning. We appreciate it very much, and the Commission will break for lunch at this time.

MR. JUNG: Thank you.

[Whereupon, at 12:15 p.m., the hearing recessed, to reconvene at 1:00 p.m., this same day.]

A F T E R N O O N S E S S I O N
[1:00 p.m.]

PANEL IV: COPYRIGHT INDUSTRIES

HEARING COCHAIR D'AMATO: The Commission will come to order. Our fourth panel of the day will focus on the particular concerns of copyright industries.

Jay Berman, founding partner of Berman Rosen Global Strategies, will provide testimony on behalf of the recording industry. Mr. Berman has worked on the passage of the Audio Home Recording Act of 1995, the Digital Performance Right in Sound Recordings Act of 1995, helped to author the Special 301 provisions in U.S. trade law, and was instrumental in defending the recording industry from censorship attacks. He has served as the President, CEO, and Chairman of the Recording Industry Association of America.

We are also joined by John McGuire, Senior Advisor to Screen Actors Guild. In addition to assisting in the union's major contract negotiations, Mr. McGuire has represented the union internationally at meetings with performer organizations around the world, and he is also President of the Council of Motion Picture and Television Unions of New York City.

Finally, the Commission is pleased to welcome back to the Hill Pat Schroeder, Congresswoman Patricia Schroeder, President and CEO of the Association of American Publishers.

Ms. Schroeder left Congress undefeated in 1996 after representing Colorado's First Congressional District in the House of Representatives for 24 years. During her tenure, she was the Ranking Member of the House Judiciary Subcommittee on Courts and Intellectual Property.

We can go in whatever order you would like. Why don't we start with Mrs. Schroeder if you would like and take as much time you would like and then we'll go to each panelist and then to some questions.

Thank you very much.

STATEMENT OF PATRICIA SCHROEDER, PRESIDENT AND CEO, ASSOCIATION OF AMERICAN PUBLISHERS, WASHINGTON, DC

MS. SCHROEDER: Thank you very much, Commissioner. I want to thank all the commissioners for this invitation. I really, really appreciate your focusing on this terribly important issue, and I know you have heard many, many people talking about how important intellectual property is and the protection of it in China, this new huge developing market that we're very concerned about and so we particularly are pleased

at being included.

The Association of American Publishers, of which I am the president, represents the $25 billion book industry in the United States and we've had quite an interesting experience in anti-piracy in China.

In 2005, we very conservatively estimate American book publishers lost $52 million in piracy there. That does not include at all the digital piracy that we're now seeing, and we're just getting phenomenal number of new calls everyday. It's like it's increasing tenfold every few weeks of the digital piracy, so we haven't even come close to guessing what that's going to be.

The reason I say our statistics are so conservative is the way we did it is we asked our members to guess how many students were working and how many courses in China that had adopted their books, and obviously people don't know if they're not really buying them. So it's kind of a really low-ball estimate.

And then also we find pirated books all over the street. So, people made a few guesses about that. But we really, it's a very, very conservative one. We think it's probably much higher and especially if you put in the digital piracy on the Internet.

Obviously, book piracy manifests itself in different forms in China. One of the things that we are terribly concerned about right now is what is going on in universities. We have found in universities, they are taking American textbooks like this one, a very exciting topic, Engineering Mechanics Statistics, but they take them and many of them in the university copy shop just plain copy the whole thing, bind it and give it to the kids free.

Some even put their own stamp of the university on it, so it's a total taking. Now, I don't think it's any secret that our higher education publishers are the platinum standard for the world. Everybody wants our higher education publishing and China wants education, and so this is just rampant at universities all over.

We have collected all sorts of information on this and we have it in front of the Chinese government at this time. Clearly, the Chinese government could do something about this if they want to since they govern the schoolhouse, and we think it's really very unfair because these books cost a lot to make and they've got every kind of book, we've got orthodontics, every kind of higher ed book possible we have found over there that that has happened to.

Some universities don't brazenly do it in their own copy shop, but they allow copy shops around the university to do it, and the kids get it. So no matter what, this is huge, we're very concerned. We've got lots of data on it. It is in front of the Chinese government and we're certainly hoping they take action because it would not be hard to do so.

We also find all sorts of trade books such as these that are both translated without permission and out there. We also find the regular, in English out there without permission, all over the streets. In fact, at September's or last September's Beijing Book Fair, a staffer went out and bought the Harry Potter books pirated all right outside the book fair. So it's really clear, you can get them in stands anywhere, and nobody seems to care.

They're in bookstores; obviously, there seems to be no penalty for taking any of these books, and as I say they're everything, they're business books, they're any kind of book you want.

China is obviously full of scholars and people trying to learn and people wanting to better themselves, and books are sold all over the place. If you go to the bookstores in China, you can hardly get through them. It's amazing. People are in the aisles trying to get these.

So obviously, this are hot and pirated copies. So we are terribly concerned about that and then, of course, sometimes they take the stuff. There was one Bill Clinton book we found that had Hillary Clinton's book inside of it and vice versa. There are all sorts of stuff that goes on that's not really legitimate but nevertheless that transpires.

One of the fastest growing problems, as I said, is the Internet digital piracy which just, I can't tell you how fast the claims keep coming in, and that's very concerning, where people just scan the book, put it up there and let everybody take it. So that's a big one.

Let me mention another one. I know you know a lot of about trademarks, but we're finding the same thing with our book publishers on trademarks. This, for example, has the Harvard University seal on it. We can find them all over too with the other university seals on it, Cambridge University and so forth.

A little story about this. The Harvard University Press went into one of the bookstores in China and asked to see all the books that had Harvard on it, and they brought a whole pile. None of them had anything to do with Harvard. Our favorite was one of them had a recommendation from Einstein which we thought was really quite remarkable.

It's hard to get a recommendation from someone from the grave, and they had made-up recommendations and reviews from the New York Times and the Washington Post. But these are really hot sellers over there because people want to improve themselves. So these aren't pirated. These are just, they take the trademark and slap it on anything and then sell the Harvard trademark. So we even have trademark issues that are very concerning.

Part of this, too, goes to market access. Publishers are not allowed to import over there. They're not allowed to publish over there. The government gives out the numbers, the ISBN numbers, and if you're a

publisher, you're not going to get one, thank you.

So if you can't import and you can't publish there, what happens is you then have to have a local partner, and some local partners are good and some aren't, and there are all sorts of problems with that, and so part of our really being able to deal with piracy is not being able to participate in the market as full players.

I must say the good thing that I can tell you is it's not just American publishers; it's Chinese publishers that are equally interested. We have been working with the Publishers Association of China, if you can believe it. We have now had two day-forums on anti-piracy issues in China. We said you're very brave to be working with us. The last one was here in Washington. The first one was in Beijing. And they said we're getting ripped off equally as bad; we can't help but not work with you. Are you kidding?

It really is across the board and they're hurting their own. As you mentioned, I have been a member of Congress, and I see the red light is on, and so I know I should behave myself and go to questions later on, but I just want to say we are working very hard with our government officials. We are working very hard with the Chinese Publishers Association. We're working with the British Publishers Association and everyone else trying to find out how we can be better players in the market, which is very important, and how we get this piracy under control, because it just is totally out of control and it's hurting everybody including Chinese publishers, and with that I'll reserve the best and we'll do questions later.

Thank you very much for inviting us.

[The statement follows:]

Prepared statement of Patricia Schroeder, President and CEO, Association of American Publishers, Washington, DC

The Association of American Publishers (AAP) thanks Commissioners C. Richard D'Amato and Kerri Houston and the U.S.-China Economic and Security Review Commission for the opportunity to participate in the public hearing of June 7-8, 2006, concerning protection of intellectual property rights in China. The pervasive problem of piracy and counterfeiting in China, exacerbated further by restrictions on market access, are some of the most important issues facing China and the U.S. today.

About AAP

The Association of American Publishers is the national trade association of the U.S. book and journal publishing industry—an industry with 2005 sales exceeding $25 billion. AAP's more than 300 members include most of the major commercial book publishers in the United States, as well as smaller and non-profit publishers, university presses and scholarly societies. AAP members publish hardcover and paperback books in every field, educational materials for the elementary, secondary, postsecondary, and professional markets, scholarly journals, computer software, and electronic products and services. The protection of intellectual property rights in all media, the defense of the freedom to read and the freedom to

publish at home and abroad, and the promotion of reading and literacy are among the Association's highest priorities.

Introduction to Book and Journal Piracy in China

In 2005, AAP conservatively estimated losses to U.S. publishers in China at $52 million, not including losses due to piracy on the internet. Visits to China and discussions with our member publishers reveal a staggering amount of book piracy plaguing this most promising of markets.

Book piracy manifests itself in a number of different forms in China. Illegal commercial scale photocopying of academic materials is the industry's most immediate concern. Print piracy (unauthorized reprints approximating the quality and appearance of the original) and illegal translations have profound effects on the market as well. Internet piracy in the form of sites offering illegally scanned books for download, peer to peer trading and unauthorized access to electronic journals and other database compilations, is growing by leaps and bounds. Furthermore, trademark counterfeiting, especially with regard to books produced by university presses, misleads Chinese consumers. All of this is exacerbated by market access barriers that deny foreign publishers the ability to freely import into the Chinese market, distribute their own materials, obtain local Chinese book publication numbers or print for the local market.

- *Commercial photocopying*

One of the most destructive forms of book and journal piracy is the type of commercial-scale illegal photocopying of academic materials that takes place on and near schools and universities all over the world. The mechanisms differ slightly from place to place. In some cases, most of the photocopying takes place at small copy shops lining the campuses. These shops often appear to be minute, independent operations, but in reality are frequently linked in ownership and highly organized. On-campus facilities are often used by individuals or organized groups to make illegal copies as well, including library books and copy machines, copiers in student centers and academic buildings and commercial operations leasing space on the premises of the institutions.

In China, this is taken one step further. Almost every Chinese university has at least one "textbook center" on campus, run by the university itself and charged with distributing textbooks to students at the start of each term. In some cases, these textbook centers are distributing legitimate texts, legally printed or imported for the use of the students. In the vast majority of cases, however, AAP representatives have found that these centers are distributing photocopied texts in large quantities. These copies are invariably made on the premises of the textbook center, presumably at the request of the university authorities or the lecturers adopting the books. It is in some cases a highly organized practice, complete with stock lists, storage warehouse, bar codes and colorful covers bearing the name of the university or department, or the university crest.

It is important to note two things when discussing these textbook center practices. First, being mindful of the notion of "fair use" or "fair dealing" in academic materials—legal provisions stipulating that a certain amount of copying is permissible for purposes of private study or research—it is important to note that the copying taking place at these textbook centers far exceeds the possible bounds of fair dealing. Routinely, books are copied in their entirety. Large portions of books or journals included in "compilations" go well beyond "fair use" as well. AAP respects the balance reflected in the fair use provisions contained in international agreements. These practices, however, disrespect that balance greatly. Second, it is important to emphasize that these textbook centers hurt Chinese publishers just as much as foreign publishers. Many of the illegally copied books found in textbook centers are Chinese language, Chinese published books. This results in massive losses to a local industry that is trying to establish itself in an

international marketplace.

The practices of these textbook centers, undertaken with either the tacit or active consent of the universities themselves, are destroying the market for English and Chinese-produced textbooks alike. AAP and its sister association in the U.K. have brought this matter to the attention of the relevant authorities in China, asking them to monitor this practice—rampant in all major universities, as well as primary and secondary schools—and use its authority through the Ministry of Education and other pertinent agencies to compel use of legitimate products on campuses.

- *Print piracy and translations*

Print piracy and unauthorized translations have a profound effect on the market as well. Bestsellers such as the Harry Potter® series, Dan Brown's novels and political autobiographies are pirated in English and Chinese within days of their home country releases. These books—of varying quality— are readily available in retail markets and street stalls, apparently without fear by the vendors of any government action. Last September, an AAP staff member purchased a pirated Chinese language copy of the sixth Harry Potter® book from a street vendor immediately outside the Beijing International Book Fair venue! Clearly, the boldness of the pirates suggests that enforcement measures to date have not been effective.

Until about two years ago, print piracy of all books was the prevalent form of piracy in China. This was due, in part, to the high cost of photocopy paper and implements—it was more profitable to undertake an entire print run of a bestselling commercial or professional book. While photocopying has caught up and perhaps surpassed this problem in prevalence, the issue of print piracy remains significant. Print piracy's effects are especially severely felt among publishers of high end technical books, reference books and English language teaching books, as well as commercial fiction.

Print piracy exists primarily in two forms. The first involves print overruns by an otherwise legitimate Chinese printer. This licensing issue is exacerbated by the market access restrictions in place (see below) that prevent U.S. publishers from engaging in direct contracts for printing for the Chinese market. Instead, U.S. publishers must partner with a Chinese publisher, who handles all contracts for book production. This lack of control over the contractual relationship means that U.S. publishers find it difficult to control licensees who violate the contract terms by printing more copies than licensed and selling the "rogue" copies for an extra profit. They then return the unsold legitimate copies to the publisher, who bears the full risk of estimating market demand under the industry's "remainder" system. Foreign publishers will remain vulnerable to this practice until market access barriers as to printing are removed.

The second form is outright piracy by an entity that has no license to print the book at all. In some cases, book pirates target an English language book that they are able to replicate almost exactly, thus being able to print a book that is virtually indistinguishable from the original. In other cases, books are clearly pirated—the quality varies greatly. Most translation piracy involves print piracy of this type—often poor quality translations, bound at a printing press. This hurts not only the original foreign publisher, but also the Chinese publisher who was granted the legitimate translation rights.

Recent studies suggest that underground dealing of pirated bestsellers, especially at places such as the Beijing Book Market in Tianshuiyuan, is flourishing. AAP suspects that Tianshuiyuan is the primary source for pirated books sold in the street vendor network in Beijing.

- *Internet piracy*

The industry's fastest growing problem—a problem we share with many of our fellow copyright industries—is internet piracy. Just in the last six months, complaints from publishers about scanned books being traded online have increased significantly. Clearly, this is a problem that threatens to do more harm to our industry than all other problems combined.

Web sites offering free book downloads are thriving. These books in most cases do not originate in electronic form, but instead are scanned versions of hard cover books. Reports indicate that these scanned versions are, in turn, reprinted and bound for distribution by second hand bookstores, with the label "e-book." Peer to peer trading of books online is growing by the day, and site operators of both types are using loopholes in the regulations governing internet infringement to affect the utility of notice and takedown mechanisms. For instance, AAP has tried for months to shut down sites such as www.fixdown.com, only to have it and other sites blossom.

In addition, electronic piracy is affecting publishers of academic and professional journals in a different way. These journals, originating this time in electronic form, are usually made available by publishers to institutional subscribers through use of passwords or similar "gateway" mechanisms. Increasingly, journals publishers are seeing evidence of these electronic "gateways" being left open or accessed by unauthorized users. Publishers have also reported evidence of abuse of "trial" samples of electronic goods sent to libraries through extensive unauthorized sharing of these samples among institutions.

- *Trademark counterfeiting*

While most book publishers are primarily focused on copyright piracy, trademark counterfeiting affects the industry as well. Counterfeiting is often incidental to copyright piracy, as pirates use the famous imprints of American publishers to get attention from readers. This is taken to a new level when well-known publishers' names are used on books that bear no content produced by that publisher at all! These books, available at mainstream bookstores in China, mislead consumers as to the origin of their content.

In addition, book publishers suffer from a sort of "passing off," by which books bearing titles and fictional authors' names similar to bestsellers are marketed at the expense of the legitimate authors and publishers. By one example, former President Bill Clinton's book was marketed, before release in China. One version contained long excerpts of Senator Hillary Clinton's book in place of President Clinton's writings.

- *Market access*

One will never effectively tackle a piracy problem without ensuring that legitimate product is available for the market in question. We cannot divorce the concept of market access from the question of piracy. As of right now, foreign publishers cannot print for the Chinese market without partnering with a Chinese publisher. Foreign publishers cannot obtain local book numbers allowing them to publish books, or import books into China without the aid of a State-authorized import agency. They cannot distribute their own materials. AAP believes wholeheartedly that, in order for publishers to be able to tailor a product to the market—in substance and in price—foreign publishers have to have better access to the market than they do today.

Publishers understand the needs of a local government to exercise some degree of content control, and remain willing to abide by China's censorship process. Yet, the censorship process should not be coupled with such severe restrictions on activities in the market. Lifting restrictions on printing books already available in the Chinese market would resolve some issues without compromising the Chinese

government's goals of control of content.

Market access issues affect the ever-growing market for online content as well as hard goods. Restrictions on, 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.

Restrictions on trading and distribution rights force publishers to import and disseminate books through licensed import agencies and government companies, resulting in price increases and delays. AAP believes that China has made a commitment to open up these activities to foreign entities and has asked for opportunities to examine the laws and regulations affecting these practices. China's lack of transparency with regard to these laws and regulations must be improved. Certainly, there is nothing in the documents to which AAP has been granted access to suggest that these practices have been opened up. Indeed, we remain concerned that documents exist that may explicitly establish that these practices remain closed. AAP calls on China to increase its transparency with regard to all provisions pertaining to implementation of its obligations under international agreements.

Industry Efforts and Activities

On May 19, 2006—just a few weeks ago—AAP partnered with the Publishers Association of China and the Publishers Association U.K. to bring a dialogue on book publishing and intellectual property rights protection in China to BookExpo America, the largest book publishing trade show in the United States. The program featured speakers from the General Administration of Press and Publication of China, the Chinese Institute of Publishing Science, the U.S. Patent and Trademark Office, the Office of the U.S. Trade Representative and many industry bodies from China, the U.S. and the U.K. This dialogue featured hopes and plans for bilateral engagements as well as recognition that piracy is a common problem affecting both economies and a host of book-related industries.

The May 19 program was an outflow of a groundbreaking event held at the Beijing International Book Fair in September 2005. Also cosponsored by the Chinese, British and U.S. publishing associations, the program was entitled "Intellectual Property in the Global Economy: China's Place in the World Publishing Community" and featured speakers from the U.S. Embassy Beijing, the National Copyright Administration of China, the General Administration of Press and Publication of China, the Beijing Municipal Copyright Bureau, Renmin University, the Chinese Academy of Social Sciences and several publishing associations and companies. Again, all came away with the clear conviction that there was a common goal to pursue.

AAP, along with its sister association in the U.K., has also taken its piracy and market access concerns directly to the Chinese government and has a number of administrative complaints pending concerning the illegal photocopying at the university textbook centers. AAP and its members also continue to combat web sites offering illegal content for download or trading, and we are ever gathering information about the market to inform us of next steps.

Conclusions and Industry Suggestions

The industry is working hard to inform itself, inform the authorities and make a dent in this landscape of piracy. AAP and its members firmly feel, however, that government to government dialogue is essential in bringing about meaningful change in the Chinese market place. We encourage the Administration and Congress to keep engaging the Chinese government in a variety of venues, consistently emphasizing the need for strong intellectual property rights protection for China's local industry as well as foreign industry. China is a country that boasts millions upon millions of eager potential readers and scholars, and these readers are largely being supplied with illegal goods.

AAP asks that discussion of book piracy be stepped up in the Joint Commission on Commerce and Trade talks, with legitimization of textbook centers a priority in that process. AAP also joins its fellow copyright industries in asking that the U.S. government continue to pursue strong laws and regulations governing internet infringement, in hopes of saving the market from utter destruction by file-sharing and downloading sites. Third, AAP emphasizes the need for more effective enforcement against hard goods pirates, through the administrative, civil and criminal systems. Finally, AAP stresses that market access for foreign companies is imperative in the fight against spreading piracy, and that transparency of laws and regulations affecting both market access and intellectual property protection must be increased. AAP looks forward to working with all relevant parties to ensure that the market becomes increasingly viable for legitimate businesses.

Thank you.

STATEMENT OF JOHN MCGUIRE
SENIOR ADVISOR, SCREEN ACTORS GUILD, NY, NY

HEARING COCHAIR D'AMATO: Thank you very much, Congresswoman. Mr. McGuire.

MR. McGUIRE: Well, good afternoon, and I'd just like thank the commissioners for holding this hearing today. My name is John McGuire. I'm the Senior Advisor for the Screen Actors Guild. I speak today on behalf of 120,000 members of the Screen Actors Guild who live and work around the world.

SAG members have brought countless hours of entertainment to global audiences and are proud to be a part of the creative community and to contribute to our American culture. Piracy is a grave concern to actors and has a direct and painful impact on their earnings.

In addition to the compensation for original session work, actors receive residual payments based on the supplemental use of their work product. We have fought hard over the almost 75-year history of Screen Actors Guild to improve the wages and working conditions for our members through the collective bargaining process.

Many times, this means we are giving up on our front-end compensation in return for additional payments when and if the movie or television program has an afterlife. The more successful the project, the more the copyright holder and the creative artist receive in back-end compensation, a simple equation. A popular movie will enjoy big box office numbers, more DVD sales, cable exhibitions, and other types of exhibition areas.

The vast majority of actors, these kind of residual payments help to offset the slow periods between jobs, the lack of adequate work opportunities, and their own lower up-front payments. Pirating takes those payments right out of our members' pockets and puts them into the pockets of criminals.

Much is said about the growing loss of revenues that the studios are

incurring as a result of piracy. We agree that those losses are profound and impact our employer's ultimate ability and desire to make movies. But there's also a very personal impact on every actor who works on a project when thieves preempt legitimate box office and DVD sales. Not only are residual paychecks smaller or nonexistent, but as a result actors may not meet the earnings thresholds to qualify for the union's health and pension plan, thus leaving our members and their families without health insurance.

No one in this room today would instruct a child to go into a store and steal a DVD; yet, the practice of illegal downloads and buying bootleg DVDs has been condoned in many households around the world. Writers, directors, technicians, craftspeople, they all share in the loss of revenue each time a movie is sold in some back alley, all under the misdirected guise of who cares if we are ripping off corporate America, when in reality the pain is felt the most by middle-class American workers.

We have worked with the FBI and many American universities to help educate young children and college students about the consequences of piracy. Our highest profile members have spoken out and made the case for legal downloading. Like the burgeoning iPod generation, people are getting used to the idea of buying music on the Internet. We want the same practice to apply when it comes to our work product.

We need more help. Law enforcement agencies around the world must enforce anti-piracy laws and shut down the offenders. We need pirates prosecuted to the full extent of the law. We need to continue and bolster our education and outreach efforts, to inform the public that they are, in fact, committing a crime when they use unauthorized copyrighted materials in any manner.

But in truth, our own country and our own producers have failed to take the steps necessary to protect the rights of performers to share in the proceeds from the supplemental markets and equally as important to be able to protect their images, their voices and their reputations.

Presently, producers and authors and soon broadcasters are protected by international treaties. Performers whose work is contained in sound recordings are also protected by treaty. Only the audio visual performers are denied this protection.

Our own members from Screen Actors Guild receive some level of protection through our collective bargaining agreements. But there are thousands of performers around the world that have no protection at all. Frankly, it is a disgrace that we fight to stop the piracy of our members' performances and yet there is nothing being done to ensure that they will really share in the legitimate proceeds that flow from the legal sale of those same performances.

I will be glad to talk a little more about that latter part during the question and answer session, but let me just close by thanking you for inviting us to have the voice of the performer heard today and to have hearings on this very important topic.

Thank you.

[The statement follows:]

Prepared statement of John McGuire
Senior Advisor, Screen Actors Guild, NY, NY

Good afternoon, and thank you cochairs D'Amato and Houston for holding this hearing today. My name is John McGuire and I am Senior Advisor for Screen Actors Guild. I speak today on behalf of 120,000 members of Screen Actors Guild who live and work around the world. SAG members have brought countless hours of entertainment to global audiences and are proud to be a part of the creative community and to contribute to our American culture.

Piracy is of grave concern to actors and has a direct and painful impact on their earnings. In addition to compensation for original session work, actors receive residual payments based on the supplemental use of their work product. We have fought hard over our almost 75-year history to improve wages and working conditions for Guild members through the collective bargaining process. Many times this means we are giving up our front end compensation in return for additional payments when and if a movie or television program has an afterlife. The more successful the project is, the more the copyright holder and the creative artists receive in back end compensation. It's a simple equation. A popular movie will enjoy big box office numbers, more DVD sales and cable exhibitions, etc. For the vast majority of actors, these residual payments help to offset slow periods between jobs, the lack of adequate work opportunities and the lower upfront payments. Pirating takes those payments right out of our member's pockets and puts them into the pockets of criminals.

Much is said about the growing loss of revenues the studios are incurring as a result of piracy. We agree that those losses are profound and impact our employer's ultimate ability and desire to make movies. But there is also a very personal impact on every actor who works on a project when thieves preempt legitimate box office and DVD sales. Not only are residual paychecks smaller or non-existent, but as a result actors may not meet the earnings threshold to qualify for the union's health and pension plans, thus leaving SAG members and their families without health insurance.

Not one of us in this room today would instruct our child to go into a store and steal a DVD. Yet the practice of illegal downloads and buying bootleg DVDs has been condoned in many households around the world. Writers, directors, technicians and craftspeople all share in the loss of revenue each time a movie is sold in some back alley. All under the misdirected guise of "who cares if we are ripping off corporate America," when in reality, the pain is felt the most by middle class American workers.

We have worked with the FBI and many American universities to help educate young children and college students about the consequences of piracy. Our highest profile members have spoken out and made the case for legal downloading. Like the burgeoning iPod generation, people are getting used to the idea of buying music on the Internet. We want the same practice to apply when it comes to our work product.

We need more help. Law enforcement agencies around the world must enforce anti-piracy laws and shut down the offenders. We need pirates prosecuted to the full extent of the law. We need to continue and bolster our education and outreach efforts to inform the public that they are in fact, committing a crime

when they use unauthorized copyrighted materials in any manner.

But, in truth, our own country and our own producers, have failed to take the steps necessary to protect the rights of performers to share in the proceeds from supplemental markets and, equally as important, to protect their images, their voices and their reputations.

Presently, producers and authors and soon broadcasters, are protected by International Treaties. Performers whose work is contained in sound recordings are also protected by treaty. Only audio-visual performers are denied this protection.

Our members receive some level of protection through our collective bargaining agreements but thousands of performers around the world have no protection at all. It is a disgrace that we fight to stop the piracy of their performances and yet do nothing to ensure that they share in the legitimate proceeds that flow from the legal sale of those same performances.

Again, thank you for inviting me here today and for focusing on this important topic.

HEARING COCHAIR D'AMATO: Thank you very much, Mr. McGuire, and we'll get back to that during the question period. Mr. Berman.

STATEMENT OF JASON S. BERMAN
FOUNDING PARTNER, BERMAN ROSEN GLOBAL STRATEGIES, LLC, New York, N.Y.

MR. BERMAN: I want to thank the Commission and the cochairs for the opportunity to appear here again. Let me start by saying that while a great deal has happened in regard to intellectual property protection in China since I was here last year, very little has actually been achieved in terms of significantly reducing piracy. I use the phrase "significantly reducing piracy" because that was the stated goal set out by the United States and China in the April 2004 declaration of the Joint Committee on Commerce and Trade.

Yes, there has been enforcement activity in China, most recently a great deal more of it. There has been a flurry of legislative and regulatory activity. All of this I attribute to the intense interest expressed by every branch of the United States government involved in trade discussions with China.

Hundreds of millions of pirated disks have been seized, a small number of production lines have been disabled, a few high profile retail markets have been closed, and the number of administrative actions against piracy has increased significantly.

This needs to be acknowledged. Unfortunately, the sum total of all these actions has not produced the significant reduction. What precisely is the disconnect in this process?

I think it can be explained by three things or more precisely the

lack of three things: a lack of transparency at every level of activity within the Chinese government; a lack of market access; and most importantly a lack of effective enforcement.

The lack of transparency. This is most evident in regard to the extraordinarily large number of optical disk plants known to be operating in China, which is the very source of the problem since the overwhelming majority of pirated product in China is produced in China. The recording industry and the United States Trade Representative Office have pressed for a joint cooperative effort with the appropriate Chinese authorities to undertake a plant visit and verification program. Such a program, based on inspections, verification of internal procedures, for ensuring that legitimate orders are executed and the gathering of exemplars from every production mode would permit scientific verifiable identification of pirate disks and the facility that produced them.

Every production mold has a unique characteristic, the equivalent of a fingerprint. It's not discernable to the eye. It has to be looked through a forensic microscope, but it will have a unique identifying line on it. and that will tell you exactly where that disk is produced.

Unfortunately, this may be too much transparency for the Chinese because to date, they appear unwilling to reach agreement on such a private-public plant visit program. Not that such programs in countries with major optical disk piracy problems have been implemented and proven successful--Thailand, Bulgaria, Indonesia and the Ukraine, to name a few.

Second, the lack of market access. What does it have to do with piracy? Actually a great deal. It's hard to imagine that piracy can be reduced significantly if the legitimate industry is severely restricted in its ability to develop the marketplace and we face such restrictions in China.

The Chinese do not allow foreign sound recording producers to enter the market except as minority shareholders in a joint venture with a Chinese company. By requiring foreign record companies to release or publish a record only with permission of a state-owned publishing house and then denying record companies the ability to integrate production, promotion, distribution and sale, all of this fragments the market, results in higher than necessary costs, and makes it impossible to deliver the product to market as quickly as the pirate.

For the recording industry, the old quota system seems to have disappeared, but the same measure of control is now exercised, only more subtly and ingeniously through delays in censorship clearance and the need to operate through Chinese entities.

If the legitimate market cannot be developed, the pirate market will continue to flourish. The irony of having pirated versions of recordings deemed inappropriate so readily available in every marketplace, while the

authorized version might be languishing in the hands of a bureaucrat, seems to have lost on the Chinese.

So while I wouldn't necessarily recommend this recording by the band Garbage, for whom it might be such, interestingly enough the pirated version carries a parental advisory. The lack of effective enforcement. Here the operative word is "effective" because as I have already acknowledged, there is enforcement. It is just not effective and it never will be as long as there is no deterrence in the process. You have heard it for years. The lack of criminal penalties in the enforcement and judicial processes makes the relatively small fines imposed a cost of doing business, and the pirates are happy to pay for the privilege of being back in business the very next day.

I might point out that this is not something that is unique to the recording industry or to the film industry. There was a recent case interestingly enough of counterfeit Zippo lighters. 32,900 counterfeits were uncovered. The eventual fine was the equivalent of $12,500 on the basis that the Chinese valued the counterfeit at a counterfeit price of 37 cents. That is not going to get the job done.

Let me cite another example of why this will not result in significant reduction. That is the more recent and much touted closing of the Xiang Yang Market in Shanghai. This was trumpeted at the conclusion of the April meeting of the Joint Commission as evidence of the seriousness of the recent antipiracy campaign.

It was said emphatically the market in Shanghai is closed. Now let me go to a story by the intelligence unit of the well-respected magazine The Economist. Reporting on the closing, The Economist titled its explanation "Another Property Deal," noting that the property housing the market had been sold to developers for many millions of dollars.

You might guess that this was a very creative way of fighting piracy. But then the story went on to point out that in an interview one of the pirate operators had expressed relief at being forced out because the rents had gotten too high and then in a revealing note said, we will continue to sell the same products but in a different part of the city.

The merchant said, and I quote, "The government is already telling some shops to move to the Lonwa [ph] area," and then defiantly concluded, "the market will not go away."

The moral of the story, sad to say, is that neither pronouncements nor press releases nor a mere continuation of the current level of enforcement will prove effective until there is a sustained effort to invoke criminal penalties on a much larger scale, until pirates actually go to jail, until the means and machinery of piracy are confiscated and destroyed, until the pirates are driven out of the mainstream of commerce, not until then will China have met its promise to reduce piracy significantly, as

well as its obligations to do so.

Thank you.[5]

PANEL IV: Discussion, Questions and Answers

HEARING COCHAIR D'AMATO: Thank you very much, Mr. Berman. Thank you all for that testimony. I have on quick question for Mr. McGuire. Based on the material in the last part of your testimony with regard to only audio-visual performers are denied the protection that are afforded to other performers in sound recordings.

What is the reasoning and what is the basis for that discrimination?

MR. McGUIRE: I have actually attended meetings in Geneva of the World Intellectual Property Organization since 1999 on the subject of an audio-visual performers treaty. From 1999 to date, I heard representatives from every country get up and say that they favor an audio-visual performer treaty. To this day, there of course is no such treaty.

The reason lies in the hands of many different governments and many different employer groups. The stated failure that happened in the early 2000 years was because they wanted to put into the treaty a provision--the U.S. did--that, in effect, would incorporate the U.S. work-for-hire doctrine into this treaty.

The European Community and, in fact, almost every country around the world were bitterly opposed to that, and the treaty failed to be concluded principally on that particular ground

We have been very frustrated because we have said to the U.S. government our view is that they should have supported the needs of the performers over the statements from the U.S. producers in this case. I would point out that the work-for-hire doctrine is not part of the sound recording treaty that was passed just in 2000.

So that type of problem and the reason why it's, I think, particularly noteworthy, as relates to piracy, the U.S. too often is viewed as being hypocritical when it talks about stopping piracy on the grounds that the proceeds should properly be shared not only with the producers but the creative community, and then the producers and for that matter, as I say, the U.S. government at times actually stops the types of treaties that would have created these rights for the performers.

HEARING COCHAIR D'AMATO: So we have protection for the sound recording performers but not for the audio-visual performers by treaty in Geneva--

MR. McGUIRE: Yes.

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[5] Click here to read the prepared testimony of Jay Berman.

HEARING COCHAIR D'AMATO: --at this particular time? And then just to clarify one other point from your testimony, in terms of what is lost by the actors and technicians through the piracy process, I think you made the comment that when you look at the losses that producers or the companies, studios cite, $240 million, if you use a rough percentage of that, of 20 percent, would that basically reflect the loss estimated, residual and other costs and payments that would have been received by the acting and technician communities, but not received because of the piracy?

So in a $240 million loss in the producers, $40 to $50 million additionally would be lost to the working American folks?

MR. McGUIRE: Yes, both performers, directors, writers, and technicians, all share in residuals on U.S. works that are done under their contract, so to the extent that piracy is preventing that money to flow to the producer and then, of course, all of those residuals are lost, and those figures are an accurate assessment based on those numbers from the producers.

HEARING COCHAIR D'AMATO: So the future income of that community should be taken into account in understanding what the impact of piracy is on the community?

MR. McGUIRE: And I would just like add, most people think of actors as the handful of our major stars who obviously make an awful lot of money in the industry. The residuals are really the lifeblood of the working actor who is not the star, and probably in the movie and television end, 40 percent of their entire income comes from residuals rather than from the up-front salaries.

So as you begin to take away those sources of income, it becomes more and more impossible for our people to earn a livelihood, and as I said in my testimony, you know how important health care is, and fewer and fewer of our people are beginning to qualify because of these kind of things.

HEARING COCHAIR D'AMATO: Thank you very much. Commissioner Wessel.

COMMISSIONER WESSEL: Thank you to all our witnesses. Congresswoman Schroeder, it is great to see you again and thank you for all your years of service. And, Jay, it's deja vu, as they say--

MR. BERMAN: All over again.

COMMISSIONER WESSEL: All over again and again and again. I want to understand if I can something that, Congressman Schroeder, you started with, which is the limits on our market access. It seems aside from the question of enforcement that some of what we're talking about here is a structural problem, that when the WTO Accession Agreement was signed, we accepted certain restrictions, I assume, that we're now

finding are coming back to bite us in much greater ways than we thought.

As I recall, copyright based industries are our second-largest export, and here we have a major market that we have certain limits. You talked about the inability to get into the market. Jay, the same thing. We see the same thing in movies with structural impediments. I don't know what the number is now. I think we started with 20 movies a year or whatever the number is now.

So we accepted as part of the original agreement a structural impediment. Can you talk about that briefly? Is that, in fact, true? How did we let that happen and what do we do about it?

MS. SCHROEDER: Well, different industries accepted different things. My understanding is the publishing industry didn't have a high enough profile then to do that. So at the time we didn't look like a player, but now we look like we're in better shape.

It hasn't made any difference. The Chinese haven't let us in either. We feel that there's a very strong case that they should be letting us in because we didn't have one of those restrictions on imports and stuff that others had at the time, that they felt they had to agree to, and I think it's just because we were not that big a player at the time.

COMMISSIONER WESSEL: So it was not part of the agreement at the time. It's just their practices in your industry?

MS. SCHROEDER: Yes. They just have not wanted to do it. Now, part of books, I think, is also the censorship thing, if I can be perfectly candid. The government is very strict about if you want to publish, they give you the number, and you can't publish without the number. And I think that's an awful lot of what we've experienced because they don't want imports coming in, and they only want us to work with local publishers that they've got their thumb on, and they're the ones that can get the number. So I think a part of it is that internal system that they've got going that hurts us.

COMMISSIONER WESSEL: So unlike MPAA, which accepted strict numbers to restrict their access--

MS. SCHROEDER: We did not do that.

COMMISSIONER WESSEL: --it's just by action that they do this?

MS. SCHROEDER: Right.

COMMISSIONER WESSEL: Jay, is that?

MR. BERMAN: Actually I don't want to speak for MPAA.

COMMISSIONER WESSEL: I'm not asking you to.

MR. BERMAN: I am somewhat familiar with the circumstances that govern their restrictions. I don't think actually it was something that was embodied in the context of the agreement. I think the sad thing is that it was quite frankly left out; therefore you accepted the status quo, which in fact was known to be that there were quotas for not just

American films but every foreign film. So Americans were competing with the Brits and the Australians and everybody else for the 20 films.

The most important lesson to be learned from this, Commissioner Wessel, I'm afraid is that it might be difficult to resolve this in the context of China. But as I said, in my written testimony, the lesson to be learned here is Russia. We are going down this path with Russian accession to the WTO, and if we make the same mistakes, we will end up, and I'm sure you have other things to do, but there will be a commission on U.S.-Russia trade security, and we will be saying the same things again and again.

So the lesson is that we need to have these things incorporated into our own bilateral agreements with those accession countries. That was not done for most of the market access issues with China. They were simply dropped off the table. So it wasn't that the copyright industries agreed to accept these things. They were not part of the dialogue that led to the U.S.-China agreement.

COMMISSIONER WESSEL: Thank you.

HEARING COCHAIR D'AMATO: Thank you, Commissioner Wessel. Commissioner Brookes.

COMMISSIONER BROOKES: Thank you. I had a question. I guess I probably have some ideas about this, but I was struck by what Ms. Schroeder said in her testimony about books reaching the Chinese market before they even reach the market here.

I completely sympathize with the challenges that you're all up against and agree with them. But how is this happening? Is this through galley copies, this economic espionage, because the horse has already, in a certain way left the barn?

MS. SCHROEDER: I don't know that they are always before, but they're almost simultaneous or very close. As you know, there are galley copies and there are advance reader copies, and you can find those for sale, unfortunately, sometimes on eBay, and there are also digital copies floating around. We're finding that more and more.

But let me just talk about Harry Potter. Very clever to translate that--that's a big book--that fast. They had it translated and on the market. When asked how they did it, they hired a different translator for each chapter. Now, I guess if you can read Chinese, you could tell it didn't flow, shall we say. But it didn't matter because they had it and they had it out. So they're very good about figuring out how to do this.

COMMISSIONER BROOKES: What sort of percentage are you seeing in the publishing industry in terms of things being out before they actually hit the market?

MS. SCHROEDER: Well, we don't know because we don't get a real good report obviously from the bookstores as to what they're selling,

and the stuff on the street, we don't know either. That's why I say our estimates as to how we're hurt are very, very conservative because the one thing we can guess are these university things. Everybody is teaching practically with U.S. materials. It's just they are the international standard. Huge numbers of students and you can kind of estimate that. The trade piracy of our trade books, it's just kind of a random guess for what period pick up.

COMMISSIONER BROOKES: So we're not looking at any sort of sophisticated economic espionage in terms of the publishing industry? And if Mr. Berman has a comment on this, I don't know if he has the same sort of problems, because obviously the high technology element of U.S. industry is targeted deliberately.

Now this is obviously more random, and we can see how this could happen. Somebody gets a-hold of a galley copy and it's off to China, that sort of thing, but you're not seeing anything in those terms in terms of somebody trying to penetrate your organizations, get a-hold of books, and then get them out of the country?

MS. SCHROEDER: I think one of the hard problems that publishers have is there's obviously tremendous transfer in our higher ed stuff for which they're paying nothing; right?

We're really educating the Chinese for nothing. And the problem with it is, is these aren't criminals. These are teachers and students doing this.

COMMISSIONER BROOKES: Right.

MS. SCHROEDER: So it makes it doubly hard to get the government to focus on that. Now, when it comes to these, these are independent--I don't know that we can really prove that it's criminal or that--but it's just an organization that local publishers do it or publishers that are marginal are doing it and getting it on the street.

But this is one of our hardest because these are respectable citizens and think what they're teaching the entire university, that you can just take this stuff and hand it out to everybody.

So we've really got a twofold problem. And whether I could say that it's not really stealing our highest technology, but it is using digital technology and other things to quickly transfer it, get it copied and, as you know, publishing is getting easier and easier, print on demand and everything else, so they can have it out and go with it.

COMMISSIONER BROOKES: Thank you.

HEARING COCHAIR D'AMATO: Thank you, Commissioner Brookes. Commissioner Reinsch.

COMMISSIONER REINSCH: Thank you. I just have one question for Ms. Schroeder. You made some very interesting comments about working with the Chinese publishers who have the same problem. What

do they tell you about their conversations with their own government? Are they lobbying?

MS. SCHROEDER: That's an excellent question. I have found this to be one of the most interesting things that has happened because when we asked them to partner with us, we just thought they'd close the door and say go away.

Instead they wanted to tell us about all their problems, and no, they aren't lobbying their own government in particular. These are, the Chinese Publishers Association are the good guy publishers that are in cahoots with the government. Most of them are part of the Party and they are the trusted one. They're not the pirated ones out on the street. And so I think because of their position in the Party, and they're kind of quasi-government, they hate to take on their government, but they understand that they're getting hurt.

That's the only reason I can think of why they're willing to work with us. I mean they don't come and tell us that, but the big surprise, that they were willing to be on the stage with us at the Beijing Book Fair for a day talking about Chinese piracy, and they were willing to come over here this May at our largest U.S. book show here in Washington and invite government officials to talk about it, but when they go back home, I think they kind of, it's like they hope the word gets to their government, but they're not too sure they want to be the ones banging on the door, is the only thing I can figure out as to why they're helping.

COMMISSIONER REINSCH: That's very interesting, probably a fruitful path to pursue. This morning before you were here we talked with some of the other witnesses about the development of Chinese intellectual property, for lack of a better term, and that that was one of the things that generally stimulates a country's interest in protection when they've got something of their own that they want to protect.

That, of course, assumes that the people who need the protection are willing to go to their government and pound the table and say you need to take care of us here because we're having the same problem the foreigners have or we're having all these problems. I think I need to process your answer a little bit. That's very interesting that they are prepared to go public, which is not an insignificant step--

MS. SCHROEDER: That's right.

COMMISSIONER REINSCH: --yet at the same time are not really prepared to press their government. I need to find out a little bit more about that. But I also think that it does suggest from your perspective, and maybe your colleagues may or may not have run into the same thing--is there a screen actors guild in China that has comparable problems. But it seems to me as an association, this is something you ought to be able to pursue with your counterparts and get them moving. Maybe I can ask the

other two, is this a comparable situation for you all or is it unique to the publishers?

MR. McGUIRE: Just to your question as to whether there's an equivalent of the Screen Actors Guild in China?

COMMISSIONER REINSCH: I think I know the answer to that part. MR. McGUIRE: There are associations of performers. As we found many years ago in Russia, the level of independence of these organizations is highly questionable. So it's beginning to come up in a formative stage that performers are beginning to try to find ways to assert rights, but there's nothing really equivalent to our construct of, particularly of the residual structures of our contract. It's only a handful of countries in the world that actually even have that structure.

COMMISSIONER REINSCH: Yes, this is not an area where activism on the part of a Chinese organization, I think, would be considered an attack on the government or an attack on the party or the system. It seems to me it might be something that they would tolerate

Jay, do you have comment on that or not?

MR. BERMAN: Well, I think it goes back to the point that was made earlier, that in some respects from the point of view of the Chinese, this is actually not a trade issue and it's not an intellectual property protection issue. This is, quite frankly, an issue about the ability of the Party to control people's access to information and entertainment, and to that extent, I think at the end of the day, we're actually talking about, if you're trying to do something about this problem, it's going to have to be through the mechanism of the Party.

Because you can have all the negotiations you want with the Ministry of Trade, and if the propaganda ministry has made a determination that only "x" number of foreign films are going to come in for a different set of reasons, you're not going to be able to change the quota.

So I think there is an underlying issue, but somewhat on point, I think it's going to be an interesting test to see how well the Chinese government enforces its intellectual property rules in regard to all of the logos and trademarks it owns in connection with the Olympics. I'm going to take a guess here, and I'm happy to go out on a limb, and if you have a meeting next year, I'm happy to come back, and if I have to eat my words, I will. But I'm going to suggest to you that the rate of piracy associated with all of the little items that are for sale officially through licensed vendors in association with the Beijing Olympics is going to be substantially smaller than it is for all of the industries represented here.

COMMISSIONER REINSCH: I think we're already discovering that, but good points. Thank you very much.

HEARING COCHAIR D'AMATO: Thank you. Maybe at the level

of zero perhaps.

MS. SCHROEDER: Yes.

MR. BERMAN: They do have a very important and effective enforcement mechanism.

HEARING COCHAIR D'AMATO: Maybe they could take those 35,000 Internet police officers and put them--

MR. BERMAN: 200,000.

MS. SCHROEDER: Yes.

HEARING COCHAIR D'AMATO: Yes. Commissioner Mulloy.

COMMISSIONER MULLOY: Thank you, Mr. Chairman. Thank each of you for being here with us today. Senator Coburn made the same point, Mr. Berman, about the Olympic logo when he testified earlier today, and he was over there quite recently with Senators Schumer and Graham on the exchange rate issue.

Congresswoman Schroeder, you mentioned on page six of your testimony about getting the issue up to the JCCT. Is that a problem getting it? That is the one mechanism in which we're trying to load a lot of these trade issues. In other words, there's such a big line up there that getting your issue into their agenda is a difficult one?

MS. SCHROEDER: Book publishers never have quite the pizzazz, to be perfectly candid, that some of the other industries have, and book publishers have never had the same amount of money to spend and so forth.

I think the JCCT, our government has been very willing to talk to us and try to help us and has called us to the table. I think the optical disk issue has been further developed and things like that at that range, but we are working with them, and we are hoping it comes up, and we are particularly concerned that the JCCT take up this academic book issue because this is total government to government, these are government universities doing this. It's just a slam-dunk. And that's what we hope we'll get more and more focus on.

COMMISSIONER MULLOY: So I guess we have such a number of issues.

MS. SCHROEDER: I know.

COMMISSIONER MULLOY: And we don't want to seem to want to go to the WTO, so we're relying on the JCCT, and then it gets overwhelming, that whole process.

MS. SCHROEDER: Right.

COMMISSIONER MULLOY: Mr. Berman, you talk about criminal enforcement. My understanding is under the TRIPS, this isn't just an option, that the Chinese are committed by their TRIPS WTO obligation to use criminal enforcement when there are vast commercial violations of the intellectual property rights agreement. So this isn't an optional thing?

MR. BERMAN: Well, as I said at the end of my testimony, their obligation. I think this is, in fact, the $64,000 question--it may be the million dollar question these days--as to whether or not the obligations incurred by a WTO member under TRIPS for providing effective enforcement, what that means in terms of criminal penalties.

You've heard from the U.S. government who would be the party in this case, in order to bring a WTO case, it's not the book publishers and the motion picture industry and the recording industry. It's the United States government that's going to have to bring this case.

Therefore, of course, if you bring it, you better make sure you're going to win it. So I think this is something that's being discussed and I'm sure you heard it from USTR today. It is a difficult question, one we're hoping that will get resolved in the next few months.

COMMISSIONER MULLOY: You also in your testimony say now Russia is coming into the WTO--there's negotiation to bring Russia in, and like China, that will require a congressional vote. Normally, the executive branch can bring these countries in without congressional involvement.

MR. BERMAN: No, well, they can bring them in, but at the end of the day, you will have to have permanent normal trading relations, which Congress will have to act on.

COMMISSIONER MULLOY: That's what I'm saying. Yes. But, on Argentina, Congress didn't have to. It goes back to that law of 1974, in which they were designated a communist country in Jackson-Vanik, so that's why you got to change that law. That's why Congress gets involved in both Russia and China.

MR. BERMAN: Right.

COMMISSIONER MULLOY: So there was a guy names Sir James Goldsmith who wrote a book about GATT: The Global Trade Trap, in which he said you're making a mistake getting involved in free trade agreements with countries like China and others who, they're not evil, they just don't have the ability to police these things like Western Europe, the United States, and others. So you need to bring them on in a different system so that they prove themselves and then you bring them in in a different way.

We didn't do that and they came in. When the WTO was being approved, Speaker Gingrich put a safeguard in saying that once every five years, Congress gets a vote on whether to stay in or not. Right? And twice there have been votes. The first time there were 45 people in the House who said get out. Last time was up around 80.

My view is if you bring a case in the WTO, and everybody says you have to have a perfect case because you can't lose it, well, if you bring a case and you begin to lose them, and you still got the huge problem,

draining our economic wealth, isn't that another way to take care of this issue?

MR. BERMAN: You mean by the U.S. rescinding its membership in the WTO?

COMMISSIONER MULLOY: Or rescinding it with regard to China, or doing something along those lines.

MR. BERMAN: I would prefer that we explore the question of bringing a WTO action. Because I think we do need to have some sense of certainty about what effective enforcement obligations are incurred by WTO members.

COMMISSIONER MULLOY: Thank you. Anybody else want to comment on that issue?

MS. SCHROEDER: I do think it's very important, having been there for those WTO debates, that the U.S. make sure that countries that come in know that it's not a free zone, you can come in and reinterpret it and do whatever you want. And I think that's one of the problems you were asking about the vast commercial obligation. They're going to interpret it in their own way.

But that was the whole purpose for having the court in Geneva where you really began to develop this body of law and how you looked at it and that all countries were to play by the same rules.

COMMISSIONER MULLOY: Thank you.

HEARING COCHAIR D'AMATO: Thank you, Commissioner. I'd like to follow up, Mr. Berman, on that point. I don't know if you're a lawyer, but if you're not a lawyer, you might as well be. You've written most of these laws in this area or consulted on them.

But you mention in your testimony that you're working intensively on a question of a case. I would like to know what is your personal assessment of the quality of the information that you have put together for your industry in terms of the case because it seems to me that we've been at this game for quite a while now. There's a lot of data out there. It seems to me that we should be at the point now where if we don't have the data for a case, we ought to know it, but we should have enough data for a very good case.

That's first, but, secondly, if we do bring a case based on this data, and we want to get criminal enforcement procedures in China up to speed where they'll be effective, isn't that the kind of thing that we would look to the Chinese to do to try and settle the case as it goes along, and we'd achieve the criminal enforcement question by just bringing the case in Geneva?

MR. BERMAN: I'm reminded of a dictum which was given to me many years ago by the very wise and sage U.S. Trade Representative Carla Hills, in which she said if you've invoked sanctions, you've lost.

That doesn't solve your problem. It may make you feel good for a moment that you've invoked sanctions.

There are two questions. I'll answer the first one about the data. The U.S. recording industry and its international counterpart and the U.S. film industry are, in fact, engaged in that kind of process right now, and on a constant and daily basis in touch with USTR trying to develop it in a way that makes sense for a WTO case.

It would not be the normal legal action that we might bring in a U.S. court. There are certain rules for WTO action, and what we would believe would constitute a prima facie case against the Chinese about the lack of effective enforcement.

That process is underway. It's a very expensive and time-consuming one, and I might point out that a difficult one, because in China, in contrast to most other countries, we have limited ability at self-help measures, so in jurisdictions like the United States or the UK, both the recording industry and the film industry have very active anti-piracy operations of their own, where we have mostly, not mostly, but formal law enforcement officials who are versed in the techniques. We do surveillance. We're able to identify product. We're able to bring cases to the attention of the authorities and that's what you need to do.

In China, we're severely limited in that respect. So one of the problems in gathering the data goes back to the restrictions on us. The second question about taking an action forward in anticipation that you might be able to produce a result by virtue of negotiating the case away, I will go back in history till the one moment in time over the past 20 years in my experience with my China when the United States actually achieved a tangible result in its trade relation with China over IPR. And that was when the United States government announced in The Federal Register the imposition of trade sanctions on $1 billion worth of Chinese exports to the United States, and in accordance with commercial procedure, not only listed the Chinese exports, but said because of the problems of goods in transit, that it would be effective 30 days from the date of publication, whereupon shortly thereafter Ambassador Barshefsky received a telephone call, and we were invited, Jack Valenti and I and a few others, to go to Beijing to actually enter into a negotiation with the Chinese on how many plants would have to be closed in order for the U.S. government to withdraw the sanctions.

In my long and tortured memory, it's the only instance in which we actually produced a result.

HEARING COCHAIR D'AMATO: So maybe we should just take a look at The Federal Register again and see whether we can get some space?

MR. BERMAN: The problem with that, Commissioner, and I'm

sure Commissioner Mulloy is going to say this if I don't, that having joined the WTO, the United States' ability to leverage certain trade relations with China are severely restricted by the rules that now govern. That's why quite frankly, I gratuitously mentioned Russia, because we're not governed by those rules in our relationship with Russia right now. I would hate to see us make the same mistake.

HEARING COCHAIR D'AMATO: Thank you. Commissioner Bartholomew.

COMMISSION VICE CHAIR BARTHOLOMEW: Thank you very much. I want to take the opportunity to note that Congresswoman Schroeder is the President of the Association of American Publishers, so we can actually refer to her as President Schroeder.

MS. SCHROEDER: I knew I liked you.

COMMISSION VICE CHAIR BARTHOLOMEW: Thank you to all of our witnesses. In a funny way, this is a tough topic to ask questions about because I feel like we have been asking many of the same questions for a number of years, and the issue is always how do we move beyond the things that we're saying, and how do we get our government to act?

Today, I'm going to ask specifically, because you mentioned the mid-1990s when, of course, Congress was very involved in making sure that the pressure was on the administration--

MR. BERMAN: Absolutely.

COMMISSION VICE CHAIR BARTHOLOMEW: --to make something happen. But I don't think that your comment about Russia is gratuitous. If we work on the presumption that Russia is probably watching what we are doing vis-à-vis China and how successful we are being, they very well could be taking lessons learned from this, and they're not very good lessons.

So one of my questions is the backsliding that has taken place since the mid-1990s. How do we correct that and what is at stake is so big because it is not just about lost opportunity in China or even lost opportunity when the Chinese are exporting these products.

MR. BERMAN: I'll answer it in a very specific context and that is the context of Russia, and I'm sure you've seen this most recently. There was a very explicit statement on behalf of the Chairman and Ranking Democrat in the Senate Finance Committee, and by Senator Hatch and Senator Bayh, and by the Chairman and Ranking Democrat of the House Ways and Means Committee in messages to the administration that they had no intention of agreeing to Permanent Normal Trading Relations with Russia based on its performance.

I just might say this. There are lots of problems and no one knows them better than I in regard to China. The problems in Russia are even worse. They're made worse by quite frankly the endemic corruption in

the system. At least every now and then the Chinese get a spasm about corruption and they go out and they kill a few people, but in Russia, the system cannot accommodate legitimate commerce.

If this is what is going to join the WTO, it's going to be a lot worse than China, trying to fix it. So I think we need to have to marshal that sense that Congress is simply not for the sake of having the Russians in the WTO for the glory of it--come on. I do believe that the Russians are watching what's happening with China, absolutely.

COMMISSION VICE CHAIR BARTHOLOMEW: Do we have any sense, and this is to all of our witnesses in terms of China, who is engaged in the piracy and who's benefiting from it?

MR. BERMAN: At the time that we actually did in the mid-'90s and we did the negotiation, quite frankly I think it was a little easier because even though we had a dispute with the Chinese over how many plants--we said 31, they said 20 something--we knew for a fact that a good number of those plants were operating either on government-owned property or by entities of the Chinese government including the Air Force, the Red Army and so forth.

So that in addition to their normal duties, they were making a few bucks on the side. And those facilities, unfortunately, were never opened to law enforcement. You couldn't deal with them. So getting those closed was the priority.

I don't think that's as true today, and we've had this vast explosion. There are more than 90 optical disk plants operating in China, but I tend to think today it's much more just a commercial venture, and so that is an issue that can be addressed by the Chinese authorities, and I think the reason why it doesn't get addressed quite frankly is we have this anomaly.

In most places in the world, we have a market and the pirates are at the fringes trying to get in. In China, the pirates have a market. We're on the fringes trying to get in. So when you think about if you were to say to the Chinese, effectively deal with this question, there would be serious political and economic consequences, and they're not going do to that on their own.

They're only going to do it, I believe, if there's an alternative price to pay for it.

COMMISSION VICE CHAIR BARTHOLOMEW: Ms. Schroeder, the university publications that you're talking about, these are state-run universities?

MS. SCHROEDER: Absolutely. They are state-run universities so this is done with the color of government approval. Let's be perfectly honest. The government could say there would be no copying by state and this won't happen, and that would be the end of it. So that certainly has that.

The other interesting thing is there are the state-approved publishers that are in the Publishers Association of China, and what they do is they will get permission from our guys to publish, but they'll find that the pirates have it out on the street first, or they will publish whatever it is that they wanted to publish and still find that the pirates instantly pirate it on the outside.

So you've got two things there. We're hit by a bifurcated system, but the one could very clearly be dealt with by the Chinese very easily, and the second part, it's amazing they don't, because these are their guys that are publishing and they're getting hurt too.

COMMISSION VICE CHAIR BARTHOLOMEW: One more quick question, Mr. Chairman. Are you seeing any evidence with the book publications that the knocked off books are being exported to Chinese-speaking populations in third countries?

MS. SCHROEDER: We really haven't looked at that. We have seen it in other countries. We haven't tracked it that far, but that is one of the concerns obviously that people have. If you can't import books and you can't publish locally, but if you have to get permission or if you have to have a joint venture, and then they just publish a whole bunch of extra books, way beyond what the license agrees, who knows what they do? They can export them back into Hong Kong or other places or Singapore or many places where there are Chinese-speaking, and we have not tracked that.

COMMISSION VICE CHAIR BARTHOLOMEW: Thank you.

HEARING COCHAIR D'AMATO: Thank you. I want to make one follow-up observation, again, to Mr. Berman on the question of bringing the case, the elements of difficulty that you mentioned.

It strikes me that maybe it's just my assumption looking at the industries affected here that it's a slam-dunk case, but it's awfully difficult to bring in this venue, and it seems to me that it's very difficult to bring cases, maybe too difficult to bring cases. The system makes it too difficult because you have to be able to get self-help in China or whatever you call it, use the remedies of the Chinese system which are very difficult to attempt to get anyway, so it's hard to even try and attempt it, and it's very expensive to bring the case.

And then the question of hostility in Geneva. We keep hearing they don't like us. So you have to bring a super-super case in order to overcome that part. It seems to me that the cards are stacked against us in terms of bringing multiple cases in a situation where multiple cases are probably necessary.

Let me ask you this. In order to help ourselves in this case, do you think it would be wise to try and develop a public fund of appropriated money for litigants to offset the cost of bringing cases. Obviously you

don't want frivolous cases, but if the bar is going to be expensed to bringing cases that are going to affect our industries, it seems to me that --we're setting ourselves up, the system is loaded against us to make the WTO work for us in terms of cases.

Am I making myself clear?

MR. BERMAN: Yes, you're making yourself perfectly clear. Would it be nice if there was a public fund where monies could be made available, the answer probably is yes. It is a very expensive proposition.

But again at the end of the day, I want to go back to this one point, it's not the Recording Industry Association of America or the Motion Picture Association of America or the Association of American Book Publishers, it's the United States government that needs to bring this case, and they need to be convinced that they're doing it for the right reasons.

Despite all of the questions of budget deficits and everything else, I believe the United States government has the resources to bring this case if the determination is made that they want to proceed.

Under the best circumstances, this is a long torturous process for our industries to put people out in the field in China and try to develop information that we believe meets the needs of USTR. And both I think the industries and U.S. Trade Representative Office have worked closely together to try to actually do that.

MS. SCHROEDER: If the gentleman would yield, I think you're hitting on something that is terribly important. I think one of the difficulties of doing a case is you obviously have to have evidence, and China makes it very difficult, as you have said, over and over again, for the industries to collect the evidence. So we have kind of a circle here.

It's amazing to me, I mean that should be one of the prerequisites of getting into the WTO. If you're going to get into the WTO and play by the rules, then you can't have restrictions upon people gathering the evidence to see if you're playing by the rules.

So I can't be clear enough about that, and I agree with Jay. Obviously, public funding would be wonderful, but there really is public funding in the end because it's the U.S. government that has to take the case there. It's the industries that have to get the evidence, and that is just very, very hard.

HEARING COCHAIR D'AMATO: Yes. The burden on the litigants is very high here. It seems to me there should be a way to make it easier to bring cases in this system. If we're going to rely on this system for our equities, it seems to me it's too tough.

Commissioner Houston.

HEARING COCHAIR HOUSTON: Thank you, Mr. Chairman. I have two questions. Congresswoman Schroeder, you mentioned censorship at one point in your statement, and my question really deals

with that in the interplay of censorship in this entire issue.

I can't imagine that the Chinese government would condone CDs of The Passion of the Christ or the Federalist Papers or Toby Keith singing "Courtesy of the Red, White and Blue."

So my question is as far as the pirating goes in each of your individual industries, are there government censors looking at what the pirates are doing because they don't want that kind of stuff in the masses of China? That brings me to the second part of the question, is there a line of things being pirated for internal distribution in China that is censored versus what's arriving on our shores?

MS. SCHROEDER: That's a very interesting question. I know on the censorship thing, the very high profile case was Hillary Clinton's book where they got a license with a local Chinese publisher to publish her book--it went through the censor. The censor took out all the parts about the women's conference in Beijing.

HEARING COCHAIR HOUSTON: Oh, gee.

MS. SCHROEDER: Remember that. It was a big--and so the publisher said that's it. Then the license is over. You cannot publish it and pulled the book back because it was like you don't get to pick and choose what part of the book you have out there.

So publishers, foreign publishers have no way to get into the market. Now, if a pirate brings it in, that's a very good question. But my guess is that the Chinese pirates would not do anything that would offend the censors because then you would bring the wrath of the government.

While they say they have no enforcement, I have a feeling they would enforce very rapidly if somebody were publishing the Declaration of Independence or an equivalent thereof. I have a feeling they would--

HEARING COCHAIR HOUSTON: Which would prove that they have to know what's going on?

MS. SCHROEDER: I don't know that for a fact. It's just a little guess that I have.

MR. BERMAN: It goes on in such a massive scale that it's not likely that they don't know what's going on and the fact is that there is no internal censorship process for the pirates.

The pirates actually do produce things that would not make it through the legitimate process. There have been issues about the Rolling Stones and a lot of others. But the irony of that just doesn't seem to penetrate, and again every now and then there is a spasm, an outbreak of we're going to attack pornography and filth and everything else and some place gets closed and after that they're back in business.

The problem is that it's imbedded in the economic system. Piracy is a feature of it.

HEARING COCHAIR HOUSTON: Mr. McGuire.

MR. McGUIRE: The only observation I could make would be with respect to the limitations on the kind of programming that our performers work in that can be shown in China at all. And second, the start of the areas of co-production work that take place in China are, of course, replete with complete censorship over what can be said in those works and limitations across anything to do with certain topics within those particular productions.

HEARING COCHAIR HOUSTON: Thank you. I have one more question that goes to enforceability, perhaps a little bit different for Congresswoman Schroeder. Your stuff stays in China, your stuff comes out of China, but a little bit of the same kind of thing.

One of my questions in one of the earlier panels, and Carolyn mentioned this earlier, we keep repeating ourselves a today. But it seems to me that we're all operating under this assumption that the Chinese government at some level really wants to cure this problem, which seems to be not very realistic.

So my question deals with what we're doing on our shores here because every time we have one more panelist here, it seems that more and more that any enforceability has to be on the delivery end. So my question for each of you is what do you see that our government actually is doing at the on-the-ground Customs enforcement guy standing at the dock level? What are they doing now and what could they be doing or do you see any potential for them to do more to stop this stuff coming in the country in the first place, our country?

MR. BERMAN: I would say quite frankly that there was a period of time from about the mid-'90s to about 2003 when there really was very little export of Chinese pirate product. It's picked up again, but it's not really an issue for the U.S. It's not finding its way into the U.S.

In 2005, we had as an industry, 206 incidents of a pirate product produced in China found in other countries, but they were Burma, Canada, Germany, Indonesia, you could purchase on Yahoo, interestingly enough, Italy, Malaysia, Nigeria, the Philippines, Singapore, Taiwan, so forth.

In terms of China specifically for the recording industry, it is not an issue of whether Customs is doing the right thing. I think Customs is doing a fine thing. I just don't think it's a problem.

Now, if I were, if I were the EU or Mexico, I'd be very worried about Chinese exports, but I don't think on our side, it is a problem, and I think the U.S. Customs Service is actually adequate.

HEARING COCHAIR HOUSTON: Okay. So what you're saying is most of these products are going to other countries other than the U.S.?

MR. BERMAN: I would say most of these products are being consumed in China as a result of which it's impossible, virtually

impossible, to create a legitimate marketplace. And that is at the end of the day the fundamental issue. And if the physical world is any guide to the problem we're facing, and I think Congresswoman Schroeder alluded to this, my God, the Internet is going to exacerbate that problem.

We've had a whole set of issues with China about joining the WIPO Treaties and their Internet rules and regulations. We went through, and again this goes back to the lack of transparency, their first attempt to draft something which was remedy-less. There was no remedy.

We've recently learned that there's a new set of regulations. We haven't seen the translation, but I believe USTR has actually described them as greatly improved over the previous ones. So I think we know where the next frontier is in regard to piracy in China.

MS. SCHROEDER: Ours would be the same. It's basically being consumed in China, and one of the interesting things is in countries where they have a VAT tax or something, you can always argue, well, at least--I mean to the government--you're missing all of this commerce because the pirates don't charge a VAT tax. But that doesn't really work in China either.

HEARING COCHAIR HOUSTON: Mr. McGuire, do you have something to add?

MR. McGUIRE: The only thing I would add to that, as I mentioned before, I think there's beginning to be an attempt to do more extensive co-productions in China which are intended for marketplaces outside of China because you're talking about international co-productions. So it might be rather interesting to see what happens to those works and whether or not pirated copies or simply the official copies are the only ones that get exported.

MS. SCHROEDER: Interesting.

HEARING COCHAIR HOUSTON: Thank you.

HEARING COCHAIR D'AMATO: Thank you. Commissioner Blumenthal.

COMMISSIONER BLUMENTHAL: Thank you. Commissioner Houston's great question, first question, actually reveals that I think I'm an inadvertent contributor to piracy because I was asked by a foundation to name the top eight books I would want translated into Chinese and distributed to other channels.

COMMISSIONER BLUMENTHAL: So I guess there's good piracy and bad piracy. But after that confession--

COMMISSION VICE CHAIR BARTHOLOMEW: Please, you'll have to tell us what they are--

COMMISSIONER BROOKES: It depends how you answered.

COMMISSIONER BLUMENTHAL: Right. I have a question that Mr. Berman's comments made me think about why we're in this

predicament in the first place, and when we hear over and over again that there is no legitimate market and it's really the pirates that are dominating the market, and so on an so forth, and you look at the numbers in terms of percentages of U.S. exports that are actually pirated and the loss to U.S. businesses, it makes me wonder, first of all, why U.S. businesses keep doing business in China? That's number one. It makes me wonder, despite all these losses.

Number two, perhaps you could put an analytical hat on, all of you, as to why the U.S. government doesn't take action. Perhaps there's a rational reason why the U.S. government doesn't take the kinds of action that you're talking about, and I have my own sort of guesses as to why it is. It may not be hurting our economy enough to matter, inertia, whatever it is.

But you go back to the initial debates we had in terms of the accession and the PNTR and so forth, and there were really two reasons. The main reason we decided to bring China into the trading system was we were going to socialize the Chinese into becoming a better actor on the world stage and develop rules and so on and so forth. That was really the main sort of grand strategic reason, right. It wasn't really about trade; it was about socializing.

Besides those other questions I had, I wonder if you can all comment on has China been socialized in the past ten years?

HEARING COCHAIR D'AMATO: That's a soft ball.

MR. BERMAN: I'll answer the first question and the last question because I forgot what was in the middle. The first question is, is because it's fool's gold and it always has been. You just take the number of people and you think about it and you say to yourself, my God, if we could just convert whatever percentage, we have a fantastic business.

COMMISSIONER BLUMENTHAL: This fool's gold continues and--

MR. BERMAN: It continues and continues. That's correct. The answer to the last question about whether they've been socialized, I think unfortunately the proof of the pudding is in the eating and right now we have to say in regard to intellectual property protection and the obligations that we believe they incur, the answer is no, but they are in, and now the question is going to be are the rules within the organization sufficient enough to, you know, spank the wayward child and we're going to find that out. At least I hope we will find it out.

COMMISSIONER BLUMENTHAL: Actually that goes to the second question, which was why isn't the U.S. government taking action?

MR. BERMAN: The U.S. government has taken actions. I mean I was there. I was in Beijing when we negotiated the closing of the plants. It is on the top of every trade negotiation list. We are in the JCCT

dialogue along with the big guys--agriculture and airplanes and everybody else. We are on the agenda because, as my friend Jack Valenti used to say, we are the crown jewels of America.

We believe people want to hear, see and read what Americans produce, and I can't say that the U.S. government has failed to deliver. I would say within the systems that we have, we haven't been able to produce the desired result, and it is very frustrating.

COMMISSIONER BLUMENTHAL: I don't mean to make this into a hostile question, but if the reason is fool's gold that businesses are in China and then businesses come and say to the United States come and take more action and help us out and enforce us, you again have to go back and wonder why the businesses continue to stay there and--

MR. BERMAN: I can answer that question quite frankly because truthfully it is impossible to fight piracy in any way if you're not there. So let's say we were to withdraw from China and we went to the United States government and complained.

The first thing the USTR Representative responsible for China would say, as they should, well, give me the evidence, tell me what's going on the ground. Well, if you're not on the ground, then you're not there, you're not in a position to provide that kind of information, and I might point out that's precisely where we are in the context of bringing a WTO action.

This is what it's going to be all about. I don't think not being there is the answer to our problem. The answer to our problem is being there and trying to create the evidence that would lead us to bring a successful WTO action, and the only way we're going to get that is to be there and to force the process along, and we are doing that, quite frankly, in some cases, at great danger to the people in the field on behalf of the motion picture and recording industry. This is not pleasant labor.

COMMISSIONER BLUMENTHAL: Anyone else want to tackle any of those questions?

MS. SCHROEDER: I would say I had studied Chinese when I was in college, my daughter did, and lived in China for awhile. I think people are always charmed by the Chinese. They're a lot more charming than the Russians, and I think that the Chinese people thought this was wonderful, they're going to come inside the world order and then the world will get them to be players at the table and they'll play by the rules.

I think China thought, well, we're big and we'll reinterpret the rules the way we would like to, and so I think it's been a disappointment, that people had hoped that there would be more progress, clearly. Clearly, they hoped there would be because it's been very disappointing.

Why are businesses in China? Legitimately, we're not. They won't let us in. We in the publishing industry would love to be in China. We're

not. But as an industry, we have to go police what's going on in China because they're stealing all of our stuff everyday, and I can't emphasize what Jay said enough.

We worry very much about the people that collect the data for us because under Chinese law, you're not supposed to be doing that. So they've kind of got us by the neck. They've signed this agreement to comply, but then if you go out and find out they're not complying, you're in trouble with their legal system.

So we've really got to get that cleared up, I think. That is something that only our government can really talk about and take us on. Why isn't the U.S. government taking action? I think that they're looking at trying to take every kind of action they can.

The JCCT, clearly they've been doing that yearly. They've been having forums at the ambassador's house. They've been doing all sorts of interchanges. The issue is just so big and we hope that people encourage them. I would like, I mean if I could turn the tables, I would love to ask all the commissioners what you heard this morning from USTR? Are they going to take action? What are they going to do?

I think everybody in the U.S. government is very concerned about this and we know Congress is very concerned about this, too, because literally our crown jewels are being locked up over there and we're getting nothing back in return. So I think the entire government and all the associations and everybody else are busy trying to figure out what in the world do we do to be very firm about if you come into this WTO group, you have to play by the rules.

Because if we don't, if we wink at China, then what's the point of the WTO? If you've got an international system that everybody can come into and they can claim all the benefits and then say we're not going to bother wit any of the things that are negative, you've created a nightmare. I think that that is where we are, and many people fear China because it's so big and keep thinking, well, if we wait long enough, they'll behave.

How long do we wait for socialization? I guess is what we say. And that may be the debate going on today in the government.

MR. McGUIRE: I could just add one quick element again. The reason I am here and the reason I talked before about the rights of performers is that one of the problems from our perspective is that this is only viewed as an issue for U.S. businesses and the protection of U.S. businesses. There's no human face to this and there really is a human face. It is the people that ultimately do share in this and to the extent that you also further the cause of recognizing performer rights even with respect to Chinese performers, you build a different base and a different understanding of what is really involved with all of this.

So, that's something I think the U.S. has got to be more conscious

of and not have this issue only as a U.S. business issue.

COMMISSIONER BLUMENTHAL: Thank you.

HEARING COCHAIR D'AMATO: Thank you. Chairman Wortzel.

CHAIRMAN WORTZEL: Thank you for very much for your testimony here today. I want to advance an argument that I have heard many times in China from Chinese publishers, from their military presses, and from their academics, and just let you respond to what I have heard from them on why counterfeiting is so rife there, and it is the low standard of living and the cost of books.

Their repetitive argument when I worked in the embassy and would be present when these things are raised or when I was at their institutions is the cost of a book, that this, well, right here, Missile Command and Control, six yuan, less than a dollar. Similar book in the United States published by a small military related press, $79.

This is a Chinese dictionary, $40 in Hong Kong; six yuan in China. So they argue that if American publishers of any kind would be willing to accept the percentage royalties off Chinese prices, which would be three percent or six percent of less than a dollar for licensing, they would comply. How do you respond to that argument?

MS. SCHROEDER: Thank you. Let me just talk about India which is a little bit similar. Many, not many years ago, I suppose about ten years ago, publishers sat down with the government of India because here is what was happening, publishers were sending the books that were out of date to India. Okay. Rather than the most up to date.

And India was very firm. We are training global competitors. We want the most up to date. We want them, and so everybody sat down and said, okay, so what do we do? It's the same thing, price of the book. So clearly you weren't going to import them from the U.S. It would be very expensive.

So the government cut a deal with publishers that they wanted there, that they wanted their books there. They gave them a special deal on taxes and they kind of allowed them to kind of license local people in the country to produce the books at a much, much, much reduced price, and that worked.

Publishers can do that. They can produce in-country, but we're not allowed to. If we could produce in-country and find out that we can compete, but you can't obviously import them and compete, and you can't obviously bring them from outside. So when they say that, my answer to them is, all right, let us in, we'll show you, we can do it cheaper, come on.

That's ridiculous. We can books all sorts of different ways. Obviously this book in the United States is much more colorful, well okay, if they want to just run it out and print it in black and white, we can

do the same thing.

But at least there is some payment, and I'm so glad Mr. McGuire keeps reminding us, for the authors and the people who wrote this, and I can imagine how exciting it is to write Engineering Mechanics Statistics, you know. If you're going to spend a couple years of your life writing this, you would like to get some remuneration.

It also helps lower the price of the books in the U.S., if there is some way that you can cut your production costs or at least your content costs. But we totally believe we have to price to market. Jay and I and others have been at meetings with USTR where they say if you want us to protect you, you've got to price to market. We agree. We will price to market, but we can't price to market if they won't let us in the market, and they won't let us be legitimate partners.

CHAIRMAN WORTZEL: Thank you.

HEARING COCHAIR D'AMATO: Commissioner Mulloy.

COMMISSIONER MULLOY: Thank you, Mr. Chairman. Mr. Berman, you tell us Ambassador Hills, at one point said if you use trade sanctions you lost, but then you show us that Charlene Barshefsky put them on a list and was going to use trade sanctions and you won.

MR. BERMAN: I think there's a fine distinction between announcing them and enacting them as the remedy.

COMMISSIONER MULLOY: So I see. But the Europeans put trade sanctions on us on the Foreign Sales Corporation Act, and they won because then we changed our law. And that's what we're thinking here.

Part of the problem for us, and I'd like to get your views on this, is Section 301 which we used to be able to unilaterally threaten to put sanctions and do it, we had to give that up essentially when we got in the WTO. In fact, we were sued in the WTO and agreed that that would only be used to implement a WTO win.

MR. BERMAN: Correct.

COMMISSIONER MULLOY: So we have to go through the WTO system. Congresswoman Schroeder points out that because of the intimidation, and this word came up earlier this morning, that the Chinese use on our companies, and our companies have to gather the data, but they intimidate our companies from doing that and giving it to the government, so we're essentially in a system where we have to go to the WTO, but the way the system works, we can't get the evidence to go to the WTO so we do nothing year after year.

My view, and I want to get your view, is bring the best case you can develop, and if you lose it, fine, at least you know what you're in then. Then public policymakers can say then we might choose a different option. What do you think of that analysis?

MR. BERMAN: I probably would have a different view if I was

Sue Schwab than Jay Berman. Jay Berman is an individual might find that a very attractive recourse because you would then have set the parameters for what in fact is the defining issue in the TRIPS Agreement, what is effective enforcement?

If you want to know what it is, the only way to find out is to bring the case. But I would say this, we are engaged, and particularly with MPA, in putting people in the field in China to actually try to produce that level of evidence that would give the United States government some comfort in bringing the case.

I think at the end of the day, that is a decision that the U.S. government is going to make and quite frankly I'd have to guess, with all deference to the great work that they do at USTR, that that decision would be taken at a much higher level given the implications of the U.S.-Sino relationship.

COMMISSIONER MULLOY: We were told this morning that it would be a White House decision.

MR. BERMAN: Absolutely.

COMMISSIONER MULLOY: Thank you. Congresswoman, do you have anything you want to add on it?

MS. SCHROEDER: I totally agree. I think you stated it very well. We're in this incredible thing, we have to use the tools we've got and then if we can show that the tools don't work, then we've really got to think about where we are.

COMMISSIONER MULLOY: Thank you very much.

HEARING COCHAIR D'AMATO: Thank you. Commissioner Bartholomew.

COMMISSION VICE CHAIR BARTHOLOMEW: Thank you very much. Just two more comments about the USTR this morning. One is they certainly gave some sense that they're looking at a fall time frame, which I hope was a message that they better have some progress made, otherwise they will move forward, although that was not said. I would be very clear about that.

And Jay, Mr. Stratford also mentioned the optical disk library. But in a rather--is that the right word--talking about creating a library of the disks that people could then track, but I have to say my sense of what he said was that he said it was a topic that was under discussion, and my sense from what he said was that he perhaps was characterizing a little bit more progress than has been made. Again, I'm reading into the words that he said, but he didn't specifically mention that.

MR. BERMAN: Yes, it is the question of forensically identifying the production line from which the product came. The only way you can do that is if you go into a plant unannounced and you're able to take a product off the line, you put it under that high-powered microscope and

you see what that unique signature is, and then if you find the disk in Moldavia, and it has some Chinese writing or whatever, and you put it under the microscope, and it has that same squiggle, very well, even though the International Standard Recording Code has been erased and everything else that that was produced in that particular plant, and it goes to the issue of transparency.

It has been on the agenda, the discussions within the JCCT. USTR continues to raise it. We have provided USTR with their own library of disks that we have seized around the world and in China from Chinese plants, and if they're making progress, I think that would be a fantastic breakthrough.

We believe that USTR has elevated this issue in its discussions with the Chinese and it would be, I would say quite frankly, if it's implemented, a lot more than just a symbolic gesture. We say there are 90 plants. If there are 90 plants, there are a lot more than 90 plants. But at least if we went to the 90 plants we know, unannounced, and we are able to take off every one of those production molds an exemplar of what that is and put it into our joint database, and this database is actually owned jointly by the recording industry and the motion picture industry, and we're able to use that information in conjunction with the Chinese authorities, share it with them, explain to them and so forth, we would have a very effective tool for actually defining where the problem is and giving Chinese law enforcement authorities the opportunity to do something about it.

COMMISSION VICE CHAIR BARTHOLOMEW: It's pretty clear that it's imperative for U.S. businesses to work in partnership with the U.S. government in order to provide the information, and my final comment is just to thank all of our witnesses for your usual and characteristic willingness to speak bluntly about what's going on because it's only going to be when the information comes out that people are really going to be able to move forward, and to frequently people don't, so thank you very much.

HEARING COCHAIR D'AMATO: Thank you. Commissioner Wessel.

COMMISSIONER WESSEL: I just wanted to follow up briefly on Chairman Wortzel's point because I think it's an important one, and I've heard it as well from nationals in China that the problem is that we price ourselves such that we have no choice. Here in the U.S., if you have a product that costs a good deal of money and people don't want to pay that price, they don't buy it.

That's part of being a market economy. In China, it's just the opposite here that if we don't adhere to their China price, we face essentially legalized extortion by the government turning a blind eye.

So I would hope, understanding that you have to price to the consumer, that you not accept the China price and the extortion that's going on to get you to go that level because we have the producers of all this art, the copyright, the artists, the authors, et cetera, who deserve fair compensation. If they don't price right to the market, it shouldn't sell, not that it should be pirated.

MS. SCHROEDER: Here, here. I couldn't say it better. But obviously what we know is you can produce things cheaper in China if you're allowed to produce them in China.

COMMISSIONER WESSEL: Clearly.

MS. SCHROEDER: It is terribly unfair to say that a book produced in the United States and exported to China is what they call the market. I mean that's just totally phony. Our people can be competitive in the Chinese market if they only let them in.

What's really the bottom line is you can't beat free, so if you're ripping it off and taking it free, obviously we can't do it free. So why do they want to pay anything if they can continue taking it free and that is just to me a total phony baloney distraction. They won't let us in to compete but tell us the prices are too high so they have to take it.

COMMISSIONER WESSEL: Understand.

MS. SCHROEDER: And that we've got to stop it. Thank you for clarifying.

COMMISSIONER WESSEL: Thank you.

MR. BERMAN: I might just add because if I had been here five years ago, certainly ten years ago, with the pirate product produced in Chinese plants, I doubt very much that it would have had any appeal to anybody. The interesting thing is that the pirate product being produced today in China because it's still an incredible business to be in, the private is now producing an encased product, lyrics, liner notes, this is the only cost of doing business now.

So instead of just putting out something in a brown paper wrapper, with a title on it, often misspelled, you have--

MS. SCHROEDER: Very sophisticated.

MR. BERMAN: --very sophisticated commercial product.

MS. SCHROEDER: Right.

COMMISSIONER WESSEL: We produce great products and we should be able to sell them there.

MS. SCHROEDER: Absolutely.

HEARING COCHAIR D'AMATO: Thank you. One last question, Congresswoman Schroeder. What has the U.S. government done if anything, what steps has the U.S. government done in terms of this one specific issue dealing with the university presses in China? Now that's a fairly discrete issue, but it seems to me an issue that ought to be managed

somehow? Has the U.S. government, the embassy there, taken steps to start solving this problem?

MS. SCHROEDER: They have helped us get appointments with the proper authorities in China. We have delivered I cannot tell you how many boxes of this type of thing that has been uncovered in China. And we wait.

HEARING COCHAIR D'AMATO: So they've set you up with appointments?

MS. SCHROEDER: Right. They're trying to get the Chinese, well, no, I mean obviously that's the proper way to go first, is to try and get the internal, you know, system to work.

We're hopeful it will, but if it doesn't, we'll be asking our government obviously to help us a whole lot more, and the question is what is the proper time frame? As you know, very often, the two cultures have very unique concepts of what a time frame is and what the proper one is and will they finally take an action to take this?

It seems to us that there's a huge volume of evidence that is very clear and we started this last year. So we hope that either we get an answer fairly soon. We have shown all of this to the U.S. government, they're very aware of it, and we hope they will help us with it.

HEARING COCHAIR D'AMATO: Well, thank you. I think that what we're doing is we're putting some new intellectual property officers in the embassy in Beijing.

MS. SCHROEDER: That's right.

HEARING COCHAIR D'AMATO: I talked to Mr. Stratford about that this morning. I wasn't sure they had arrived yet. But this would be something for them to start doing that would be useful for you.

MS. SCHROEDER: I'm very pleased that the Beijing Embassy is really beefing up that area because they realize they're just under siege.

HEARING COCHAIR D'AMATO: Yes, thank you very much. Anyone else have anything? This has been a very, very productive panel. We appreciate your time. It was very useful, and we hope that some good recommendations will come out from the Commission to the Congress on this one.

So that concludes this panel. We'll take a five minute break and then we'll go to our next panel.

[Whereupon, a short break was taken.]

PANEL V: PHARMACEUTICAL INDUSTRY – GOVERNMENT PERSPECTIVE

HEARING COCHAIR HOUSTON: We're ready to get started on the next panel on counterfeit drugs. We've had all interesting panels

today on IPR. That's the subject of our hearing today, and it reminds me a little bit of a quick story I want to tell about my children. In my house, we learned about property rights. They learned very young.

My daughter was eight and my son was four, and my son stuck in his hand in her bedroom door to try to steal her Easter basket candy, and she promptly shut the door on his hand. So I explained to her it wasn't nice to shut the door on her brother's hand and I explained to her brother about property rights.

And he said, well, what are those, Mom, and I said you don't touch other people's stuff. So in my house even today, if you have asked either of my children what are property rights, they'd say you don't touch other people's stuff.

We've had some interesting testimony today and we're still a little bit unclear on how to make the Chinese not touch other people's stuff. So we're hoping that you gentlemen in the next couple of panels can help us with that.

In 2001 alone, a total of 192,000 Chinese patients were reported to have died from the use of fake drugs produced inside its own borders. In 2004, Chinese authorities claimed to have closed about 1,300 factories and investigated 480,000 cases of drug counterfeiting.

As I mentioned earlier in my opening remarks, experts estimate that upwards of 15 percent of drugs in the world market today are counterfeit and over 50 percent of drugs used in Asia and South Africa are fake or substandard.

These estimates suggest annual criminal sales in excess of about $35 billion, and the use of counterfeited and useless HIV drugs can be directly tied to a number of deaths from AIDS on both continents.

India and China lead the world in producing counterfeit drugs. India has passed a law that would allow the death penalty for drug counterfeiters, but China's action against its domestic drug counterfeiters remains difficult to calibrate.

However, it's clear that counterfeit drugs made in China are having a tremendous negative effect in the U.S., and "pharmafeiting," as I like to call it, is not an arms-length problem. Just last week a pharmacist in Texas was convicted for ordering and accepting delivery of over 6,000 counterfeit pills sent directly from China, which he ordered. He intended to sell these fake drugs in his Houston area pharmacy to patients who had, of course, no idea that they were fake and they came from China.

Counterfeiting is not only an IPR and economic problem, but a safety challenge for pharmaceutical companies in the U.S. government to battle.

This afternoon, we'll hear testimony on the concerns for the U.S. economy and the health of U.S. citizens in response to counterfeit

pharmaceuticals from China.

On our first panel, we welcome Mr. Kevin Delli-Colli, who is the Deputy Assistant Director, Financial and Trade Investigations Division, Office of Investigations for the U.S. Immigration and Customs Enforcement, or ICE, which is a cool new name--pardon the pun--associated with Homeland Security.

And also Dr. Randall Lutter, who is Associate Commissioner for Policy and Planning at the FDA. Welcome, gentlemen. Kevin, why don't you go first.

STATEMENT OF KEVIN DELLI-COLLI, DEPUTY ASSISTANT DIRECTOR FOR FINANCIAL AND TRADE INVESTIGATIONS, U.S. IMMIGRATION AND CUSTOMS ENFORCEMENT DEPARTMENT OF HOMELAND SECURITY

MR. DELLI-COLLI: Good afternoon, Vice Chairman Bartholomew, Cochairs D'Amato and Houston, and other distinguished members of this Commission. My name is Kevin Delli-Colli, and I am the Deputy Assistant Director for Financial and Trade Investigations at U.S. Immigration and Customs Enforcement, or ICE.

I am pleased to appear before you today to speak about ICE's role in investigating individuals and groups involved in intellectual property violations in trafficking in counterfeit pharmaceuticals. I have a statement which I will submit for the record, and I will make a brief oral statement.

In January 2004, ICE in San Diego initiated a multi-agency investigation incorporating assets from ICE, the Food and Drug Administration, U.S. Postal Inspection Service, IRS and FBI targeting various Websites, Internet payment networks and pharmaceutical supply chains.

The targets utilized more than 650 affiliated Websites to distribute more than 25 million in counterfeit and unapproved pharmaceuticals within a three-year period. The distribution network extended throughout all of North America and the source country, India, was disguised by transshipping the product through other countries.

To date, this investigation has resulted in 20 indictments, 18 convictions, and the seizure of $1.4 million. The primary violator was sentenced in January 2005 to 51 months imprisonment. Prosecution of other defendants is ongoing.

This one case highlights many of the challenges confronting U.S. law enforcement in combating the trafficking of counterfeit

pharmaceuticals. As the largest investigative arm of the Department of Homeland Security, ICE plays a leading role in targeting criminal organizations responsible for producing, smuggling and distributing counterfeit products including counterfeit pharmaceuticals.

ICE investigations focus not only on keeping these products off U.S. streets but also on dismantling the criminal organizations that initiate, support and sustain this activity.

Information gleaned from numerous ICE investigations reveals that China has been a significant source of supply for a variety of counterfeit pharmaceuticals, although it is certainly not the only source country.

China also has been a channel for payment processors, a source for obtaining active pharmaceutical ingredients, a transshipment point, and a source of gray market distribution.

ICE addresses the threat posed by counterfeit pharmaceuticals in several ways. ICE has a cadre of dedicated and trained special agents assigned to 26 ICE Special Agent in Charge offices across the nation who specialize in investigating counterfeiting violations.

ICE also draws heavily upon relationships with law enforcement partners throughout the world. ICE Special Agents are deployed to 56 overseas attaché offices making it possible for ICE to effectively conduct global IPR investigations.

Another key to our investigative efforts at ICE is the strong support provided by our partners at U.S. Customs and Border Protection, or CBP.

CBP's interdiction and regulatory mission results in many investigative referrals that launch ICE investigations. In 2000, the National Intellectual Property Rights Coordination Center, or IPR Center, was created and staffed with agents and analysts from ICE and the Federal Bureau of Investigation. The IPR Center hosted by ICE coordinates the U.S. government's domestic and international Law enforcement attack on IPR violations.

The IPR center serves as the primary liaison between private industry and law enforcement in targeting IPR crimes. This is very important because the industry is often the first to know that their product is being counterfeited.

By maintaining an ongoing open dialogue with the pharmaceuticals industry, we are able to quickly follow up on counterfeiting allegations brought to our attention.

The Internet has become a primary, if not the primary, tool used by organizations engaged in the trafficking of counterfeit pharmaceuticals, whether for advertisement, direct sales or as a communication tool.

ICE agents in the United States and abroad work closely with the ICE Cyber Crimes Center, C3, to combat the problem of piracy and related IPR violations over the Internet. C3 is a state-of-the-art center

designed exclusively for conducting computer-based investigations, providing expertise, computer forensics and investigative tools to help agents target Internet piracy.

We also participate in the Interagency Pharmaceutical Task Force, which is composed of personnel from CBP, ICE, FDA, DEA, Department of Justice, the Office of National Drug Control Policy, and the United States Postal Service.

This task force fosters mutual cooperation among the responsible agencies and the regulation and enforcement of laws governing prescription drugs that are being illegally imported via the mail and courier facilities.

Before I close, I would like to briefly mention two recent successes we have had working jointly with Chinese officials on counterfeiting matters.

The first one began in September 2003 when our office in Gulfport, Mississippi and Houston, Texas began an investigation known as Operation Spring, which grew to include the ICE attaché in China and the Internal Revenue Service. Chinese Ministry of Public Safety soon joined the investigation, turning the case into the first joint undercover investigation between U.S. law enforcement and Chinese authorities.

In July 2204 with the assistance of ICE agents, Chinese officials arrested Randolph Guthrie and several co-conspirators in China. Guthrie was considered to be the largest distributor of pirated DVD movies in the world with annual sales exceeding $2 million.

At the time of his arrest, Chinese officials seized approximately 160,000 counterfeit DVDs valued at approximately $3.5 million.

In April 2005, Guthrie was convicted in a Shanghai court on criminal charges and sentenced to a jail term of 30 months. In late September 2005, Chinese authorities expelled Guthrie to the United States where ICE subsequently arrested him on U.S. charges. He later pled guilty and was sentenced to five years imprisonment and forfeited $800,000.

The second investigation began in February 2005 when the ICE Attaché Beijing received information that a Richard Cowley of Shelton, Washington was linked to groups of individuals involved in the sale of pharmaceuticals in the United States and Europe.

This information led to the initiation of Operation Ocean Crossing, the second joint undercover enforcement operation with the Chinese. This operation targeted counterfeit pharmaceuticals being distributed via the Internet.

In September 2005, Chinese authorities took action against the largest counterfeit pharmaceutical operation in China and 12 Chinese nationals were arrested. Three illicit pharmaceutical facilities were shut

down. Cowley was arrested in the U.S. and eventually pled to importing counterfeit drugs, and we are very hopeful that this mutual cooperation with continue to produce significant results.

This concludes my remarks and I would be pleased to answer your questions at this time. Thank you.

[The statement follows:]

Prepared statement of Kevin Delli-Colli
Deputy Assistant Director For Financial and Trade Investigations, U.S. Immigration and Customs Enforcement, Department of Homeland Security

INTRODUCTION

Good afternoon Chairman Wortzel, Vice Chairman Bartholomew and distinguished members of this Commission. My name is Kevin Delli-Colli and I am the Deputy Assistant Director for Financial and Trade Investigations at U.S. Immigration and Customs Enforcement (ICE). I am pleased to appear before you today to speak about the ICE role in investigating individuals and groups involved in intellectual property violations and trafficking in counterfeit pharmaceuticals. I have a statement, which I will submit for the record, and will make a brief oral statement.

In January 2004, the ICE SAC/San Diego initiated a multi-agency investigation incorporating assets from ICE, the Food and Drug Administration, U.S. Postal Inspection Service, IRS and FBI, targeting various websites, Internet payment networks and pharmaceutical supply chains. The targets, *WorldExpressRx.com* and *MyRxForLess.com*, had in excess of 650 affiliated websites responsible for the illegal distribution via the Internet of more than $25 million in counterfeit or unapproved pharmaceuticals in a three year period. The distribution network extended throughout the U.S., and into Mexico and Canada. The source country of the pharmaceuticals was India, and the drugs were transshipped through the Caribbean and United Kingdom to disguise their origin. To date, this investigation has resulted in 20 indictments and 18 convictions for various federal criminal charges. The primary violator, Mark Kolowich, was sentenced in January 2005 to 51 months imprisonment. More than $1.4 million was seized. Prosecution of violators related to this investigation continues. This case represents the scope and challenges confronting US law enforcement in combating the trafficking of counterfeit pharmaceuticals.

THE ICE MISSION

As the largest investigative arm of the Department of Homeland Security, ICE plays a leading role in targeting criminal organizations responsible for producing, smuggling, and distributing counterfeit products, including counterfeit pharmaceuticals. ICE investigations focus not only on keeping these products off U.S. streets, but also on dismantling the criminal organizations that initiate, support and sustain this activity.

INTELLECTUAL PROPERTY RIGHTS ENFORCEMENT

Information gleaned from numerous ICE investigations reveals that China has been a significant source of supply for a variety of counterfeit pharmaceuticals, although it is certainly not the only source country. China has also been a channel for payment processors, a source for obtaining active pharmaceutical ingredients (API), a transshipment point, and a source of gray market distribution. In some instances, web hosting companies and servers containing information of great value to investigations, such as online communications, customer lists and financial records, have been located in China, but again, China is not the only country to play such a role in these cases.

ICE addresses the threat posed by counterfeit pharmaceuticals trafficking in several ways. ICE has a cadre of dedicated and trained special agents assigned to the 26 ICE Special Agent in Charge offices across the nation, who specialize in investigating counterfeiting violations. ICE also draws heavily upon our relationships with law enforcement partners around the world. We are able to do that because of ICE's global presence. Our special agents are deployed to 56 overseas Attaché offices. This global reach and our preexisting relationships with foreign law enforcement make it possible for ICE to effectively conduct IPR investigations around the world.

Another key to our investigative efforts at ICE is the strong support provided by our partners at U.S. Customs and Border Protection (CBP). By virtue of CBP's interdiction and regulatory mission on the nation's physical borders, that agency provides the many of investigative referrals that launch ICE counterfeiting investigations.

The National Intellectual Property Rights Coordination Center (IPR Center), which is hosted by ICE, was created in 2000 and is staffed with agents and analysts from ICE and the Federal Bureau of Investigation. CBP also works closely with the IPR Center. The IPR Center coordinates the U.S. government's domestic and international law enforcement attack on IPR violations. The IPR Center serves as the primary liaison between private industry and law enforcement in targeting IPR crimes. This is very important in counterfeit pharmaceuticals cases because industry is often the first to know about these violations. ICE maintains an on-going, open dialogue with the pharmaceuticals industry to identify these cases.

ICE agents in the United States and abroad work closely with the ICE Cyber Crimes Center to combat the problem of piracy and related IPR violations over the Internet. The Cyber Crimes Center is ICE's state-of-the-art center for computer-based investigations, providing expertise and tools to help agents target Internet piracy. The Internet has become a tool that is used by organizations engaged in trafficking counterfeit pharmaceuticals. ICE targets the illegal importation of commercial shipments of legitimate, re-directed or unapproved pharmaceuticals via the operation of rogue Internet websites and affiliates operated for the sole purpose of making money with complete disregard for the safety and health of the American Public.

ICE participates in the Interagency Pharmaceuticals Task Force, which is composed of CBP, ICE, the Food and Drug Administration, the Department of Justice, the Drug Enforcement Administration, the Office of National Drug Control Policy, and the United States Postal Service (USPS). The task force fosters mutual cooperation among the responsible agencies in the regulation and enforcement of laws governing prescription drugs that are being illegally imported via the mail and courier facilities.

WORKING WITH CHINA

ICE has recent investigative successes in counterfeiting investigations that were conducted in cooperation with Chinese officials:

In September 2003, ICE Gulfport, Mississippi, began an investigation, known as "Operation Spring," which grew to include the ICE Attaché in China, the ICE Office of Investigations in Houston, the IPR Center and the Internal Revenue Service. Chinese law enforcement soon joined the investigation, turning the case into the first undercover investigation conducted jointly by U.S. and Chinese authorities. In July 2004, with the assistance of ICE agents, Chinese officials arrested Randolph Guthrie and several co-conspirators in China. Guthrie was considered by the Motion Picture Association of America to be the largest distributor of pirated DVD movies in the world, with sales over $2 million annually. At the time of Guthrie's arrest, Chinese officials seized approximately 160,000 counterfeit DVDs valued at approximately $3.5 million (U.S.) and the equivalent of approximately $200,000 in U.S. and Chinese currency. In April 2005, Guthrie was convicted in a Shanghai court on criminal charges. He was sentenced to a jail term of 30 months in China, issued a fine of 500,000 Chinese Renminbi (equivalent to $62,500 U.S.), and ordered

deported from the country upon completion of his sentence. In late September 2005, Chinese authorities expelled Guthrie to the United States where he was arrested by ICE. He pled guilty in January 2006 and forfeited more than $800,000. In March 2006, Guthrie was sentenced to 60 months in prison and 3 years of supervised release, and was fined $15,000.

In February 2005, ICE Attaché Beijing received information that Richard Cowley of Shelton, Washington, was linked to groups of individuals involved in the sale of pharmaceuticals in the United States, the United Kingdom and other locations throughout Europe. This information led to the initiation of Operation Ocean Crossing, the second joint undercover enforcement operation with the Chinese. This operation targeted counterfeit pharmaceuticals being distributed via the Internet. In September 2005, Chinese authorities took action against the largest counterfeit pharmaceutical operation in China and 12 Chinese nationals were arrested. Three illicit pharmaceuticals facilities were shut down. Cowley was arrested in September 2005, and in February 2006, he pled guilty to importing counterfeit drugs.

CONCLUSION

ICE will continue to aggressively apply our authorities to combating the transnational organizations that violate IPR laws and traffic in counterfeit pharmaceuticals. This concludes my remarks and I would be pleased to answer your questions.

HEARING COCHAIR HOUSTON: Thank you very much, Mr. Delli-Colli. Dr. Lutter.

STATEMENT OF DR. RANDALL LUTTER
ASSOCIATE COMMISSIONER FOR POLICY AND PLANNING
FOOD AND DRUG ADMINISTRATION

DR. LUTTER: Thank you. Good afternoon.

HEARING COCHAIR HOUSTON: Yes.

DR. LUTTER: Good afternoon, Commissioner Houston. I'm Randall Lutter, Associate Commissioner for Policy and Planning at the Food and Drug Administration. Thank you for the opportunity to testify about FDA's efforts to fight counterfeit drugs. I plan to focus my remarks today on our efforts to combat counterfeit prescription drugs as opposed to other products regulated by the Food and Drug Administration.

I have written testimony submitted for the record and I also have a collection of slides as a handout that I may refer to later.

Americans are fortunate in being able to trust that the medicines that they receive in hospitals or buy at their local pharmacies are indeed safe and effective products approved by FDA. We're committed to preserving that trust and to keeping fake medicines out of pharmacies and medicine cabinets.

Organizations and individuals who peddle fake medicines do not merely abuse intellectual property, they put unsuspecting patients at risk by exposing them to unknown contaminants and denying them medicines

known to be safe and effective at treating their medical condition. Counterfeit products are a major concern to FDA. Our focus is to protect the public health, and I'll discuss today measures FDA has taken and continues to take to support this effort.

I serve as Cochair of FDA's Counterfeit Drug Task Force. The task force was established in 2003 and consists of senior FDA officials. Our mission is to develop recommendations for steps FDA, other government agencies, and industry could take to minimize the risk to the public from counterfeit drugs getting into the U.S. drug distribution system.

Today I'd like to review with you some of the work of the task force, how it relates to FDA's general efforts to fight counterfeit drugs. In these remarks, I'll talk about FDA's recent experience in fighting counterfeit pharmaceuticals, progress to date of the Counterfeit Drug Task Force, and future actions to look for regarding electronic track and trace technologies to fight counterfeit medicines.

Before discussing steps to improve the integrity of the U.S. drug supply, it's important to note how good it already is. We have no direct quantitative evidence of the prevalence of counterfeit drugs because they so successfully mimic genuine products and by all accounts are rare. We're confident that the overwhelming majority of prescription drugs sold in the U.S. are products genuinely approved by FDA.

Slides two to four in my handout illustrate how similar fake medicines can be to the genuine product. On slide two, there's a picture of authentic Viagra pill and a suspect Viagra pill, which superficially appear indistinguishable to the untrained eye.

When subjected to analytic chemistry methods, one can see that the lettering is slightly different and by that means help distinguish the authentic from the suspect.

On the next slide, there's a photograph of authentic versus genuine Lipitor. Again, these look for all intents and purposes so similar as to be indistinguishable. Even trained pharmacists sometimes can't tell the difference, but when the image of one is superimposed against the image of the other, you can see that they're different, and indeed, they in fact may have very different effects in terms of the treatment.

On the next slide, I have pictures of the packaging of Serostim, which is to treat wasting disease associated with AIDS, and here you see again that the packaging is so similar as to be virtually indistinguishable. As a result of the similarities, it's very difficult to make general statements about how prevalent the counterfeit drugs are in the United States.

In contrast to the United States, in some countries with less effective regulatory systems, fake medicines may be a significant share of all medications so that avoiding them is a major concern of patients and

doctors.

The high confidence that FDA and the public have about the integrity of the distribution system for U.S. drug products stems from a web of federal and state laws. Despite this high confidence, FDA has been concerned that the drug supply is under increasing threat of attack from evermore sophisticated counterfeiters.

The agency has witnessed an increase in counterfeiting activities and a greater capacity to introduce finished dosage form counterfeits into legitimate drug distribution channels.

Illicit wholesale drug diverters and others in the supply chain provide the window through which most counterfeit drugs have historically entered legitimate distribution channels. Through our years of experience battling counterfeiters, we've seen a trend in the type of drugs that are most often counterfeited. We use this knowledge to allocate our resources while keeping abreast of new trends.

The number of newly initiated counterfeit drug cases seems to be on the rise. For fiscal year 2004, FDA's Office of Criminal Investigations, or OCI, initiated 58 counterfeit drug cases, a significant increase from the 30 cases initiated in FY03 and from an average of less than ten in the four years before 2001. That's slide five in the handout that I've distributed.

We believe that the unusually high number of cases in fiscal year 2004 is in part due to an increased awareness and vigilance at all levels of the drug distribution chain. We believe the Counterfeit Drug Task Force Report that FDA issued in 2004 of that year may have been a contributing factor to that peak.

A second is increased referrals from and coordination with state and other federal law enforcement agencies such as ICE, DEA, and FBI and communications with drug manufacturers. In 2005, the number of counterfeit drug cases dropped back down to 32. This drop may be due partly to a positive deterrent effect of the 2004 cases.

Let me stress that these are estimates of the number of newly initiated counterfeit drug cases being investigated, and since these are ongoing cases, we have no estimate of the volume of counterfeit drugs involved in each case. It could vary from dozens to thousands of prescriptions.

Fortunately, most of the counterfeit drugs at issue didn't reach consumers because we focused our resources and developed proactive investigations. We believe that this strategy enabled us to identify components of counterfeit products and interdict finished counterfeit drug product before they entered retail distribution.

It's important to note that the number of cases that OCI has opened is not an indication of the prevalence of drug counterfeiting in the U.S.

Nearly, four billion prescriptions are filled annually. That means a very large volume of drugs is moving through the supply chain.

Unfortunately, not everybody abides by the rules. Counterfeit, stolen, and otherwise fraudulently obtained pharmaceutical drugs can enter legitimate channels through preexisting illicit diversion networks.

OCI enforcement efforts against these diverters have resulted in detection and dismantling of counterfeit schemes. In 2004, FDA released a report entitled "Combat in Counterfeit Drugs." We recommended a use of radio frequency identification as an example of promising electronic technologies to promote track and trace of drugs throughout the supply chain in the United States.

Electronic track and trace technology such as RFID would help stakeholders meet and surpass the goals of the Prescription Drug Marketing Act. That act was enacted in 1987 in response to a number of counterfeit drug incidents in the U.S. where patients received counterfeit drugs.

The Counterfeit Drug Task Force was reconvened last fall by Acting Commissioner Dr. Andrew von Eschenbach because progress has been made toward adoption of RFID and implementation of the electronic drug pedigree across the U.S. drug supply chain, but more slowly than FDA had earlier anticipated.

Acting Commissioner von Eschenbach asked the task force to assess the progress that has been made in adopting electronic track and trace technologies and to look at the obstacles that have been encountered and what measures should be taken to quickly overcome these obstacles.

He also asked the task force to address what, if anything, the agency should do upon the expiration in December 2006 of the stay of certain provisions in the regulation related to PDMA.

The task force organized a public meeting and a vendor display in Bethesda, Maryland on February 8 and 9 to address these issues. It is preparing a report based on what it learned in the public meeting and from comments submitted to the public docket. This report is scheduled to be released very soon.

At the meeting, Acting Commissioner Dr. von Eschenbach and Assistant Secretary for Health Dr. Agwunobi discussed electronic track and trace as a way of fighting counterfeit drugs. The agenda, slides of many presentations, and the entire transcript are available at fda.gov in the counterfeit drug section.

We were pleased to have in attendance senior representatives of some of the biggest stakeholders in the manufacture and distribution of pharmaceutical products, as well as ECP Global, a standard-setting organization.

During the public meeting, we heard vendors, wholesalers and some

manufacturers agree that radio frequency identification pilot projects conducted to date showed that providing real-time electronic pedigrees is already feasible in a production environment with single wholesalers.

But no pilot projects were presented that provided an RFID base pedigree for a drug product sold by one wholesaler to another before being sold to a retail pharmacy. The RFID tags that might be used to provide electronic pedigrees are illustrated in the last slide of the handout that I've distributed.

Some vendors also discussed hybrid technologies such as two-dimensional bar codes combined with RFID that might provide both identification and electronic pedigrees even without RFID being universally adopted.

We continue to believe that electronic track and trace technologies could offer substantial advantages both to RFID in its effort to ensure the protection of the drug supply and to industry.

Electronic track and trace along with software solutions could create a chain of custody for FDA-approved products and could thwart efforts by would-by peddlers of diverted or fake medicines, leaving them unable to sell to unsuspecting U.S. wholesalers, pharmacists, and most importantly patients.

If there were universal adoption of electronic track and trace technology, the label in this instance would not only convey FDA approval but also provide assurance to confirm that a particular package was tracked at each stage of the distribution chain from the FDA approved manufacturing facility to the dispensing pharmacist through this electronic pedigree.

This system if properly implemented could offer savings to private firms so that the benefits of greater certainty about safety and efficacy are realized without any untoward increase in the cost of medications at a retail level.

This final point is important. While fighting counterfeit drugs is a key part of FDA's mission to ensure drug safety, we acknowledge important public concerns about the cost of medications and implications of high cost for access to drugs.

Based on discussions with some drug companies and retailers, we believe that electronic track and trace could offer significant savings to manufacturers, wholesalers and retailers alike from better inventory management.

In conclusion, stakeholders should look for additional actions by industry to adopt electronic track and trace technology. A confluence of two separate interests, both safety concerns and business concerns, will carry forward these actions.

As stated by Assistant Secretary Dr. John Agwunobi at the public

workshop, our interest in electronic track and trace technologies is primarily about safety. My family, like yours, walks into a pharmacy to get a prescription filled and then takes it home and gives it to the kids. My family like yours doesn't worry about whether the drugs are fake and we're grateful that we don't have to worry, but we at FDA worry whether we will have done enough to avert a tragedy that might grab headlines and TV time.

But apart from this safety concern, which some businesses share, adopting RFID may simply be very good business for drug makers and distributors alike. It's entirely possible that one day we'll all wake up, we'll open the newspaper and splashed across the headline of the newspaper will be a tragic event affecting a friend or a member of our community.

This person will have ingested something they thought was a legitimate medication, but in fact was counterfeit and dangerous and toxic. On that day, as network news is running the story, some companies will be able to stand and say the tragedy didn't occur for their drugs because they were protected throughout the distribution chain.

A brand will stand out while others will be tainted. Manufacturers ought to think about this eventuality, at least as hard as we consider the safety risk posed by failure to adopt appropriate measures to fight counterfeits.

Thank you for this opportunity to testify today on this important issue. I'd be pleased to respond to any questions.

PANEL V: Discussion, Questions and Answers

HEARING COCHAIR HOUSTON: Thank you very much to both of you.

Mr. Delli-Colli, four or five years ago when importation of counterfeit drugs appeared on everyone's radar screen, it seemed like it was fundamentally associated with Internet Websites, and there was much discussion about Websites that claimed to be in Canada where they were really everywhere else and someone just bought domain name, stuck a Canadian flag up there, and started selling counterfeit prescriptions to unsuspecting Americans.

It seems that the balance might be shifting a little bit. We read more and more stories in the newspaper that these counterfeit drugs from China, as well as other countries, have appeared in pharmacies, and I know one of the most recent cases that I read about, it was counterfeits from China that appeared in the pharmacy.

What do you see as the balance between the Internet sales now and those counterfeits from China that are appearing in the distribution chain

directly here? And does your agency have any direct interaction with the Chinese government as far as these counterfeits go?

MR. DELLI-COLLI: Yes. With respect to the balance, I don't have any direct information to actually show what percentage of cases we have involve direct Internet sales versus what ends up in a pharmacy. Because we're a border investigation agency, most of the cases that we initiate oftentimes develop either as a result of the industry providing information to us or more commonly as a result of a seizure at a port of entry.

I would say that most of the cases that I'm familiar with still seem to be cases involving the internet and involving people ordering drugs over the internet either for personal consumption or they're engaging themselves in distribution and they're using the Internet as a source of their supply and people that, when we tend to do these control deliveries, oftentimes the people that are ordering the pharmaceuticals do not have prescriptions themselves, and they are ordering over the Internet because they're trying to evade the law.

HEARING COCHAIR HOUSTON: To the best of your knowledge, has our government approached the government of China to discuss this Internet issue? Are they looking at that from their end at all?

MR. DELLI-COLLI: We're engaged with law enforcement entities in China, specifically the MPS, in working these investigations. The intellectual property right issue, multi-agencies are engaged with China on that, the Department of Commerce, Department of State. ICE being a law enforcement agency, we tend to deal strictly with law enforcement issues in trying to when we can trace, take an investigation and trace the origins of that investigation back to specific people in China or other countries.

We will attempt to engage with local law enforcement there to try to take action against the suppliers. In my testimony, I gave two examples where we are beginning to work closely with China MPS in carrying these investigations back to their country and identifying the source of supply for these drugs.

HEARING COCHAIR HOUSTON: Thank you. Dr. Lutter, a similar question for you. As far as China goes, does China have an agency that's complementary to our FDA here, and how cooperative are they? Has FDA here made an attempt to discuss with the Chinese government these problems? Certainly, losing 200,000 people in one year to fake drugs made in China, and I understand there's problems in China also with babies' formula, they've had a number of deaths there.

Is there a liaison between the two agencies? Is there a similar to the FDA over in China that you've been working with?

DR. LUTTER: There is a Chinese equivalent to the FDA. It is

called SFDA, at least in English. We do have contacts with them. The Office of International Programs at FDA has the lead on that, and we share an interest in ensuring effective regulation of foods and drugs to ensure that health and safety is promoted four our respective citizens.

HEARING COCHAIR HOUSTON: Thank you very much. Chairman Wortzel, you had a question?

CHAIRMAN WORTZEL: Thank you. Dr. Lutter, could you tell us the number of counterfeit drug cases, let's say, you've got 2004 and 2005 in your testimony, that deal with China? And what counterfeit medicines have come in? China is not mentioned anywhere that I can see in your testimony. This is the U.S.-China Commission, so I really appreciate your description of the efforts, but can you tell us what China has done in this country to either introduce counterfeit drugs or what counterfeit drug cases, you have been part of that involve China?

DR. LUTTER: Let me provide some information on that. We have, first of all, some enforcement efforts pertaining to China. In January of 2005, FDA obtained a guilty plea from an individual for importing more than 30,000 counterfeit Viagra tablets from China and manufacturing 700,000 counterfeit Viagra tablets at a laboratory in the U.S., and the total value of that counterfeit Viagra in this case was more than $5.5 million.

In September of 2005, an indictment and arrest was accomplished for the importation and distribution of counterfeit Viagra and Cialis that were manufactured in China and distributed via an online Internet site. In conjunction with this investigation in the U.S., Chinese authorities arrested 11 individuals in China and seized equipment used to process counterfeit pharmaceuticals. There were 600,000 counterfeit Viagra labels and packaging, 440,000 counterfeit Viagra and Cialis tablets, and 260 kilos of raw materials used to manufacture counterfeit pharmaceuticals.

In discussions with the enforcement staff and the Office of Criminal Investigations, we unfortunately do not have an up-to-date quantitative estimate of the share of these cases that involve enterprises in China or Chinese nationals. The consensus view, however, is that a significant share of these cases do have some link to China, and I think that's consistent with the information provided by my colleague.

CHAIRMAN WORTZEL: How about antibiotics? At the time when people all around the United States were trying to get antibiotics because they were worried about terrorist threats and things like that.

DR. LUTTER: You're concerned in particular, perhaps, with Tamiflu which could be used for bird flu?

CHAIRMAN WORTZEL: That or the broad-spectrum antibiotic--

HEARING COCHAIR HOUSTON: Oh, Cipro.

CHAIRMAN WORTZEL: Ciprofloxacin.

DR. LUTTER: Cipro. I regret that I don't have information--

CHAIRMAN WORTZEL: Did they try and get any in? Did any hit the U.S. market?

DR. LUTTER: --on the share of those that may have come from China.

CHAIRMAN WORTZEL: Was there counterfeit Cipro in the U.S.?

DR. LUTTER: I'm not certain of that. I'm sorry I don't know.

CHAIRMAN WORTZEL: Can you provide that for back-up?

DR. LUTTER: Yes, I could provide that.

[Note: On July 6, 2006, Dr. Lutter provided this follow-up to his prepared statement regarding counterfeit pharmaceuticals:]

1. Does FDA have evidence of counterfeit Cipro entering the United States?

FDA has no record of confirmed cases of counterfeit Cipro sold in this country but we do have cases of unapproved foreign ciprofloxacin being imported and some of this originated from China. Not only are unapproved drugs illegal in the US, they are generally of unknown quality and may contain active ingredients in concentrations that are too high or low for the proper therapeutic effect, contain no active ingredients at all, or fail to meet standards for purity, or dissolution. As a result, they pose a threat to public health.

2. Are there facilities that manufacture FDA-approved drugs [or drug products] in China?

Over the past 12 years, FDA has received applications for new drugs or for supplements that have led to inspections of 80 facilities located in China.

These include:

71 (Active Pharmaceutical Ingredient) API manufacturers

1 Finished dosage manufacturer

3 Both API & finished dosage manufacturers

2 Intermediate drug substance manufacturers

2 Contract Laboratories

1 Repackager

HEARING COCHAIR HOUSTON: Commissioner Mulloy.

COMMISSIONER MULLOY: Thank you both for being here. We're talking about intellectual property rights, today, and you're fitting into that, and our problem is that our own law is protecting patents and copyrights and trademarks and all these things cannot apply in China, so the TRIPS Agreement was rather than have our laws apply in China, that they would agree internationally in the WTO to put their own laws in

place policing patents, copyrights, trademarks, which they would enforce in China.

So what goes on in China, we worry about through the TRIPS--but then the problem is we now--and I saw the show on Sunday night on Dateline about all of the counterfeit drugs coming out of China to the United States. Now, we can apply our own laws to things coming within our own nation.

In the show on Sunday night, they talked about Lipitor being one of those drugs that gets counterfeited, and as a person who takes Lipitor and then reading about your point that somebody is going to die and there will be a picture in the paper and everybody will be saying, gee, why didn't we do something to protect, I'm thinking maybe that's me.

Do we have laws in our country that prevents those counterfeit goods from coming into our country? And two, if we have such laws, do they have criminal penalties, meaning jail time, associated with their enforcement? Three: Do those laws need to be strengthened in any way? In other words, I worked in the Senate when Senator Proxmire wrote the Foreign Corrupt Practices Act, and in that law, it said that if you're associated with making bribes or have reason to know that you're making a bribe, that you can be criminally liable, jail time?

Do we need to strengthen our laws in any way to make them more of a deterrent? This is a very, very scary subject for Americans to think about.

Four: Following up on Commissioner Houston's point, can you give us a rough outline--is coming from China? How much is coming from the Internet via China? And how much is coming by these packages that get sent by express mail from China? So if I could throw that open to maybe either of you or both of you to comment on?

MR. DELLI-COLLI: You've asked a few different questions. If I forget to cover one of them, you can ask it.

COMMISSIONER MULLOY: Yes.

MR. DELLI-COLLI: Regarding U.S. laws, we do have the effective laws that combat the importation of counterfeit products. It's detecting it. You have to actually interdict the product before you know it's counterfeit.

But there are various laws. There's trafficking and counterfeit goods. There is a criminal sanction on that. If you're importing it, you know, 18 U.S.C. 545, smuggling or importing goods contrary to law now carries upwards to a 20-year sentence, recently changed.

The laws are there. I think in the past, though, the sentencing guidelines haven't been all that effective in providing serious sanctions to people that do get caught, and so the profits that can be made versus, you know, the consequences made it a very profitable business.

We're starting to see a swing in the direction of greater sentencing with respect to intellectual property rights enforcement, but, you know, I think that's something that could be looked at with the sentencing commission to see if the guidelines are appropriate, especially when it comes to products that could affect the public health and safety.

Regarding China and their laws, I don't know the whole Chinese legal system. I do know, though, that they do have criminal sanctions.

COMMISSIONER MULLOY: I don't care about that in China. I'm worried about here.

MR. DELLI-COLLI: Yes.

COMMISSIONER MULLOY: We have criminal penalties.

MR. DELLI-COLLI: We have criminal penalties.

COMMISSIONER MULLOY: If people can be put in jail and do jail time? But your point is that even if they get convicted, the sentencing guidelines may give them a fine rather than jail time?

MR. DELLI-COLLI: That's correct. If you're a first-time offender, dependent on the level of fraud associated with the counterfeiting that goes along with that. Again, over the last several years, we are starting to see better sentencing. I mentioned in my statement a couple sentences where this gentleman Guthrie on the DVDs was given a five year sentence here in the United States. So those sentences starting to get significant will make people think twice about engaging in that.

COMMISSIONER MULLOY: Yes, exactly.

MR. DELLI-COLLI: And that's the trend; we need to continue that trend.

COMMISSIONER MULLOY: Okay.

MR. DELLI-COLLI: You had a question regarding the Internet?

COMMISSIONER MULLOY: Yes. How much of this is coming? Do you know that? Do you have that breakdown from China, how much is coming in via the Internet versus how much?

MR. DELLI-COLLI: China, with respect to ICE, we're engaged in all sorts of intellectual property rights violations and pharmaceuticals represent about two percent of what CBP and ICE seized in 2005. About $2 million worth of counterfeit pharmaceuticals were seized.

Again, how much comes from China, it's hard to break that down, because there's a lot of transshipment going on. There's a lot of anonymity about where the source of this stuff is once we do seize it. I will say, though, that China represents about 70 percent of all counterfeit products coming into the United States. China is the source country for that.

So it would be safe to say that China probably represents the majority of the pharmaceuticals. Although we have seen Mexico, we have seen Thailand, we have seen India even. Recently India has popped up

with respect to the production of Viagra. So it's there, but other countries are finding that the profit margin is great.

DR. LUTTER: If I could offer one comment in response to your last question about the Internet. We lacked to speak directly to it, but I could offer a little bit of information that might be informative. We reported, I believe it was December of last year, on an operation that we call Bait and Switch, and this was what we sometimes call a blitz, where we stopped at the borders a collection of individual parcels that contained pharmaceutical products typically ordered from Internet pharmacies located outside the country, and the instructions were to stop all of those from four countries.

They were India, Israel, Costa Rica and Vanuatu, which in the packaging had had some evidence indicating that they were ordered at apparently Canadian Websites, and I emphasize the apparently, that there was something in the name of the Website to suggest that it was affiliated with or located in Canada.

And the conclusion was of all the drugs stopped from these countries, nearly half had documentation suggesting that they were coming from apparently Canadian Websites and of those, I think it was 85 percent came from 28 countries around the world. I can't remember the importance of China among those countries, but the key message is there's essentially an illicit international black market, if you will, completely unregulated in finished pharmaceutical products.

In other words, Websites that claim to be Canadian in some way were shipping drugs or arranging for the shipment of drugs from say Israel or Costa Rica which actually originated in places like Bulgaria seemingly. Now, where they actually came from, who knows? Whether they were manufactured in China and packaged in Bulgaria, I don't know.

But the key message is that it's very difficult to link the actual shipments to particular countries because in this instance consumers thought that they were buying them from apparently Canadian Websites, discovering shipments come from third-party countries, but from fourth-party countries and who knows where they really originated from?

All of these raise questions not only with respect to the counterfeiting and the manufacturing, but also the safe handling of the drugs themselves. Good pharmacy practices are not being followed in these cases where the pharmacies themselves are outside of any regulatory system.

COMMISSIONER MULLOY: Thank you both.

HEARING COCHAIR HOUSTON: Can I just ask a clarifying question for my own edification following up on what Commissioner Mulloy asked?

Does current U.S. law say that importing counterfeit drugs is

illegal or that importing any drugs not through the approved chains is illegal? So if I'm an American citizen and I go on an alleged Canadian Website, which is probably in China, I am breaking the law by doing that; am I not?

DR. LUTTER: Let me try and answer that, please. The counterfeit in the Food, Drug and Cosmetic Act is a drug that masquerades as a genuine product. So it's a drug which is packaged as if it is genuinely made by an FDA approved manufacturer, but in fact is not, and an unapproved drug is simply one that lacks FDA approval.

So it could be one that is sold to treat a certain disease but we've never approved it for such. And in that sense, the Federal Food, Drug and Cosmetic Act prohibits the importation of unapproved drugs and including counterfeit drugs.

Mind you, there's one other important distinction to bear in mind. We do allow importation of FDA approved drugs. For example, many U.S. based pharmaceutical companies have manufacturing facilities located outside this country. For business reasons, they choose to locate elsewhere and we offer inspection of these manufacturing facilities verifying in the course of that inspection that the facilities follow good manufacturing practices and produce drugs that meet our standards for safety and efficacy and those drugs are permitted to come into the United States.

In essence, they're manufactured in facilities which are underneath the FDA regulatory umbrella.

HEARING COCHAIR HOUSTON: Okay. Commissioner Bartholomew.

COMMISSION VICE CHAIR BARTHOLOMEW: Thank you very much. Thank you to our witnesses. A couple of questions. One is what do we know about the production facilities in China in terms of where these counterfeited drugs are coming from?

We heard this morning, for example, about some brake pads that were coming in that were made out of compressed wood and grass. They were not at all related to anything that would go into a brake pad, and yet we've also heard about other facilities that do legitimate production work all day long and essentially at night do counterfeiting of some of the same products. The source of some of these counterfeit drugs, is it legitimate facilities that are doing knockoffs on their own time? Is it people making things in their kitchen? That's one question.

Second question is some of these other locations, Dr. Lutter, that you mentioned, places like Vanuatu, is the product being transshipped? Is it being produced somewhere like China, being transshipped through these places? Or do we know if production is going to be there?

My third question, specifically to Mr. Delli-Colli is, are we

following up. I see a press release in our briefing book from February 6, about the successful case that you guys had, and it notes that 11 individuals were arrested in China and charged with manufacturing and distributing the counterfeit Viagra, Cialis and Lipitor.

Do we keep track of what happens to those people afterwards? Are they indeed serving prison time? Do they just get a slap on the wrist and then are they released? Or once the arrests have taken place, do we stop tracking what's going on? Thanks.

MR. DELLI-COLLI: I'll answer that last question. We do keep track of that. We have a special agent that is assigned to the Beijing office that works very closely with the Chinese MPS on these cases, and that's the case actually mentioned in my testimony. I personally don't know the status of those arrests.

They do have a judicial system. It does take time to go through their process, but we will eventually find out exactly what happens with those 11 individuals.

COMMISSION VICE CHAIR BARTHOLOMEW: I mentioned it specifically, of course, because on the counterfeiting of other products, CDs, movies, things like that, a lot of times the punishment essentially just becomes a fine or something and it's a cost of doing business.

So it would be interesting if you could provide some follow-up information for us about where we think these people are. It would be interesting to know.

MR. DELLI-COLLI: Yes. I just said to the extent that we do find out, but our attaché will continue to press to follow up in these cases because it's a joint case, we work with them, so obviously we have a reason to want to know. And we are trying to do other cases like this with them. We want to continue this. These are two nice stories, but we need to keep that momentum going over there.

COMMISSION VICE CHAIR BARTHOLOMEW: Okay. And then production facilities, do we know anything about it?

DR. LUTTER: Let me start with the easier one, if I may. You asked about transshipment from countries like Vanuatu. We don't know. We know what we find at the border when our inspectors during that operation found the parcels, read carefully the labeling, looked carefully at the packaging, did some analysis of the drugs and made judgments about, based on that information, where they originated.

Those judgments are limited in terms of what they can tell us where the products actually originally came from. If you distinguish for a moment between the active ingredient and the finished pharmaceutical product, this information tells us nothing about where the active ingredient comes from. That could well come from a fifth country which is then sent, call it China, but I don't really know, and then goes to a

manufacturing facility in Bulgaria where some of these packages, in fact, originated, where a product was then made in pill form, which was then packaged with counterfeit labeling in a third country before being shipped from a pharmacy, call it Vanuatu, located in Vanuatu, in response to orders on a potentially, allegedly Canadian Website.

So it's very difficult to track this given the legal authority that we have. This is an unregulated wild West international market. With respect to the locations of the manufacturers' facilities in China, we don't have information on that.

COMMISSION VICE CHAIR BARTHOLOMEW: But on this case, we must have tracked the product back to some production facility, the successful case. And I'm just wondering what we know about the production facility itself?

MR. DELLI-COLLI: I know it was a sophisticated operation with respect to the equipment they used, but it was not like a legitimate pharmaceutical facility. It was sort of fly-by-night set-up.

DR. LUTTER: Let me comment on that. Even if legitimate, I'm not quite sure that means, but a key concern from a safety perspective is that if the active ingredient is present, that doesn't mean that it's substitutable or safe. It could be in too low a concentration, what we call subpotent. It could be in too high a concentration, what we would call superpotent. Either one can have very harmful effects on patients.

If potency is too low, they won't enjoy the therapeutic benefits that the doctor expects. If potency is too high, there's adverse side effects resulting from exposure to the drug. If the actual pill is made wrong so it dissolves improperly, the pharmacokinetics will be wrong so that the concentrations of the active ingredient in the blood won't correspond to what the physician expects. All of these pose problems.

COMMISSION VICE CHAIR BARTHOLOMEW: I certainly did not mean to imply that there were some counterfeit drugs that might be safer or better than other counterfeit drugs. I'm trying to understand the nature of the problem that we are confronting. Is this large-scale manufacturing facilities that have some aura of legitimacy, is this stuff that is being done by people who are opening up one place, shutting down, moving to another place, opening up, that's all? And just trying to find out.

Obviously, figuring out ways to track the product to its source is going to be a piece of addressing the problem where it starts as well as stopping it along the way. I'm just trying to figure out what we know if anything about it. Obviously figuring out ways to track the product to its source is going to be a piece of addressing the problem where it starts, as well as stopping it along the way.

DR. LUTTER: Again, I wish I had direct information to answer

you exactly on point, but the slides that I showed indicating how similar the counterfeits are to the authentic products suggest, and this is a view shared by the pharmacists and analytic chemists at FDA, suggests that we're dealing with very sophisticated production facilities because these are so good that you can take them to trained pharmacists who dispense them on a regular basis, and they can't tell.

COMMISSION VICE CHAIR BARTHOLOMEW: And for the people who are producing them, they are people who need a degree in chemistry or in pharmacy, something like that?

DR. LUTTER: Oftentimes the manufacturers themselves can't tell without sending it to an analytic chemistry lab.

COMMISSION VICE CHAIR BARTHOLOMEW: Thanks.

HEARING COCHAIR HOUSTON: A follow-up to Commissioner Bartholomew's question. I remember about a year and a half ago the Minnesota Pharmacy Association took a field trip, and they went over the border to Canada to several of the pharmaceutical houses, warehouses, that actually allowed them to come in, not to mention the ones that didn't allow them to come in, that were what many people would call reimporting American drugs in.

And the Minnesota Pharmacists Association found 1,152 violations in these legitimate Canadian warehouses including not keeping insulin in a refrigerator, things of that nature, safety issues. And these were people who were licensed in Canada to do legitimate business in pharmaceuticals.

Maybe this is part of what you are asking, Commissioner, are there any legitimate pharmaceutical producers in China? You mentioned that some of our pharmaceutical houses have production facilities overseas. Are there any in China that also have the side business or are there no legitimate approved safe pharmaceutical manufacturing facilities in China as relates to our pharmaceutical industry here?

DR. LUTTER: FDA would have no judgment on the safety and efficacy of products which are not submitted to us for approval. So with respect to whether the Chinese products are safe and effective, we don't know. We haven't seen any data.

With respect to whether there's manufacturing facilities approved by FDA, located in China, I believe the answer is yes, but let me confirm that later.

HEARING COCHAIR HOUSTON: Any other questions? Thank you, gentlemen, very much. We appreciate your time. We'll take a quick five minute break and then we'll come back.

[Whereupon, a short break was taken.]

PANEL VI: PHARAMACEUTICAL INDUSTRY

HEARING COCHAIR HOUSTON: Back to drug counterfeiting in China. We are going to look at that from an industry perspective. With us this afternoon is Peter Pitts, who is the Senior Vice President of Global Health Affairs. He has in the past been an FDA Associate Commissioner for External Relations. He supervised FDA's Office of Public Affairs, Office of Special Health Issues, Office of Executive Secretariat. Sounds like you were in an awful lot of offices, Mr. Pitts.

He's also associated with the Hudson Institute. He's an author. He has a book called Become Strategic or Die and writes a column for UPI, and we're very thankful that you're with us today because you are indeed a wonderful expert on the joys of counterfeiting.

PETER PITTS
PRESIDENT, CENTER FOR MEDICINE IN THE PUBLIC INTEREST, NEW YORK, NY

MR. PITTS: Commissioner Houston, thanks very much. Thank you very much for inviting me to testify this afternoon. My name is Peter Pitts and today I am here in my capacity as president of a think tank, the Center for Medicine in the Public Interest. As was mentioned, I was previously an FDA Associate Commissioner and during my tenure at the FDA I was proud to have served on the agency's Counterfeit Task Force that was mentioned by Dr. Lutter.

When asked why he robbed banks, Willy Sutton, the Depression era desperado, replied, "Because that's where the money is." And as my former boss, former FDA Commissioner Mark McClellan, used to say, if Willy Sutton were alive today, he'd be selling counterfeit drugs.

The bad news is that international prescription drug counterfeiting is on the rise and it's nothing less than international health care terrorism.

The Center for Medicine in the Public Interest estimates that globally counterfeit drug commerce will grow 13 percent annually through 2010. That means that counterfeit drug sales will grow at nearly twice the rate of legitimate pharmaceutical commerce.

In 2010, this illegal business will generate $75 billion in revenue, a 92 percent increase from 2005. The profits are high and the risks are low. And that's a deadly combination.

A large proportion of the world's counterfeit medicines originate in Asia and end up in the U.S. and the EU. In the EU, between 1998 and 2004, there has been a 1,000 percent increase in seizures of counterfeit prescription drugs and China in particular is a production center.

In 2001, it was reported that Chinese authorities closed 1,300

illegal factories will investigating 480,000 cases of counterfeit drugs worth $57 million. The State Food and Drug Administration, the SFDA, of China announced that from January to November of 2005, it banned 114,000 unlicensed drug manufacturers, destroyed 461 illegal pharmaceutical factories.

It is estimated that in China between 200,000 to 300,000 people each year die due to counterfeit or substandard medicine, and these are reported cases. The true number of cases is likely to be far higher.

Unfortunately, their product is fast becoming our problem. This past December, U.S. Customs agents intercepted more than 50 shipments of counterfeit Tamiflu, the antiviral drug being stockpiled in anticipation of a bird flu pandemic. The fake drugs had none of Tamiflu's active ingredients. Information on the packaging shipments was written in Chinese.

Jeffrey Gren, the Director of the Commerce Department's Office of Health and Consumer Goods, announced in a recent speech that the U.S. government is working on stopping the illicit flow of active pharmaceutical ingredient API, which can be used in counterfeit medicines. Gren said that the Commerce Department is focusing efforts on China and India. China maintains that it cannot be responsible for the API produced in China used outside of China.

The production and trading of an active pharmaceutical ingredient in bulk form needs to fall under the same rules that govern the production and trading of manufactured pharmaceuticals.

Today, this is not the case in China and the unfortunate result is that exports of active pharmaceutical ingredients are not regulated by the SFDA.

On April 29, 2006, the Chinese Department of Health announced that fake medicines purporting to lower blood sugar resulted in at least three blood poisoning cases last year. Patients received fake medicines with illegal chemicals, oftentimes paint.

The SFDA has released a warning about counterfeit Glucobay, a diabetes medicine. After receiving a complaint from a consumer, the SFDA worked with Bayer to determine that the suspect product was counterfeit. Currently Chinese officials believe 6,000 boxes could be affected, and an investigation against the counterfeit producers has been launched.

Since early 2005, health and regulatory officials in Leizhou have seized 308 types of fake and substandard medicines and medical devices.

Nigeria's health agency, the NAFDAC, recently issued a public criticism of China's perceived unwillingness to collaborate against counterfeit medicines. Counterfeit medicines account for approximately 68 percent of the drug market in Nigeria with the vast majority of illicit

products coming from China.

Taiwan's Criminal Investigation Bureau, the CIB, announced this week that roughly $9 million worth of counterfeit drugs was seized recently in Taipei. Counterfeits including cold treatments, gastrointestinal medicines, sedatives, anti-obesity and erectile dysfunction drugs and 210,000 unknown pills were claimed. The CIB claims that the counterfeits were mainland Chinese origin.

During a recent FDA blitz operation, that Dr. Lutter mentioned, at airports in New York City and Miami, over 25 different controlled substances, controlled substances, were found including drugs such as Diazepam, codeine, Valium and anabolic steroids. Many of these were counterfeit and of Chinese origin. The Internet via China has the very real possibility of becoming the 21st century's virtual drug cartel.

Imposing effective deterrent penalties on those engaged in prescription drug counterfeiting is the most important step the Chinese government can take to stem the tide of illegal and unsafe counterfeit drugs. An effective criminal deterrent is a requirement of TRIPS, the Trade Related Aspects of Intellectual Property Rights, Article 61.

The EU Council of Ministers recently approved a plan issued by the European Commission to improve Customs coordination against counterfeit goods. Currently, in the EU, 70 percent of seizures are from China.

At the beginning of my testimony, I mentioned that I served on the FDA's Task Force on Counterfeit Drugs. The task force recommended eight measures that should be taken to address this public health concern. The eighth and final recommendation is collaboration with foreign stakeholders to develop strategies to deter and detect counterfeit drugs globally.

I strongly urge this commission to help make the FDA's recommendation a reality because if we wait for the current problem to become a disaster, we will have only ourselves to blame. As the Chinese proverb says, an ant may well destroy a whole dam.

Thank you.

[The statement follows:]

Prepared statement of Mr. Peter Pitts
Center for Medicine in the Public Interest, N.Y., N.Y.

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concern in open-air markets.

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The eighth and final recommendation is:

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As the Chinese proverb says, an ant may well destroy a whole dam.

Thank you.

PANEL VI: Discussion, Questions and Answers

HEARING COCHAIR HOUSTON: Thank you very much, Mr. Pitts, and let me start with the first question. All day we've been hearing testimony about what the Chinese government is or is not doing about IPR violations and counterfeiting, and you mentioned that in 2005, they did

close about 100,000 unlicensed drug manufacturers and 461 illegal pharmaceutical factories.

Does that mean that they are doing something or they're posturing and looking like they're doing something or do you in your opinion think they really are taking the counterfeit problem seriously?

MR. PITTS: I think the Chinese government is taking the problem seriously in the sense that commerce they cannot control, they cannot help to kind of grow and grow globally. The factories that by and large they're closing down are garage operations, small storefront operations. The few large pharmaceutical manufacturers that they've closed down were not moonlighting in counterfeits. They were counterfeits from beginning to end.

So, yes, I think the Chinese government is beginning to take it seriously, but it is not a country as developed from a rule of law standpoint clearly as we would like to see. And the more pressure the U.S. and the EU can put on the Chinese government to take this issue very seriously, either through a TRIPS standpoint or more importantly in my opinion, as a former public health official, from a public health standpoint, the more rapidly the Chinese government will take it more seriously and deal with it much more effectively and with greater force.

HEARING COCHAIR HOUSTON: And do you see, are they working government to government from the Chinese government to the U.S. government, or are they also working in partnership with some of the U.S. pharmaceutical companies like Pfizer or Merck or companies that are finding their drugs counterfeited over there? Do they allow them in to work on Chinese turf to try to close some of these counterfeiting operations down?

MR. PITTS: That's somewhat of a touchy subject. On the one hand, yes, the SFDA and the FDA do work together on certain high level issues, not really so much on the ground. To my knowledge, pharmaceutical companies who feel and have proof that their products are being counterfeited in China, go to China, do investigations and then hand over to their investigations to the Chinese government.

Some are followed up; others are not. So, yes, I think it's industry to government, it's government to government, and then it will be governments collectively with industry as well. It will have to be.

HEARING COCHAIR HOUSTON: Thank you. Dr. Wortzel.

CHAIRMAN WORTZEL: I'd like to follow up on the issue that you raised of American companies going to China, doing an investigation, and then going to the Chinese government with an investigation. Now, how do they do that? How do they manage to send Americans over to China, wander around cities, run clandestine or covert investigations? Is it the companies doing this or are they hiring Chinese attorneys or security

firms to do it for them?

MR. PITTS: I imagine it's probably a combination of all of those things, but at the end of the day, these are privately run, privately designed, privately funded investigations. Again, I also watched the Dateline special on Sunday and obviously NBC put some money on the table and did an investigation and went to China, bought some fake drugs, did a sting operation.

If you have the money and you have the means and you have the desire to do it, it can be done. And I know that the Chinese government is none to happy about it either.

CHAIRMAN WORTZEL: Then if a company can do that, why can't the United States government do that out of the American Embassy?

MR. PITTS: Well, I think that's an entirely different situation. The U.S. government can't provide a U.S.-funded, U.S. government-backed, basically in many respects espionage operations on foreign soil. I guess, to your point, it becomes kind of a technicality. What's the difference if the government does it, the U.S. government does it in China, versus Pfizer, for example, that has a Chinese operation does it in China? I think it makes a world of difference.

I wish that the U.S. government and the Chinese government would cooperate on more government to government operations that would dig deeper and come up with problems that could be more aggressively dealt with rather than putting one or two people in jail or closing four or five factories.

CHAIRMAN WORTZEL: Thank you.

HEARING COCHAIR HOUSTON: Thank you very much. Commissioner Blumenthal.

COMMISSIONER BLUMENTHAL: Yes, thank you very much. I was intrigued by one part of the testimony where you mentioned a statement about Nigeria and you singled out Nigeria. I think this is important, particularly in the sense, that China is much more of a global player these days and certainly Africa is one of those playing fields and Nigeria is one of those playing fields. And a lot of times this is hailed as a very positive thing in these countries that China is bringing commerce and investment and so on and so forth, and this is one of those instances where there is clearly irresponsible behavior on the part, I presume, of the Chinese government.

Is that correct? Can I pull the thread a little bit on that and see--

MR. PITTS: Sure. I think the issue--

COMMISSIONER BLUMENTHAL: --if you know a little bit more about that case?

MR. PITTS: I think that's a good point. Obviously, China has played a role in the third world for quite awhile and it's generally viewed

as positive because of investment purposes. But in Nigeria's case, and it came up earlier, where does the product come from? You know the issue with Nigeria is that while the Chinese government has at least mouthed the words that counterfeit produced product will be dealt with, you know, strongly.

They have said they can't control the shipment of active pharmaceutical ingredient, literally the barrels of unprocessed ingredient that goes into pills. So when we hear that pills are coming into this country from Vanuatu or Bulgaria or Latvia or Portugal, sometimes the pills are produced in those countries but the active ingredient from my information generally is coming from a broad degree in China.

The problem with Nigeria is Nigeria asks China to stop counterfeit active pharmaceutical ingredient from leaving the country to go into Africa and the Chinese government has not done that. So it's been, whether you want to call it complicit or neglectful, it's one or both.

COMMISSIONER BLUMENTHAL: How would you assess their ability to do that if they wanted to?

MR. PITTS: I don't know. I would believe it's probably limited. Obviously, any government of any size that wants to really do something it can get it done. It's a question of whether the will is there to do it. I don't know what interest within China would be hurt to do that. Clearly, it is big global business.

COMMISSIONER BLUMENTHAL: Are there other examples of developing countries with the equivalent magnitude of the problem? You said 68 percent of the drug market in Nigeria is counterfeit?

MR. PITTS: I would say mostly every African country.

COMMISSIONER BLUMENTHAL: Where China is, but are there other examples where China has acted similarly in terms of--

MR. PITTS: Nigeria is the only case I know where the government has officially complained. I'm not aware of other countries that have filed government-to-government complaints. In a lot of countries, especially in the area of anti-malarials, AIDS drugs and anti-infectives, the drugs are oftentimes subpotent or expired which leads to patients becoming immune to the active ingredient and a lot of these drugs, again, anecdotally are coming from China.

COMMISSIONER BLUMENTHAL: But no one else has complained about it?

MR. PITTS: Not that I know of.

COMMISSIONER BLUMENTHAL: Thank you.

HEARING COCHAIR HOUSTON: Commissioner Mulloy.

COMMISSIONER MULLOY: Thank you for being with us, Mr. Pitts. You're very helpful. Let me, I want to understand this, coming from China, you talk about in China two to 300,000 people die each year

due to counterfeit or substandard medicine. And you say their problem is becoming our problem. Do we import from China drugs that are not counterfeit and that could come into the country from China?

MR. PITTS: Dr. Lutter mentioned that he was not sure if there were any FDA approved facilities for drug production in China. I don't know the answer either. But I do know that there are no Chinese pharmaceutical companies that have FDA approved lines in China. So any drug that is being sent into this country manufactured by a Chinese concern is either illegal or counterfeit or both.

COMMISSIONER MULLOY: Do we have American drug companies that manufacture in China and ship back here?

MR. PITTS: I don't know.

COMMISSIONER MULLOY: Okay. So can we make the presumption, the working presumption, that almost all the drugs coming from China into this country are coming in illegally?

MR. PITTS: I think that's a very fair assumption, yes.

COMMISSIONER MULLOY: You think that's a fair assumption?

MR. PITTS: Yes, sir.

COMMISSIONER MULLOY: Then why can't we, why can't we just, why can't we get control of this problem and just, how does it come in that we can't?

MR. PITTS: Well, it comes in in a number of different ways. If you personally go to an Internet site and order drugs, they'll come to you in the U.S. mail. Sometimes they're stopped and sometimes they're not. Generally they're not. The flow is just too enormous.

If you are a criminal and you want to order tens of thousands of pills to try to get into the wholesale system of the U.S., then you'll be getting carts, crates and containers coming in by ship. Similarly, they're not stopped and they're not investigated.

COMMISSIONER MULLOY: Do they have to put on them what's in those cartons, that these are cartons--

MR. PITTS: Well, generally speaking, they don't say these cartons include illegal drugs.

COMMISSIONER MULLOY: No, but do they have to say what they do contain?

MR. PITTS: Yes, they lie. They purposefully misstate what are in those packages. It's a criminal enterprise, beginning to end.

COMMISSIONER MULLOY: Okay.

MR. PITTS: That is the most important thing to remember. This is not about lower cost pharmaceuticals. This is crime.

COMMISSIONER MULLOY: Crime. Okay. So then we got, so there are two ways. One, you order it on the Internet and it comes in a little package to you, and then there are larger shipments but they're all

disguised as to what they really are.

MR. PITTS: That's right.

COMMISSIONER MULLOY: That's the problem. We really have no way of detecting this.

MR. PITTS: Well, it's a question of resources. When I was at the FDA, people asked me why don't you stop people at the border and arrest them coming in from Canada? The answer is that's not the best bang for the regulatory dollar. What government needs to do is go after the big time criminals.

The question is, is government doing that? Is it at the top of the priority list? At this point, I think the answer unfortunately is it's not because people are not dying on the street from counterfeit drugs.

COMMISSIONER MULLOY: Yes. So your view then, we find it difficult to really police the border on this stuff ourselves, that we have to work with their government to help us police this problem?

MR. PITTS: Oh, no question about it. Obviously the best defense against counterfeit drugs coming into this country are prophylactic efforts put forth in the country of origin. Absolutely, yes.

COMMISSIONER MULLOY: Okay. Well, that's very helpful that this is one where we really have to work with their government to help us get a handle on this problem.

MR. PITTS: Another point to remember, too, is that in this country, the penalty for counterfeiting the package is stronger than counterfeiting the product. So the laws in this country need to change to become I think much more aggressive to make sure that these people realize that you do the crime, you're going to do the time.

COMMISSIONER MULLOY: Here--

MR. PITTS: Yes, in this country.

COMMISSIONER MULLOY: --the laws need to be strengthened?

MR. PITTS: Absolutely.

COMMISSIONER MULLOY: Can you give us a recommendation on that? What you think it needs to be done?

MR. PITTS: I could certainly come up with one.

COMMISSIONER MULLOY: I think that would be very helpful to us.

MR. PITTS: Yes. Clearly, right now, I'm sure you've heard and you'll hear again, it's a lot easier and much more lucrative to send in counterfeit Viagra than it is to ship in cocaine. The profits are a lot higher, the risks are a lot lower.

COMMISSIONER MULLOY: Well, thank you. If you could do that, that would be helpful for us to have, Mr. Pitts. Thank you again.

HEARING COCHAIR HOUSTON: Commissioner Bartholomew, you had a question.

COMMISSION VICE CHAIR BARTHOLOMEW: Thank you very much. Thank you, Mr. Pitts. This has been very informative, and I will just note my frustration that the FDA representative did not provide information even about the FDA's activities that you have. I feel like I have a clearer sense of some of what's going on. You mentioned the FDA blitz operation and what they've accomplished.

My question, though, still sort of trying to get to--I don't know if you were here earlier. I was trying to get to the production facilities and are they sort of fly-by-night facilities or are they perhaps state-licensed facilities that are doing state-licensed stuff all day long and doing knockoffs at night.

That's one piece of it, but also you note in your testimony that China maintains that it can't be responsible for the active pharmaceutical ingredient which is being shipped overseas. Do you have any sense of whether the Chinese government might be less willing to tolerate counterfeit drugs for Chinese domestic consumption than counterfeit drugs for exports to people outside of China?

MR. PITTS: That's an interesting question. I think, and again, not being an expert in Chinese culture, I would imagine that the Chinese government would be a lot more concerned about people flaunting its authority at home than it would be doing commerce abroad that brings in Western currency into the Chinese economy.

You asked about fly-by-night factories. In the past, the recent past, say four or five years ago, the stories out of China were of paint cans and oil bins being used to create drugs, real garage operations, and those still exist. They make wonderful horror story pictures, but I think what is considerably more frightening, and Dr. Lutter alluded to it, is that the product that's coming in now, both the packaging and the finished product, are so sophisticated that they are absolutely being created in very high tech factories.

Whether or not they are licensed by the Chinese government, I would certainly hope not. Or if they are, I would hope they're being licensed for something other than creating counterfeit drugs.

But you raise an interesting point. At what stage of development of the nation's law can you have factories that employ people that operate clearly within the awareness of at least the local authorities that continue to do business?

COMMISSION VICE CHAIR BARTHOLOMEW: And Chairman Wortzel mentioned, just as we were speaking up here, you note about the banning of 114,000 unlicensed drug manufacturers. What he noted was that the licensed drug manufacturers are state-owned and state run.

MR. PITTS: That's right.

COMMISSION VICE CHAIR BARTHOLOMEW: So there's a

question, of course, of competition that arises as well as consumer safety. That the unlicensed drug manufacturers are producing and competing with the state run and state-owned facilities and potentially cutting into their profit margins as well as the nightmare that comes about when people die because of tainted medicines or counterfeit medicines.

MR. PITTS: Well, in many respects, the FDA, the basic legislation that founded the FDA was done in 1906, a hundred years ago, and it was basically in response to a lot of snake oil that was doing serious damage to lots of people, and in that respect, China is in that phase of the operation, where you have real drug manufacturers and you have fake drug manufacturers, and you have the beginning of unfettered uncontrolled capitalism, where all these people are competing, and at what point does the public health have to come to the fore and supersede that, all of that, and I think that time is now.

COMMISSION VICE CHAIR BARTHOLOMEW: Okay. Thanks very much and, Commissioner Blumenthal, I just wanted to mention why you were asking about the Nigeria situation, I think it must have been probably about ten years ago now that there was a bunch of tainted children's cough medicine that showed up in Haiti. And I'm not quite sure. The Haitian government certainly got involved.

It was a very big PR nightmare for people at that time, so I think that there might be some precedent out there, but I think we'd have to go out and look.

Thanks very much, Mr. Pitts, for very interesting testimony.

HEARING COCHAIR HOUSTON: Thank you very much. Does anyone else have any additional questions for Mr. Pitts? All right. Thank you very much. Appreciate your testimony. The hearing is adjourned and will reconvene tomorrow morning at 8:30 a.m.

[Whereupon, at 4:30 p.m., the hearing was recessed, to reconvene at 8:30 a.m., Thursday, June 8, 2006.]

INTELLECTUAL PROPERTY RIGHTS ISSUES AND IMPORTED COUNTERFEIT GOODS

Thursday, June 8, 2006

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION
Washington, D.C.

The Commission met in Room 385, Russell Senate Office Building, Washington,

D.C. at 8:30 a.m., Chairman Larry M. Wortzel, Vice Chairman Carolyn Bartholomew and Commissioners C. Richard D'Amato and Kerri Houston (Hearing Cochairs,) presiding.

HEARING COCHAIR HOUSTON: Welcome to the second day of the U.S.-China Economic Security and Review Commission's hearing on Intellectual Property Rights and the Import of Counterfeit Goods from China.

We are honored this morning to be joined by Senator Orrin Hatch. Senator Hatch is Chairman of the Senate Judiciary Committee's Subcommittee on Intellectual Property, which has jurisprudence over copyright, trademark and patent law, as well as treaties intended to protect American intellectual property overseas.

Last year, he introduced Senate 167, the Family Entertainment and Copyright Act of 2005, a bill to provide for the protection of intellectual property rights, which did indeed become public law. Senator, thank you very much for being with us.

PANEL VII: CONGRESSIONAL PERSPECTIVES

STATEMENT OF SENATOR ORRIN HATCH
A U.S. SENATOR FROM THE STATE OF UTAH

SENATOR HATCH: Thank you, Chairman Wortzel, Madam Vice Chairman and the rest of the members of the Commission. I'm honored to be before you and thank you for the kind invitation to make a few remarks. I believe the Commission's mandate of reviewing the national security implications of the trade and economic ties between the United States and the People's Republic of China is a vital one and that the research that the Commission publishes has been an invaluable resource to Congress as we debate these timely issues.

However, any discussion of our nation's economic relationship with China must be viewed in the context of our overall trade situation. In 2005, the United States trade deficit widened to a record $726 billion, increasing to 5.8 percent of the Gross Domestic Product from 5.3 percent in 2004 and 4.5 percent in 2003.

Many economists now describe the trade deficit as unsustainable. For example, C. Fred Bergsten, Director of the Institute for International Economics, has pointed out that, quote, "The United States must attract almost $7 billion of capital from the rest of the world everyday to finance our current account deficit and our own foreign investment outflows."

Now, one of the greatest components of our deficit is the trade imbalance with China. Last year it totaled $201.6 billion, an increase of

24.5 percent from the previous year.

As Chairman of the Subcommittee on Intellectual Property, what alarms me most is that this is far from being a case where American industries are being beat on a level playing field. In fact, the theft of intellectual property in China is rampant.

It is astounding to learn that according to industry group estimates, the United States lost $2.3 billion in 2005 due to copyright infringement. They also report that nine out of ten optical disks and 17 out of 20 sound records sold in China today have been pirated.

The Congressional Research Service estimates, quote, "Counterfeits constitute between 15 to 20 percent of all products made in China, and this sum amounts to eight percent of China's Gross Domestic Product."

These pirated goods are not only depriving American producers of profits in the Chinese market. China, like Russia, continues to export pirated products to other nations, further increasing America's trade imbalance.

Many of the countries where pirated goods are sold enjoy large trade surpluses over the United States, thereby further hurting our economic position. All of this in an industry where the United States enjoys a decisive advantage over foreign competitors. It should also not be forgotten that we will rely in substantial part upon intellectual property industries, which exported over $90 billion in goods last year to close our trade deficit.

This has all taken place despite China's repeated commitments to the United States to reduce significant piracy rates in China. These promises occurred first during negotiations on Chinese accession to the World Trade Organization, then in April of 2004, and most recently during the April meeting of the U.S.-China Joint Commission on Commerce and Trade, or JCCT.

Despite a nationwide anti-piracy "campaign," industry groups state that little improvement has occurred. These industry groups also point out that similar campaigns have been launched in the past with inadequate results.

Yet, there are tools at hand which China could use. For example, the Chinese government could rigorously enforce their copyright infringement laws under Article 217 and 218 of their Criminal Law. Under these statutes, an individual can be incarcerated for up to three years for copyright infringement. However, under current practices, individuals are rarely criminally prosecuted and the occasional seizure is seen as the cost of doing business.

China's Criminal Law is still not in compliance with the TRIPS Agreement. Moreover, its statutes are insufficient. For example, according to the Recording Industry of America, questions have been

raised about what exactly constitutes a crime due to ambiguities in Chinese law as to what constitutes legal harm.

Ambiguities such as these make criminal prosecution exceptionally difficult. The administration is heeding this call. For example, on February 14, 2006, the Office of the United States Trade Representative issued a report describing the results of its top-to-bottom examination of U.S. trade policy toward China and outlined steps that would be taken to ensure China's compliance with these trade commitments.

These provisions include the creation of a China Enforcement Task Force at USTR to be headed by a Chief Counsel for China Trade Enforcement. However, many of us in the Senate do not believe that this initiative goes far enough.

Accordingly, I joined Senator Baucus in sponsoring the Trade Competitiveness Act of 2006. This legislation will create a Chief Enforcement Officer at USTR to investigate and prosecute all trade enforcement cases.

Many in the Senate also look forward to positive developments arising from the recent JCCT. As the Commission knows, the Chinese government made a number of commitments during this meeting which occurred shortly before President Hu's visit.

This included intensifying China's efforts to ensure that their public markets are free of infringing goods. The Chinese also announced that legal action has been taken against 14 factories producing illegal optical disks.

I hope these commitments are met. Unfortunately, I am skeptical. Remember the JCCT would not have had to devote much of its time to intellectual property issues if the Chinese government had merely lived up to its obligations after its WTO accession and its other assurances.

I'm also pleased that legal actions are being brought against 14 factories that are producing pirated goods. Yet, I wonder how fast other Chinese factories that produce pirated goods will increase their production to meet the difference?

In addition to the economic harms caused by China's failure to meet its international obligations, there appear to be significant safety issues with some of the counterfeit goods being exported by Chinese entities. There is an enormous body of anecdotal evidence indicating that many counterfeit goods, principally medical and electronic goods, pose serious health and safety risks to individuals in our country.

There is evidence that Chinese counterfeiters are exporting everything from counterfeit pharmaceuticals to batteries to automobile parts to low-cost electronic devices.

There have been numerous reports, for example, of deficient automobile brake pads, exploding batteries and fake and often ineffective

prescription drugs. These counterfeits pose obvious and frequently very serious public health and safety risks to the American people.

Our nation has been slow in bringing claims to the World Trade Organization against China's lack of IP protection. However, the administration has initiated a special process under WTO rules to obtain detailed information on China's intellectual property rights enforcement efforts.

Late last year, China responded by challenging the legal basis for such a request. U.S. officials have stated that failure by China to provide the requested information could lead the United States to bring a trade dispute resolution case against China in the WTO.

Yet, these should only be seen as preliminary steps. I think we have to keep going. We must be aggressive in this area. In sum, our total national security and future economic health of our nation are being jeopardized by a large trade deficit, a deficit that is increasing in large part due to imports from China.

Yet, in those industries that rely on intellectual property where we have a market-based advantage, our products are being pirated. This cannot continue. We cannot stop until the Chinese completely ceases the piracy of IP products.

Therefore, Mr. Chairman, and other members of the Commission, I look forward as I have in the years past to reading the Commission's report and recommendations that will assist us in rectifying the trade imbalance with China.

Again, thank you for your kind invitation. I apologize I will not be able to remain for questions due to a heavy schedule, but I appreciate your efforts. I appreciate the work you're doing. We pay attention to these reports. I think you have had an influence in our country for good and frankly, I just want to compliment you, and that's one of the reasons why I'm here today.

HEARING COCHAIR HOUSTON: Thank you very much, Senator.

COMMISSIONER MULLOY: Thank you, Senator.

HEARING COCHAIR D'AMATO: Thank you so much, Senator.

SENATOR HATCH: Good to see you.

HEARING COCHAIR HOUSTON: We're waiting for our other congressional visitors to come, so feel free to relax and we'll get started as soon as they arrive.

[Whereupon, a short recess was taken.]

HEARING COCHAIR HOUSTON: Ladies and gentlemen, we're ready to get started again. Congressman Manzullo was planning to be with us this morning, but has been called away on a family emergency, and he sends his regrets. We do have testimony from Congressman Manzullo. If anyone is interested, I'm sure we have copies outside.

We are joined this morning by Congressman Knollenberg who introduced H.R. 32, the Stop Counterfeiting in Manufactured Goods Act, which amends the Federal Criminal Code and provides criminal penalties for trafficking in counterfeit marks. The bill has passed in the House and Senate and we welcome the Congressman this morning. Thank you so much for being with us.

STATEMENT OF JOE KNOLLENBERG
A U.S. CONGRESSMAN FROM THE STATE OF MICHIGAN

MR. KNOLLENBERG: Thank you for having me. I appreciate the opportunity to speak with you this morning and good morning, everybody. I am very delighted to have a chance to speak to you on this subject. I'm very encouraged by the Commission's hearings this week on intellectual property rights and counterfeit goods.

The loss of intellectual property rights and the proliferation of counterfeit goods not only costs American jobs, they pose serious safety risks to the American people, and I'll cover some of that as we go along.

As you probably know or may know, I represent a congressional district in the suburban Detroit area, and it's largely centered around the auto industry. Daimler-Chrysler's North American headquarters is in my district, and a quarter of the top 100 of the largest auto suppliers in North America are headquartered in my district, in the 9th District of Michigan.

This includes Bosch's North American headquarters, Delphi, and Arvin-Meritor. Overall I have over 1,500 manufacturing entities, and 92 percent of them have less than 100 employees so there's a lot of small manufacturing that takes place in my backyard.

I was particularly struck by the impact counterfeiters are having on the auto supply industry. I knew counterfeiting was a problem, but I didn't realize the extent of the problem until two or three years ago when countless companies made the effort to educate me on that issue.

What I learned was that counterfeit parts and goods cost American jobs. Counterfeit automobile parts cost the automotive supplier industry over about $12 billion annually. It's estimated that if these losses were eliminated, the auto industry could hire 200,000 additional workers.

When it comes to the economy overall, the U.S. Customs Service has estimated that counterfeiting has resulted in the loss of 750,000 jobs and costs the U.S. around 200 billion annually.

The International Chamber of Commerce estimates that seven percent of the world's trade is in counterfeit goods. I rather believe that that's more like ten percent because these are old numbers. And that the counterfeit market is worth probably close to a half a trillion dollars. That used to be about 350 billion, but it's risen over the last 18 months.

It's important to remember these numbers because counterfeiting is not a victimless crime. In addition to selling bogus products, the counterfeiters are stealing jobs and money away from legitimate companies. Counterfeit parts are not only damaging our economy; they compromise the safety of the American people.

Counterfeit auto parts such as fake tail-lights and brake pads have been found installed in New York City's taxi cabs. Knockoffs to popular prescription drugs such as Lipitor have been confiscated and are nearly identical to the real thing; they just don't have the right stuff in them.

On the personal security side, and that's what we're talking about here, pharmaceuticals, if anybody happened to see the NBC program on Sunday evening, you got some ideas from that as to what's happening. The profits are huge. We've even heard reports that counterfeit parts unintentionally installed in military combat vehicles. This affects our national security and that is key as well.

So on both the personal security side and the national security side, we do have some problems. Oftentimes, there's virtually no way of telling the difference between a legitimate product and the counterfeit. Much of this can be attributed to the fact that counterfeiters have perfected everything, all the way down to the label and the packaging, which I believe you have seen first-hand.

We've got to take a more aggressive stand against counterfeit parts, and one of the ways we're going to do that is to give the government more tools to fight counterfeiters. To help accomplish this task, I introduced H.R. 32, the Stop Counterfeiting in Manufactured Goods Act. It could have been shorter, but that's what it is.

I was very pleased that President Bush signed this bill into law earlier in the spring. Before my bill was enacted, a convicted trademark counterfeiter was only required to give up the actual counterfeit goods. The problem was the criminals could just turn around and make more, and typically the penalties were very minor.

In order to stop the counterfeiters, the consequences have to go further and that's why H.R. 32 includes a provision that establishes mandatory destruction, forfeiture and restitution provisions in trademark law, similar to those that are already in copyright law. This change is necessary to get at the roots of the problem.

Further, my bill would require the convicted criminals to give up not just the counterfeit goods, but also the equipment they use to make those goods. Seizing and destroying equipment used to make counterfeit goods is necessary to put the criminals out of business.

In addition, the bill prohibits trafficking in counterfeit labels, patches and medallions that are not necessarily attached to a particular counterfeit good. What counterfeiters typically do is send them

counterfeit goods over in a container with no branding of any kind, no trademark. When they get here, their accomplices on this side, which happen to be in many, many cases Americans, will attach those labels and put those products in retail or whatever it might be for sale.

Before it was legal to make and sell these items if they were not attached to a particular counterfeit good. That was before. But that just doesn't make any sense under the current circumstances. Why would counterfeiters make these labels if not for the chance at illegal profits and they're making a lot of illegal profit.

These simple changes will have, I think, a profound effect and impact on combating counterfeit manufactured goods in many different ways. H.R. 32 sends a signal to the counterfeiters in the U.S. and also around the world that the U.S. is serious about combating this growing problem.

The enactment of this bill gives prosecutors more tools to go after the criminals here in the U.S. and punish them severely. The bill is also necessary to address the problem globally. A large part of the counterfeit auto parts are coming from other countries and you would probably guess particularly China.

So we need our trade negotiators to demand that our trading partners have strong anti-counterfeiting provisions. I didn't mention, but al-Qaeda, the terrorist network, is also involved in the business of producing counterfeit goods of one kind of another. They would like to point toward the kind of thing that might be used in combat, and as I mentioned, many of the trucks, airplanes even, aviation, have found parts, mysterious parts, that do not live up to the quality that they should in those vehicles.

But U.S. negotiators can't demand that other countries take steps to combat trademark counterfeiting unless we're taking the very same steps ourselves. So by enacting my bill and improving our own law, Congress has empowered our trade negotiators to press for stronger anti-counterfeiting provisions in other countries. Passage of this bill will also send an important signal to our manufacturers here in America by demonstrating to them that the U.S. Congress is serious about improving the environment in which they compete by cracking down on the counterfeiters who cost them money and cost Americans their jobs.

The International Anti-Counterfeiting Coalition, the U.S. Chamber of Commerce, the National Association of Manufacturers, the National Electrical Manufacturers Association, and a host of major corporations all supported H.R. 32. So again, thank you very much for having me here today. The size and scope of counterfeit manufactured goods around the world is still growing.

Legitimate manufacturers are making every reasonable effort that

they can to prevent it, but they could use some additional assistance from the federal government, and that's what H.R. 32 will do.

Again, thank you very much for having me here this morning. If there are questions, I've got time for a couple or so. Thank you.

[The statement follows:]

Prepared Statement of Joe Knollenberg
A U.S. Congressman from the State of Michigan

Good morning everyone, and thank you for having me here today. I am extremely encouraged by the Commission's hearings this week on intellectual property rights and counterfeit goods. The loss of intellectual property rights and the proliferation of counterfeit goods not only cost American jobs, they pose serious safety risks to the American people.

As you probably know, I represent a congressional district in suburban Detroit whose economy is largely centered around the auto industry. Daimler-Chrysler's North American headquarters is in my district, and a quarter of the top one-hundred of the largest auto suppliers in North America are headquartered in my district. This includes Robert Bosch's North American headquarters, Delphi, and Arvin-Meritor. Overall, I have over 1,500 manufacturing entities, and 92% have less than 100 employees.

I was particularly struck by the impact counterfeiters were having on the auto supplier industry. I knew counterfeiting was a problem, but I didn't realize the extent of the problem until countless companies made the effort to educate me about it.

What I learned was that counterfeit parts and goods cost American jobs. Counterfeit automobile parts cost the automotive supplier industry over $12 billion annually. It's estimated that if these losses were eliminated, the auto industry could hire 200,000 additional workers.

When it comes to the economy overall, the U.S. Customs Service has estimated that counterfeiting has resulted in the loss of 750,000 jobs and costs the United States around $200 billion annually. The International Chamber of Commerce estimates that seven percent of the world's trade is in counterfeit goods and that the counterfeit market is worth $350 billion.

It's important to remember these numbers, because counterfeiting is not a victimless crime. In addition to selling bogus products, the counterfeiters are stealing jobs and money away from legitimate companies.

Counterfeit parts not only damage our economy, they compromise the safety of all Americans. Counterfeit auto parts, such as fake tail-lights and brake pads, have been found being installed in New York City taxi cabs. Knockoffs to popular prescription drugs, such as Lipitor, have been confiscated and are nearly identical to the real thing. We have even heard of reports that counterfeit parts have been unintentionally installed in military combat vehicles.

Often times, there is virtually no way of telling the difference between a legitimate product and the counterfeit. Much of this can be attributed to the fact that counterfeiters have perfected everything - all the way down to the label and packaging - which I believe you have seen first-hand.

We must take a more aggressive stand against counterfeit parts. And one of the ways we are going to do that is to give the government more tools to fight counterfeiters.

To help accomplish this task, I introduced H.R. 32, the Stop Counterfeiting in Manufactured Goods Act. I was very pleased that President Bush signed this bill into law earlier this spring.

Before my bill was enacted, a convicted trademark counterfeiter was only required to give up the actual counterfeit goods. The problem was, the criminals could just turn right around and make more. In order to stop the counterfeiters, the consequences have to go further.

That is why H.R. 32 includes a provision that establishes mandatory destruction, forfeiture, and restitution provisions in trademark law - similar to those already in copyright law. This change is necessary to get at the roots of the problem.

Further, my bill would require the convicted criminals to give up not just the counterfeit goods, but also the equipment they used to make those goods. Seizing and destroying the equipment used to make counterfeit goods is necessary to put the criminals out of business.

In addition, the bill prohibits trafficking in counterfeit labels, patches, and medallions that are not necessarily attached to a particular counterfeit good. Before, it was legal to make and sell these items if they were not attached to a particular counterfeit good. This just didn't make sense. Why would counterfeiters make these labels, if not for the chance at illegal profits?

These simple changes will have a profound impact in combating counterfeit manufactured goods in many different ways.

H.R. 32 sends a signal to counterfeiters that the United States is serious about combating this growing problem. The enactment of this bill gives prosecutors more tools to go after the criminals here in the U.S. and punish them severely.

The bill is also necessary to address the problem globally. A large part of the counterfeit auto parts are coming from other countries, particularly China. So we need our trade negotiators to demand that our trading partners have strong anti-counterfeiting provisions.

But U.S. negotiators can't demand that other countries take steps to combat trademark counterfeiting unless we are taking those same steps ourselves. So, by enacting my bill and improving our own law, Congress has empowered our trade negotiators to press for stronger anti-counterfeiting provisions in other countries.

Passage of this bill also sends an important signal to our manufacturers here in America by demonstrating to them that the U.S. Congress is serious about improving the environment in which they compete by cracking down on the counterfeiters who cost them money, and cost Americans their jobs.

The International Anti-Counterfeiting Coalition, the U.S. Chamber of Commerce, the National Association of Manufacturers, the National Electrical Manufacturers Association, and a host of major corporations all supported H.R. 32.

Thank you again for having me here today. The size and scope of counterfeit manufactured goods around the world is growing every day. Legitimate manufacturers are making every reasonable effort they can to prevent it, but they could use some additional assistance from the federal government. That's what H.R. 32 will do.

Thank you again, and I look forward to your questions.

Panel VII: Discussion, Questions and Answers

HEARING COCHAIR HOUSTON: Thank you. We had Senator Levin here yesterday and he brought with him electrical wire and some kind of heavy car widget.

COMMISSIONER BROOKES: It was a wire set.

MR. KNOLLENBERG: I see.

HEARING COCHAIR HOUSTON: A wire set and something that attached the front of the car--

COMMISSIONER BROOKES: Tie rods.

HEARING COCHAIR HOUSTON: Showoff.

COMMISSIONER BROOKES: Engineer by education.

HEARING COCHAIR HOUSTON: He had the genuine article and then he had the Chinese counterfeit, and they really were virtually identical. It was very scary to see it right up front because as you've pointed out, Congressman, there are really serious safety issues.

One of the things that we heard in some of our testimony yesterday was that in China there is spotty prosecution of counterfeiters there but one of the things they don't do is what is your bill, where you're actually confiscating the machinery and the equipment required to make the counterfeited goods.

So hopefully that's something that we can talk to our Chinese counterparts about and see if that can move along.

One of the other things we learned yesterday, especially in pharmaceuticals and auto parts, is that a lot of these counterfeits are getting in the wholesale chain. I'm curious, under your bill that covers anyone here in America who's taking delivery of a counterfeit product and do you have to prove that they know it's counterfeit or what is the standard for prosecuting someone taking delivery of those items?

MR. KNOLLENBERG: What we've done truly is to empower Customs inspectors, people at the border. They've seen this over the years. They've seen it come in and they know there's probably something tainted about it, but they've got no place to go. Now, they do, but the fact is that we must empower obviously ourselves first and then make sure that, China, for example, which is not the only country, but it's a very large country that does a great deal of this, some of this can be done over in China before that particular shipment comes over.

But what oftentimes is the case is that the product comes over, it may be bundled up in bubble wrap or whatever it might be, in the case of pharmaceuticals, and then when they get over here, of course, they have to--I think that's legitimately something they could attach or they could go after if it doesn't have--if you don't know what it is. If it can't be

branded and it's not branded, I think it becomes suspicious and it gives them a chance then to actually look into it pretty much in-depth. You've heard the story about Canada. Just because you got your prescriptions from Canada doesn't mean they were made there and often times they're made in the Middle East or Indonesia.

So I think the mere fact that it comes in and it doesn't have a branded or labeled kind of composure to it, that does arouse some suspicion on the part of your Customs people. I think they will be helped greatly by this, and some of the stoppage will occur at that point before it even gets inside the country.

HEARING COCHAIR HOUSTON: Right. Just to follow up very briefly, what if you're an American company, you’re an auto repair shop and you order some parts and they come in and you discover through perhaps a tragic accident that the parts were substandard and they were counterfeit. Would that company be liable for accepting that when the company itself, doing the repairs or whatever the example is, has no idea that they've just accepted counterfeit parts? Are they protected in any way?

MR. KNOLLENBERG: To respond to that as best I can, because our biggest job now is going to get the various federal agencies, the government agencies, to get involved in this process, and there's probably five or six of them for sure, to make sure that they do their job. It's a matter of enforcing the law that we have in place. So it's going to have to be some time spent with them, but interestingly you asked the question about, you've heard of the RFIDs or RFIP, the radio-frequency--

HEARING COCHAIR HOUSTON: Oh, yes.

MR. KNOLLENBERG: That would be one way that they're trying to--

HEARING COCHAIR HOUSTON: The chips, yes.

MR. KNOLLENBERG: It's a chip, yes, that they would utilize. I have in my district a company that works with the insurance industry on a variety of things like air bags and anything that might go into the car that might be of a life-threatening nature should it malfunction, and it could be something as simple as an oil filter, but whatever the case with brakes and what have you, it's more so.

But I would say that when we get our implementation team in force, and I'm going to be meeting with government agencies in a multiple group of agencies to make sure they understand what the problems are. It's just coming up to speed. I'm delighted the bill passed, but we have to make sure that it gets implemented.

HEARING COCHAIR HOUSTON: Right.

MR. KNOLLENBERG: And that the various government agencies, federal agencies, are involved in a proper way. But to answer your

question, they have been sued. Many of these companies have been sued because who knows who the counterfeiter is and where do they get it?

I think illegitimate prescriptions, for example, have fallen into use in this country and Merck and Pfizer and all the rest of the names are on the bottle, but it's not they that made the product. That's the first step. They're going to sue Merck.

They're going to sue Pfizer. They're going to sue General Motors or ABC bump shop or whatever it might be, and we've discovered also that some of the people that have air bags replaced, it's not really an air bag at all. It's a phony, and it may not even be replaced at all, but yet they're charged for it in the repair of the vehicle after an accident. This particular company that I'm referencing is one that does this work around the country.

They're just into the beginning stages of it, so I think that we've got a long way to go on some of this, but you're bringing up a problem that is very much a concern. It's heartburn for all of us. So this bill, while it's tough, if you can't implement, and you don't get the cooperation at the various agencies and the president himself said that at the signing in the White House, we have to get these agencies on board so they understand. First of all, the Trade Representatives have to be empowered to make these requirements or demands of any other country they might be dealing with.

But you touched on something that I don't have a total answer to, but we have to get to that answer, and I think there's some things happening that I think will help us get there.

HEARING COCHAIR HOUSTON: Right. Because some of those end users could be considered victims as well. Thank you very much, Congressman, and we have a question for you from Congressman Mulloy.

HEARING COCHAIR HOUSTON: It's early. I'm sorry.

MR. KNOLLENBERG: You're the 436th, right.

HEARING COCHAIR HOUSTON: Commissioner Mulloy. It begins with a "C". It's close.

COMMISSIONER MULLOY: Thank you. Thank you, Madam Chairman. I saw the show the other night that you referred to. It was terrific. Senator Orrin Hatch was just here and he indicated that, quote, "Our national security and the future economic health of our nation are being jeopardized by our large trade deficit, a deficit that is increasing in large part due to imports from China, and then he ties some of this problem and the imbalances due to the intellectual property rights violations.

He further goes on to talk about our nation has been slow in bringing cases to the WTO on IPR. One of the things we learned yesterday, Congressman, was one of the reasons is USTR does not want to

bring a case until they've got all the evidence, and our companies are being intimidated by the Chinese in terms of bringing this evidence to USTR.

So there's kind of a catch-22. You can't bring the case to the WTO without the evidence, and then the companies are worried about being retaliated against so they're not cooperating and bringing the evidence.

Our judgment was bring the best case you can because if the WTO, which is now our only tool to get at some of these problems in China, if that doesn't work, then we have to develop other tools, but I just wanted to get kind of your impression on that conundrum.

MR. KNOLLENBERG: We're having a meeting also with the Trade Representative, actually Rob Portman just left that position. Prior to him, of course, was Bob Zoellick, and we were making some progress there, but he's just been moved over now to the OMB so the new person on line I haven't had a chance to meet. I know who she is, but we're having meetings with all those people to make sure that the trade negotiators are going to promote and enforce particularly this bill. That has to be coordinated with several other agencies, but we're just in the beginning stages of that because that is a problem.

WTO, yes, there's some timidity on their part, and our part, in terms of taking it to the WTO. But I do think we're closer now if we can stop it at the border, if we have more scrutiny at the border with the Customs inspectors, and they've been crying for something like this for years. Because our Customs inspectors see stuff, but there's no law that would even be available for them to enforce the situation.

But that's just one area that we have to strengthen. China, by the way--I don't know if Senator Hatch talked about this--but they're getting it to some extent now. I was there a year ago and we peppered them for two weeks with questions about counterfeit goods. We were visiting manufacturers, some of our own, too, over there as well, and the Chinese understand, and you have to listen to them carefully because they understand, but the penalties are weak, the penalties are small, and the Chinese government doesn't do much about stopping anything beyond just taking the confiscated goods.

But they understand very well now that Indonesia, the Middle East, and other countries are pirating their intellectual property so they're beginning to learn that they're losing on this, too.

They're still playing a bit of a game with us, and they're also, as you say, brandishing their club, so to speak, and scaring off some of our people. But I'm hopeful that the American business community, in particular, will not waiver on this thing, but will get strengthened by this law being in place. Various federal agencies are also doing their work to make sure they all work together to a point where we can bring some

strength and some commonality in terms of what we all want to do here. And there is a path we have to take now to make sure that these federal agencies do understand what this law is, what it does.

Also it's got to work with all of the other parts and pieces around the country, around the world rather, including all the other countries that we're doing business with.

COMMISSIONER MULLOY: Thank you, Congressman.

HEARING COCHAIR HOUSTON: Thank you very much, and Commissioner D'Amato, you have a question as well.

HEARING COCHAIR D'AMATO: Yes, just briefly. Thank you very much for your testimony, Congressman, and for your tackling a really huge issue and your leadership on that issue legislatively, and hopefully that leadership will help buttress business community to help step up to the plate and develop the kind of case that we need vis-à-vis the Chinese particularly in many of these industries.

Once the legislation passed, of course, that's the first step, and then as you point out, the question of implementation in the Executive Branch is really going to be a daunting next step. My question is have you looked at all at the WTO as a tool? Here's a tool that we have underutilized and utilized almost not at all, but do you feel that we ought to pursue the WTO dispute settlement issues in cases vis-à-vis the Chinese as another track in terms of bringing pressure to bear on Chinese and making it a more effective organization that we gave our support to and spent a lot of time getting the Chinese into but have not used?

MR. KNOLLENBERG: I think we've got a long way to go with respect to the WTO and I'm going to have a conversation with them shortly in the next 30 days along with three or four other agencies.

We've been timid as we've talked about here as a country with respect to our companies. That one test case that has the parts in places so that we can advance it to the WTO and make our claim, if they're still waiting for that, maybe it will never get there. I don't know. I hope they do, but I certainly think that we ought to be at least aware of the strength that we've got now that we didn't have before so that we can approach these with some aggression and the WTO would be one of those agencies and one of those organizations rather that we would certainly like to apply some of this pressure to.

I can't remember what our record is with the WTO in terms of wins/losses/ties, but I would say that in terms of the grand total of impact, it's probably not near as much as we'd like. That's got to improve, I believe.

HEARING COCHAIR D'AMATO: Yes, sir. Thank you.

MR. KNOLLENBERG: You're welcome.

HEARING COCHAIR HOUSTON: Commissioner Bartholomew.

COMMISSION VICE CHAIR BARTHOLOMEW: Thank you very much. Thank you, Congressman Knollenberg. I just wanted to mention to you that we're going to be holding a hearing in July in Dearborn, Michigan to focus on some of the auto issues. It's not about IPR, but I think we've sent invitations out or we will shortly be sending invitations out. It's another opportunity to raise some of those issues.

MR. KNOLLENBERG: Thank you.

COMMISSION VICE CHAIR BARTHOLOMEW: One of the issues that I was thinking about and asking about yesterday is on the issue of the China price. Do you know how--

MR. KNOLLENBERG: Yes.

COMMISSION VICE CHAIR BARTHOLOMEW: --as U.S. companies are producing overseas, particularly the large-scale manufacturers, the difficulties for small and medium-American manufacturers to be able to compete as they're being forced overseas, and one of the questions I started having was whether companies that are bidding are ending up having to bid against companies that are counterfeiting and whether bigger companies are ending up using this as a way to drive the price down?

I don't know yet if there is data on that, but I just wanted to mention it. Have you heard anything anecdotally because it would put our small and medium-sized businesses at such a terrible disadvantage than they are already, but if they end up having to bid against companies that are counterfeiters, would it be to the advantage of the bigger companies that are trying to get the lowest possible price they can?

MR. KNOLLENBERG: I can't really expand on it too much because I don't know the whole picture. What I do know is that some of the Chinese companies make legitimate parts for two shifts of the day.

COMMISSION VICE CHAIR BARTHOLOMEW: Right.

MR. KNOLLENBERG: Third shift they go south and nobody knows exactly what they're doing and they're really hard to follow. But I think for the most part--and this is just a thought of my own, based on my own assessment of what I have experienced over the last several years--is that the competition really doesn't have to come from a counterfeit company. These companies may be partially in the counterfeit business and the legitimate business and they make money.

They've got plenty of money to throw around, and if a U.S. company is trying to compete with them, we probably have a hard time competing with them on the legitimate business products that they're making because they can afford to discount those to a point from the money they make from some of the counterfeit activity. So they're in a position to make it work and put our local or small business out of business. I think there is some of that taking place, but I really don't have

a grip on it. We'd like to know more about it. That's some of the things we need to know to go forward.

COMMISSION VICE CHAIR BARTHOLOMEW: Right. I think we're just going to start asking some of those questions of people who are trying to do business.

MR. KNOLLENBERG: Yes.

COMMISSION VICE CHAIR BARTHOLOMEW: People who are trying to keep jobs in America and produced--

MR. KNOLLENBERG: Maybe in Dearborn, you can, if that would be a part of your schedule, but--

COMMISSION VICE CHAIR BARTHOLOMEW: We'll ask around. We'll talk to your staff to see if there is anybody that they would suggest that we talk to up in Michigan about this. Thank you. And thank you, also, Congressman Knollenberg, for all of your leadership on international affairs generally. I know you play a very important role in foreign ops.

MR. KNOLLENBERG: It's on the floor this morning.

COMMISSION VICE CHAIR BARTHOLOMEW: Indeed. So we really appreciate your taking time out of your busy day to come and talk to us. Thank you.

MR. KNOLLENBERG: Well, thank you. Thank you very, very much. I'm pleased to be here and appreciate your asking me to come in. Thank you.

HEARING COCHAIR HOUSTON: Thank you so much. You've been very generous with your time. We really appreciate it.

MR. KNOLLENBERG: Thank you.

HEARING COCHAIR HOUSTON: Thank you. We will reconvene at 10:00 o'clock sharp.

[Whereupon, a short recess was taken.]

PANEL VIII: ELECTRONICS, AUTOMOTIVE, AND MANUFACTURING INDUSTRIES

HEARING COCHAIR HOUSTON: If everyone will take their sheets, we will get going. In our second panel today on manufacturing and the automotive industry, we will hear the implications of China's IPR violations to the U.S. electronics, automotive and manufacturing industries.

We are joined by the Honorable David McCurdy, President and CEO of the Electronic Industries Alliance. Mr. McCurdy oversees the activities of the National Trade Organization that comprises 1,300 member companies and includes the full spectrum of U.S. high tech businesses representing a $400 billion electronics industry.

Congressman McCurdy spent 14 years in the House of Representatives as the member from the 4th Congressional District of Oklahoma, and we are also joined by Daniel Chow, Professor of Law at Ohio State University. Professor Chow joined Ohio State University in 1985 and teaches international law, international transactions, jurisprudence, Asian law and property.

He is the author of numerous books and articles including two case books, International Business Transactions and International Intellectual Property, and Professor Chow, you would probably get a kick out of this. Congresswoman Pat Schroeder was here yesterday talking about counterfeiting in the publishing business and one of the textbooks that she was touting that she got from China was on international intellectual property, so kind of ironic.

Congressman McCurdy, if you'd like to start, that would be great.

STATEMENT OF THE HON. DAVE McCURDY
PRESIDENT AND CEO, ELECTRONIC INDUSTRIES ALLIANCE
ARLINGTON, VA

MR. McCURDY: Thank you, Madam Chairman. It's a pleasure being here again, and thank you for holding a hearing on this important topic. It's good to see you and also many of my friends of long-standing. With your permission, I would like to have my full testimony admitted into the record and--

CHAIRMAN WORTZEL: It will be in the record, sir. Thank you.

MR. McCURDY: With your permission, I will try to summarize just a couple of key points and then obviously just be prepared to take your questions and have a dialogue.

For two days, you've been hearing the importance of the U.S.-China relationship. You've heard the trade figures. The integration of the global economy and the topic that you want to focus on today is one that I think is probably the most difficult part of that ongoing and emerging relationship between Western economies and China.

On many fronts, we see indications, albeit small, that the Chinese government is taking intellectual property more seriously. There's been some progress but not nearly enough. The truth is that China does not have a strong tradition of protecting intellectual property rights.

Until it does, the abundant awards of trade with China will always be tempered by equally abundant risks. Also you heard and I heard testimony, as well, from Congressman Knollenberg and others who commended China in looking towards development of its own innovative capacity and developing its own technology. Until it does so, it's not going to probably respect intellectual property until it has some at risk

itself.

It's encouraging that the government wants China to develop these commercial technologies because that is the most effective way to foster true enforcement of IPR protection when their domestic entrepreneurs and small businesses have a stake in the system.

It's encouraging that the government is encouraging innovation rather than mandating technology and standards and it's clearly a more definite step in the right direction of lowering non-tariff barriers.

But on the other hand, we've seen that the pressure from the government to develop domestic technologies has led to some abuses. You heard the story of the dean of one of the leading university's Microelectronics School who falsely claimed to have developed a domestic computer chip. In fact, the research was stolen and faked and the chips that were revealed were, in fact, those of Freescale Semiconductor, which is one of our member companies - from which the trademarks had been scrubbed and replaced.

Now, Shanghai's Jiaotong University dealt quickly and severely with the situation, firing the dean, but this is an example of some of the challenges that they face.

Later this year, Research in Motion will launch RIM, its famous BlackBerry service, in China after two years of negotiation, bureaucracy and red tape from the state. Two years, as it turns out, however, was long enough for a competitor, China Unicom, a state-controlled telecommunications company, to come out with its own "push-mail" service. They launched it this April. They call it the RedBerry. So never let it be said that the Chinese don't have a sense of humor.

RIM, which is another one of our members, did virtually everything right. They worked with the Chinese government. They worked within the rules. They also knew that despite all their efforts, they were taking a risk, and it's clear that this case will not help the perception that the Chinese government bends and contorts rules to support local and sometimes state-owned companies.

The last few years have brought major reform to China's intellectual property laws, but China is still not enforcing these laws consistently.

Another of our members had a far worse experience. After acquiring a high-end auto equipment manufacturer, the company began production in China. It also started registering its trademark internationally, but in China, Korea and Thailand, they found that the trademark had already been registered.

They soon discovered that another company was producing counterfeit products using its trademark. The company found out the hard way about China's first to file trademark system, as many international

companies have. They also found out how difficult it can be to prosecute international property infringement in China. It was advised to take at least three years to have the mark canceled and as much as five if the counterfeiter appealed.

It was also informed that in order to proceed with administrative action, it would have to disclose the Chinese manufacturing partner. When it did the Chinese manufacturer would be subject to an injunction by the counterfeiter. So two years later, this company has not made much progress. The counterfeiter, on the other hand, has expanded into Singapore and Malaysia, even though in these countries, the U.S. company has registration rights.

So the point is, and let me say, that I believe very strongly in the rewards of trading with China. When we combine China's markets with American innovation, the result is often better, cheaper products for American consumers.

In fact, China's market liberalization means better cheaper products for new Chinese consumers as well. And history has shown that economic liberalization is often the first step towards political liberalization. Obviously we cannot simply ignore a country that is more than a sixth of the world's potential customers.

But even if we could, the opportunities of greater access to the Chinese market are proving themselves day after day. Yet, many companies are learning that the opportunities in China go hand-in-hand with certain risks. U.S. firms must do business within a complicated and sometimes unpredictable legal framework. A sound transparent legal system is perhaps the most important ingredient of a flourishing free market and until people feel they can count on their legal system, they will not be willing to make the investments that a vibrant market demands.

As the Chinese say, one cannot refuse to eat just because there is a chance of being choked. While the opportunities found in China are abundant, many firms have indeed been choked there by regulation, by state bureaucrats, by uneven application of the law, or simply by an unfamiliar legal system and customs.

There are two approaches that Electronic Industries Alliance is taking to help more firms succeed and thrive in the Chinese market. The first is self-help. U.S. companies must learn to navigate the Chinese legal system and local customs to protect their intellectual property.

The second is encouraging the U.S. government to continue putting pressure on China to reform its laws and enforce them transparently and consistently. Also, I've been urging our government to work with the Chinese government to foster a climate that allows companies to raise their rights and claims without the fear of retaliation and retribution.

Now let me start by talking about how companies can learn to help themselves. According to another Chinese proverb, experience is a comb that nature gives to men when they are bald. By now, thousands of U.S. firms have had experiences in China, many good, some bad. EIA is working to ensure that companies receive the benefit of that experience before, as the proverb has it, they go bald.

Now, not to be politically incorrect, you could insert the term maybe "growing gray" which I achieved sometime ago. But to this end, EIA published in April a best practices guide, which we've provided to the Commission, entitled "Protecting Intellectual Property Rights in China," and we sent it to senior executives at each of our nearly 1,300 member companies, and the guide was a collaboration between EIA and the China Alliance, which is a partnership of North American law firms.

The best practices guide was produced under the supervision of Charles Freeman, III, the China Alliance managing director, and many of you no doubt are familiar with Charles from his previous role as Assistant U.S. Trade Representative for China Affairs.

He knows the issues U.S. companies face there. We're very proud of the guide, and I'm confident that many small and mid-sized U.S. businesses will benefit from the wisdom and experience found in its pages.

I'd like to briefly take you through some of the recommendations in the guide because they illustrate the challenges high tech firms face when they do business in China. Many of these measures would be unnecessary, perhaps even unthinkable, in the U.S. or other developed markets. I think the most important message in the guide though is that in many ways there are no markets like China.

The companies that have been the most successful that have anticipated the immense legal, political and cultural differences between China and the U.S.

For those companies that decide to do business in China, the unfortunate reality is that they all must expect IP problems eventually. The problem may originate from suppliers or other Chinese manufacturers. It may come from former employees. It may even come from state-sponsored reverse engineering programs. In March, the Chinese railway ministry proudly announced the new high speed railway system from Beijing to Shanghai. I noticed in China Daily when they made the announcement, how they expected to achieve this great leap forward in transportation: Railroad Minister Liu Zhijun explained it to the Chinese press by saying, quote, "Our technology is a re-innovation on the basis of assimilating advanced technologies of foreign countries."

"Re-innovation," whether by the state or other local businesses is a fact of life in today's China. As our guide recommends, companies must

expect and plan for the worst even as they hope to be pleasantly surprised.

Many of these measures that our guide recommends have little to do with Chinese law. No matter what part of the world you're talking about, it makes sense to try to ensure that no one has the full picture of a company's valuable intellectual property. Companies need to keep their IP on a need-to-know basis. They should also ensure that one direct company employee is on site at all times. And finally, when there are problems, businesses will be more likely to secure favorable outcomes if they're known in China to be good corporate citizens.

But we believe that self-help is not enough and that's why we're encouraging the government, U.S. government, as a trading partner with China, to continue to press them to vigorously and consistently apply their laws.

The recent announcement in USTR's annual Special 301 report, that it will begin a provincial-level review of China's IPR protection enforcement is a very welcome effort. I can relate from personal experience just how apt is the saying - and again another Chinese saying - "The mountains are high and the emperor is far away."

On one of my trips to China, I was giving a speech in Qingdao, and was followed with a senior minister from Beijing, and then after my speech I was sitting in the audience, and was followed by a local Qingdao official of the State Intellectual Property Office.

Since he was speaking to an auditorium of local businessmen and Chinese local officials, perhaps I should have expected the candor with which he spoke, but my jaw dropped when I heard off-message rhetoric immediately following his own minister, that enforcement of trademark, patent and copyright laws could lead to monopolies by foreign multinationals, that different economic development levels call for different standards of enforcement, and that better enforcement cannot come at the expense of domestic innovators.

That is certainly not the language we hear from Vice Minister Wu Yi and other Beijing officials working to improve China's record. I believe in the sincerity of the people at the top, but it is clear there is a great deal of work to be done at the local and provincial level, and we appreciate USTR's recognition of this fact.

Mr. Chairman, in conclusion, EIA has placed the issue of intellectual property rights in China at the top of our priority list and we coordinate on a regular basis with Chris Israel and Tim Stratford and other officials at Commerce, USTR and the Patent and Trademark Office and other agencies working to further this cause.

We're actively engaged in a number of industry coalitions, and we're working with the administration and we'll continue to lobby

Congress for new and effective legislation on the IPR front.

I'm grateful for the opportunity to present our perspective and certainly look forward to answering your questions.

[The statement follows:]

Prepared Statement of the Hon. Dave McCurdy
President and CEO, Electronic Industries Alliance
Arlington, VA

Thank you, Mr. Chairman, Commissioner Houston and members of the Commission. I am appearing before you today as the President and Chief Executive Officer of the Electronic Industries Alliance (EIA), which is an alliance of several trade associations representing nearly 1,300 companies from the full spectrum of U.S. technology manufacturers. Our member companies' products and services range from the smallest electronic components to the most complex systems used by defense, space and industry, including consumer electronics and telecommunications equipment.

I appreciate the opportunity to come before you to discuss the issue of intellectual property protection in China. I know the Commission is aware of what a growing problem this is. China is now our third-largest trading partner. Last year American firms exported $42 billion in goods and services to China, and exports rose 40% in the first quarter of this year, with high-tech products such as medical and scientific equipment and semiconductors among the fastest-rising major products.

But for firms that, fundamentally, trade not in tangible things but in innovation, China can be a risky place to do business. China's share of infringing goods seized at the U.S. border is more than 10 times greater than that of any other U.S. trading partner – and that doesn't even reflect the goods that never leave the country.

We have seen some small indications that the Chinese government is taking intellectual property more seriously. There has been progress – a very tiny amount – but not nearly enough. The truth is that China has no strong tradition of protecting intellectual property rights. Until it does, the abundant rewards of trade with China will always be tempered by equally abundant risks.

The concerted effort begun by the Chinese government in recent months to encourage homegrown innovation and lessen the country's economic development reliance on imported technology is in some ways a double-edged sword. On one hand, it is encouraging that the government wants China to develop its own commercial technologies, because the most effective way to foster true enforcement of IPR protection is for domestic entrepreneurs and small businesses to have a real stake in the system. It is impossible for someone to take enforcement seriously if they have nothing of their own to protect. Encouraging innovation rather than mandating technology and standards is a definite step in the right direction of lowering non-tariff trade barriers.

On the other hand, the pressure from the government for researchers and technology developers to produce the demanded domestic successes has led to at least one alarming scandal uncovered just a few weeks ago, in which the dean of a leading university's Microelectronics School falsely claimed to have developed a "domestic" computer chip. In fact, the research behind the series of digital signals processing chips he introduced was allegedly faked, and the chips were revealed to be those of Freescale Semiconductor – an EIA member company – from which the trademarks had been scrubbed and replaced. The good news is that Shanghai's Jiaotong University dealt quickly and severely with the situation, firing the dean, ordering him to pay back research funds he had received, and banning him from future state research projects. But

the fact that domestic scientists are under such intense pressure to demonstrate China's domestic capability quickly is cause for some concern and something we must monitor.

Later this year, Research in Motion will launch its BlackBerry service in China, after two years of negotiation, bureaucracy and red tape from the state. Two years, as it turns out, was long enough for China Unicom, a state-controlled telecommunications company, to come out with its own "push-mail" service. They launched it in April. They call it the RedBerry. Never let it be said that the Chinese don't have a sense of humor.

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What exactly happened is not clear. But this case will not help the perception that the Chinese government bends and contorts the rules to support local and sometimes state-owned companies. The last few years have brought major reform to China's intellectual property laws. But China is still not enforcing these laws consistently.

Another of our members had a worse experience. After acquiring a high-end audio equipment manufacturer, the company began production in China. It also started registering its trademark internationally. But in China, Korea and Thailand it found that the trademark had already been registered. It soon discovered that another company was producing counterfeit products using its trademark.

The company found out the hard way about China's "first-to-file" trademark system. It also found out how difficult it can be to prosecute intellectual property infringement in China. It was advised that it would take at least three years to have the mark cancelled, and as much as five if the counterfeiter appealed. It was also informed that in order to proceed with administrative action, it would have to disclose its Chinese manufacturing partner. When it did, the Chinese manufacturer would be subject to an injunction from the counterfeiter.

Two years later, the U.S.-based company has not made much progress. The counterfeiter, on the other hand, has expanded into Singapore and Malaysia, even though in these countries the U.S. company has registration rights.

Let me say that I believe very strongly in the rewards of trading with China. When we combine Chinese markets with American innovation, the result is better, cheaper products for American consumers. In fact, with China's market liberalization, it means better, cheaper products for new Chinese consumers too. And history has shown us that economic liberalization is often the first step to political liberalization.

Obviously, we cannot simply ignore a country that has more than a sixth of the world's potential consumers. But even if we could, the opportunities of greater access to the Chinese market are proving themselves day after day.

Yet many companies are learning that the opportunities in China go hand in hand with certain risks. U.S. firms must do business within a complicated and sometimes unpredictable legal framework. A sound, transparent legal system is perhaps the most important ingredient of a flourishing free market. Until people feel they can count on their legal system, they will not be willing to make the investments that a vibrant market demands.

In China, they have made some strides toward this ideal – some of them remarkable strides, considering the country's history. But they still have a long way to go. Nowhere is this more apparent than in the realm of

intellectual property rights.

As the Chinese say, one cannot refuse to eat just because there is a chance of being choked. While the opportunities found in China are abundant, many firms have indeed been choked there – by regulation, by state bureaucrats, by uneven application of the law or simply by an unfamiliar legal system and customs.

There are two approaches that the EIA is taking to help more firms succeed and thrive in the Chinese market. The first is self-help. U.S. companies must learn to navigate the Chinese legal system and local customs to protect their intellectual property. The second is encouraging the U.S. government to continue putting pressure on China to reform its laws and enforce them transparently and consistently.

Let me start by talking about how companies can learn to help themselves. According to another Chinese proverb, experience is a comb that nature gives to men when they are bald. By now, thousands of U.S. firms have had experiences in China – many good, some bad. EIA is working to ensure that more companies receive the benefit of that experience before – as the proverb has it – they go bald.

To this end, EIA published in April a best practices guide entitled *Protecting Intellectual Property Rights in China* and sent it to senior executives at each of our nearly 1,300 member companies. The guide was a collaboration between EIA and the China Alliance, which is a partnership of four North American law firms: Armstrong Teasdale of Missouri, Blake Cassels & Graydon of Canada, Butzel Long of Michigan and Michael Best & Friedrich of Wisconsin with a collective team of legal experts on China.

The best practices guide was produced under the supervision of Charles Freeman, the China Alliance's managing director. The Commission is no doubt very familiar with Mr. Freeman from his previous role as the Assistant U.S. Trade Representative for China Affairs; he knows the issues U.S. companies face there. We're very proud of the guide and I feel confident that many small and mid-sized U.S. businesses will benefit from the wisdom and experience found in its pages.

I would like to briefly take you through some of the recommendations in the best practices guide because they illustrate the challenges high-tech firms face when they do business in China. Many of these measures would be unnecessary – perhaps even unthinkable – in the U.S. or other developed markets. I think the most important message of the guide, though, is that in many ways there are *no* markets like China. The companies that have been the most successful are those that have anticipated the immense legal, political and cultural differences between China and the U.S..

The first challenge is that counterfeiters and pirates do not honor borders. For this reason, any business may be at risk from China's ineffective intellectual property protections, whether they interact with the Chinese market directly or not. In a global world, intellectual property piracy is a global problem. This is why the U.S. and other countries pursue global solutions – global solutions that China often implements half-heartedly if at all. Until China can be considered a full partner in intellectual property protection, all businesses will have to factor it in to their plans. Trade with China is optional; planning for China is not.

For those companies that do decide to do business in China, the unfortunate reality is that they all must expect intellectual problems eventually. The problem may originate from suppliers or other Chinese manufacturers. It may come from former employees.

It may even come from state-sponsored reverse-engineering programs. In March, China's railway ministry proudly announced two new, high-speed railway lines. Government officials announced that the new railways would use only Chinese technology. How did China achieve this Great Leap Forward in transportation technology? Railroad minister Liu Zhijun explained it to the Chinese press: "Our technology

is a re-innovation on the basis of assimilating advanced technologies of foreign countries."

"Re-innovation," whether by the state or by other local businesses, is a fact of life in today's China. As EIA's guide recommends, companies must expect and plan for the worst, even as they hope to be pleasantly surprised.

Many of the measures that our guide recommends have little to do with Chinese law. No matter what part of the world you're talking about, it makes sense to try to ensure that no one has the full picture of a company's valuable intellectual property. Companies should keep their IP on a need-to-know basis. They should also ensure that one direct company employee is on site at all times. Finally, when there are problems, businesses will be more likely to secure favorable outcomes if they are known in China to be good corporate citizens.

So businesses that choose to produce or sell in China must protect themselves against intellectual property theft. But we believe that self-help is not enough. That's why we are asking Congress and the Administration to continue putting pressure on the Chinese government.

As a new market and an ever more important trading partner, China holds great promise. But there are still many challenges that U.S. companies face in doing business there. Sometimes the opportunities outweigh the risks; other times, firms run into serious trouble in China. In every case, the Chinese market will never meet its full potential until it is governed by a sound and transparent legal system, particularly in terms of intellectual property rights. Congress and the Administration have a great opportunity now to put pressure on the Chinese government to reform its intellectual property laws and enforce them more vigorously and consistently. Once that happens, the benefits to the American economy and indeed the Chinese economy will be immense.

The recent announcement in USTR's annual Special 301 report that it will begin a provincial-level review of China's IPR protection and enforcements efforts is a welcome one. I can relate from personal experience just how apt is the saying "The mountains are high, and the Emperor is far away." On one of my trips to China, I had the chance to sit in on a speech made by a local Qingdao official of the State Intellectual Property Office. Since he was speaking to an auditorium of local businessmen and Chinese government officials, perhaps I should have expected the candor with which he spoke, but my jaw still dropped when I heard off-message rhetoric that enforcement of trademark, patent and copyright laws could lead to monopolies by foreign multinationals, that different economic development levels call for different standards of enforcement, and that better enforcement could not come at the expense of domestic innovators. That is certainly not the language we hear from Vice Minister Wu Yi and other Beijing officials working to improve China's record. I believe in the sincerity of the people at the top, but it is clear that there is a great deal of work to be done at the local and provincial level, and we appreciate USTR's recognition of this fact.

EIA has placed the issue of intellectual property rights in China at the top of its priority list, and we coordinate on a regular basis with Chris Israel, Tim Stratford and other officials at the Commerce Dept., USTR, the Patent & Trademark Office and other agencies working to further this cause. We are actively engaged in the industry-led Coalition Against Counterfeiting and Piracy, which is doing excellent work to develop best practices, pool corporate resources, coordinate with the Administration and lobby Congress for new, effective legislation on the IPR front.

I am grateful for the opportunity to present EIA's perspective on this critical issue to the Commission, and on behalf of all of our member companies. Thank you.

HEARING COCHAIR HOUSTON: Thank you very much, Congressman. Professor Chow.

STATEMENT OF PROFESSOR DANIEL C.K. CHOW
PROFESSOR OF LAW, THE OHIO STATE UNIVERSITY
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MR. CHOW: Good morning. I've been asked to address the issue of manufacture and distribution of counterfeits in China, exports and the role of foreign direct investment in fueling the growth of counterfeiting in China.

Let me first start by saying that although the counterfeiting problem in China is considered to be the most serious in world history, it appears to be getting worse and in my opinion it is unlikely that we are going to see any real improvement in the future.

When I say it's the most serious in world history, what do I mean? Well, China's own estimates put the problem at between $19 and $24 billion per year and eight percent of the Gross National Product. There are millions of people, perhaps tens of millions of people, in China that depend upon counterfeiting for their livelihood. This is a crucial point because if there is going to be a national crackdown on counterfeiting--and I'll go into this in some detail--it is going to put out of business a lot of businesses and it's going to create serious unemployment for millions of people and these are some serious economic and social consequences.

The trade in counterfeit goods has become such an integral part of the economy that any crackdown is going to have very severe consequences, and I will detail what I mean by that.

U.S. industries estimate that losses are in the billions to tens of billions of dollars per year. Multinationals claim that between 15 and 20 percent of all brands are counterfeit. Microsoft claims that it alone loses ten billion dollars per year to counterfeiting and piracy in China.

Of course, no problem this size and scope could exist without the direct or indirect involvement of the state. That's a critical part of this and I want to detail that in my discussion.

Finally, I've been asked to discuss exports and I want to just point out for your attention that we are about to see or perhaps are in the midst of seeing a tremendous increase in the amount of exports of counterfeits from China to destinations around the world, and I will discuss this in detail.

First, I've been asked to discuss the role of foreign direct investment in counterfeits, and let me talk about why it's so important. China's economic growth through the 1990s has been fueled in large part by foreign direct investment from the world's largest multinational

companies.

In any foreign direct investment, there are two components. When you set up a joint venture in China or when you set up a wholly foreign-owned subsidiary in China, there are two inputs. The first is capital. By that, cash or equivalents, which is necessary for physical inputs such as plant buildings, equipment, manufacturing.

The second component is technology, and by that I mean copyrights, patents, trademarks, and know-how. So there are these two components. The first is a tangible component, capital, and the second is an intangible component, intellectual property.

In the world today it is the second component that is often the most critical to the success of a company or to the economic development of a country. Let me give you an example. The value of the Coca-Cola trademark to Coca-Cola is worth ten times, a hundred times, a thousand times, the hundreds of millions of dollars that Coca-Cola has invested in China.

It is the value of that trademark and the goodwill that it represents that is critical to the success of that business in China as around the world, not the ingredients in the drink. You can copy that exactly. No one is going to buy it. It is the goodwill and the prestige of that brand that make the product successful not its ingredients.

The same is true with Pfizer and other pharmaceutical companies. What is critical to the success of these businesses in the United States and in China is the value of their patents and their know-how, In many cases today, the second component, that is the technology component, is the more critical component for the success of a foreign direct investment.

China is now one of the world's largest recipients of foreign direct investment, and in fact, in 2002 China briefly passed the United States as the world's largest recipient of foreign direct investment.

Today, China is the third largest recipient of foreign direct investment with inflows of about $60 billion. China is getting access to the world's most valuable technology, and once it gets into China and once it is absorbed, there is nothing to prevent people from copying it and from counterfeiting it.

Let me just emphasize how important technology is to China's national plan. What China wants to do is, of course, modernize its economy to make up for the lost 20 year period of the Cultural Revolution and all of the years of decay and defeat in the 20th century. The way to do that is to get advanced technology, and it is through advanced technology that China is going to modernize, and it is China's goal to, through the use of advanced technology, to dominate in every sector of the economy.

By that, I mean from the lowest, most labor intensive to the most advanced. China is not like Japan or Korea. When Japan moved up the technology ladder, it abandoned the lower level technology rungs, but China has no intention of doing that. It intends to dominate in every sector, and it has the size and the resources to do so.

Let me discuss now manufacture and distribution, and if I could call your attention to the chart on page five of the handout, I'd like to go through and tell you maybe more than you ever wanted to know about the way counterfeits are manufactured and distributed.

If you go to the chart on page five of the handout, you will notice that there is a shaded area which is in the southeast of China and then there are also these circles. The shaded area represents Guangdong and Fujian Province, which were some of the first areas open to foreign direct investment. This is where a lot of the manufacture of counterfeit goods occurs.

It is no coincidence that where legitimate manufacturing occurs, illegitimate, illegal, counterfeiting also occurs, because, of course, there's going to be a leak in technology and there is going to be theft.

Let me just mention one other connection here which is very important, and that is in these areas in the south which are shaded, you have now organized crime involved in funding many of these factories in Fujian and in Guangdong Province. For example, Guangdong is the ancestral home of many people from Hong Kong, and Fujian is the ancestral home is many people from Taiwan.

Criminal organizations which are involved in narcotics, smuggling and prostitution have now migrated to counterfeiting. Why? Because of the high profits and the low risks. Counterfeiting is almost as lucrative as narcotics but with much less risk. If you deal in narcotics in China, you get a bullet in the back of the brain, but if you're a counterfeiter, hey, you're just a businessman.

So a lot of people have moved to counterfeiting because of its highly attractive, lucrative, low risk nature, and you've got organized crime now which is actively involved.

The circles that you see here are now part of the distribution network. Of course, it doesn't do you any good if you're a counterfeiter, if you counterfeit goods, if you can't deliver them to the end-use consumer. So distribution is essential and counterfeiters can't use qualified large scale distributors because they won't deal in counterfeit goods.

So how do these reach people? They reach people through a series of large wholesale markets which exist all throughout China's coast. I'm going to focus my discussion on Yiwu which is Zhejiang Province, which you see right above that shaded area, and it is the largest and most

successful wholesale market in east China.

Let me mention that what happens in Yiwu is that there are these open air semi-enclosed wholesale markets where you have retailers and secondary level wholesale distributors come, they buy the product, and the product then is shipped to densely populated urban areas in Shanghai, in Beijing, in Tianjin, places where you have huge demand for counterfeits.

The market in Yiwu was actually set up by the local government, by the local Administration of Industry and Commerce. They set it up; they invested $10 million in that market. They collect licensing fees from that market. In one year, $55 million in terms of fees which are collected from the market. The market is a large taxpayer. It's the single largest taxpayer in Yiwu. In the 1990s, it accounted for 26 percent of the revenue, the tax revenue of that market.

The government is also in charge of enforcement against counterfeiting. Now, this might look to you like a conflict of interest. If the government has set up the market, which is so lucrative, and it's also in charge of enforcement against counterfeiting, what's going to happen is that there is not going to be a lot of enforcement.

In fact, the opposite occurs which is that the activity is heavily defended and protected at local levels.

Let me mention one other thing about Yiwu which is I think also critical, and that is that although the counterfeiting business is huge, there are many legitimate businesses which have grown up around counterfeiting, so thus hotels, restaurants, nightclubs, transportation companies, warehousing companies, all of these support the trade in counterfeit goods.

If you go into Yiwu, everything revolves around the trade. What happens if you shut down the trade in counterfeit goods in Yiwu? You shut down the entire local economy. All of the legitimate businesses, which have grown up around the counterfeit trade, they will also shut down. You will have businesses which will go bankrupt. You'll have unemployment and you'll have something that the Chinese government fears more than anything else: you will have social unrest and turmoil, and that is again what China fears more than anything.

Let me turn now to exports because I know that I've exceeded my time. But let me talk now about exports because I want to emphasize why this is an important development.

People estimate that China accounts for probably 80 percent of the exports of counterfeits to the United States and to other countries. We are about to see or are in the midst of seeing a sharp increase in the export of counterfeits from China.

Why is that? As part of China's commitments to the WTO, which it

entered in 2001, China had to liberalize trade and to help further legitimate trade, but some of these same measures that helps legitimate trade will also help the illegitimate trade in counterfeit goods.

Here is a very specific example. Under prior law, the state had a monopoly on trading rights and in order to export or import goods, you had to go through a state-owned trading company. So if you're a counterfeiter and you want to export your goods, you have to find a compliant state- owned trading company who is going to do the export.

There is no shortage of state-owned trading companies that are willing to do this. However, keep in mind that using an intermediary still is a necessary extra step and an extra expense. As a result of China's entry into the WTO in July 2004, China amended the Foreign Trade Law to eliminate the state monopoly on export and import trading rights.

Any business operator who is registered can export or import their products, which means that the floodgates have been flung wide open. You're going to see now a sharp increase in exports of counterfeits around the world because, although there's not a huge risk of law enforcement resulting in severe consequences in China, there's even less risk when you export, and China like most countries cares much less about what leaves the country than what comes in.

So we are seeing now exports of counterfeits from China to southeast and central Asia, Thailand, Vietnam, the Philippines, Indonesia, Malaysia, to the Middle East, and from the Middle East to Africa and to Africa now also directly through Nigeria, South Africa, Algeria, Morocco, and some northern states. Also counterfeits to Eastern Europe as well as South America and Central America. This is important because counterfeits that go to South America, Brazil and Central America, Mexico, are transshipped to the United States. This is how a lot of auto parts come into the United States.

In fact, counterfeits do very well in many of these locations because counterfeits do well when they're few or no legitimate goods against which to compete, because the existence of legitimate goods makes it much easier to detect a counterfeit. In many of these markets, there are very few legitimate goods.

Finally, let me just mention very briefly the issue of political will. As I mentioned and from the Yiwu example, the problem right now is that it's become so big, so integrated, it's such an important part of the economy. There are millions, or perhaps tens of millions of people, and hundreds of cities, like Yiwu. Yiwu is a model--everyone wants to be like Yiwu. Hundreds of cities depend upon the trade in counterfeit goods.

So what happens if you have a national crackdown? You have a severe economic and social problem. It's going to involve a huge expenditure of resources and political capital, and it is something that the

Chinese government is not going to do unless it has to do. That's what you have on one side.

What do you have on the other side? You have multinational companies in China--I used to work for one, so I know--who are reluctant to do anything to offend the Chinese government. They're afraid of retaliation against their businesses so they often praise the Chinese government. When President Hu visited Microsoft several weeks ago, Chairman Bill Gates thanked him for the improvement in their protection of intellectual property.

That very same week I was talking to somebody from Microsoft in China and she was telling me how she's tearing her hair out because they're losing $10 billion a year. So, they're getting a mixed message, and the message, these companies are being politically correct to maybe the most politically incorrect country in the world. But that's what they're doing. They're telling China, oh, you're making great progress. So, on the one hand, you've got the very severe economic and social consequences of a national crackdown.

On the other hand, you have multinationals afraid to do anything to offend the Chinese government. What's the Chinese government going to do? It's going to do what it's doing now, which is it's going to appease the multinationals by making what, in essence, in my opinion, are cosmetic changes that do not address the serious fundamental issues of the dependence of local economies on the illegal trade in counterfeit goods, the existence of organized crime, the existence of local protectionism and corruption at the local level.

Unless I think these root causes are really squarely addressed, we're not going to see in my opinion any significant improvement in the problem in counterfeit goods in the near future. Thank you.

[The statement follows:]

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COUNTERFEITING AND CHINA'S ECONOMIC DEVELOPMENT

I. Introduction

China has the most serious counterfeiting problem in world history. According to recent estimates by the PRC's own State Council Research and Development, in 2001 China was flooded with between $19-$24 billion worth of counterfeit goods. This figure, although substantial, may underestimate the size of the problem. Brand owners estimate that between 15-20% of all well known brands in China are counterfeit. Brand owners claim that they are losing tens of billions of dollars in China due to counterfeiting. Microsoft's annual losses alone due to commercial piracy in China are estimated to be $10 billion.

Counterfeiting is now estimated to account for 8% of China's gross domestic product. Many municipalities and towns in China depend upon counterfeiting to sustain their local economies. There are millions of people, perhaps tens of millions of people, involved in counterfeiting in China. There are hundreds of thousands of people involved in anti-counterfeiting.

Although the current situation suggests a formidable problem, future trends are a source of even greater concern. First, despite the intense international attention focused on the counterfeiting problem in China for the past decade, counterfeiting in China appears to be getting worse, not better. I will give a specific and detailed example of why this is so. Second, the PRC government lacks the political will to engage in a crackdown on counterfeiting or to make any meaningful progress in addressing the problem. The result is that for the foreseeable future, there is unlikely to be any real improvement in the counterfeiting problem in China.

II. Counterfeiting in China, China's Economic Development, and Global Competitiveness

China's unprecedented economic growth through the decade of the 1990s was fueled in large part by a substantial infusion of foreign direct investment (FDI), much of it by the world's leading multi-national enterprises (MNEs). Throughout much of the 1990s, China trailed only the United States as a recipient of FDI. Briefly in 2002, China surpassed the United States as the world's largest recipient of FDI, with capital inflows of about $50 billion. According to recent statistics, China now ranks third in the world, with capital inflows of about $60.6 billion, behind only the United Kingdom ($78.3 billion) and the United States ($96.8 billion). China is far and away the largest recipient of FDI among developing countries. For example, China receives nearly 8 times the FDI that India receives, even though India is often considered to be China's closest economic rival among developing countries.

FDI is the best means of technology transfer in the world today. In addition to the capital that is injected, FDI often involves the transfer of patents, copyrights, trademarks and other forms of intellectual property as part of the process of investment. In many cases, the intellectual property component of the FDI is the most important part of the investment. For example, the value to Coca-Cola of its trademark is worth many times more than the hundreds of millions of dollars that Coca-Cola has invested in China. When a global pharmaceutical company sets up a manufacturing facility in China, the company will invest capital to establish the physical plant. More importantly, the company will hire local scientists and engineers and will teach them how to use the company's patents and other forms of technology. In today's economy, a company's advanced technology, know-how, and other forms of intellectual property are often the most crucial element of its success. FDI in China provides access to this technology.

China is using its unprecedented access to some of the world's most advanced technology as a means of leapfrogging into the modern industrial age. China has been able to use this technology to upgrade its industries and to become globally competitive in a short span of time. For example, in the 1980s, China began as an original equipment manufacturer (OEM) for a number of multi-national companies in producing color television sets that were distributed under various international brand names. These MNEs provided detailed specifications and technical training and assistance to Chinese manufacturers. Once the Chinese OEMs manufactured these TVs, the MNEs would put their private labels on these sets and sell them under their own brands. Having developed OEM capabilities, absorbed technology, and learned about distribution, supply, and marketing from MNEs, China now makes TVs directly for export to large distributors, such as Wal-Mart and Costco. In the short span of a decade, China has become a dominant player in the area of televisions and other consumer electronic goods.

This process of absorbing technology and using it to compete with the technology's original owners and creators is being repeated in China in many industries. China's goal is to use this process to

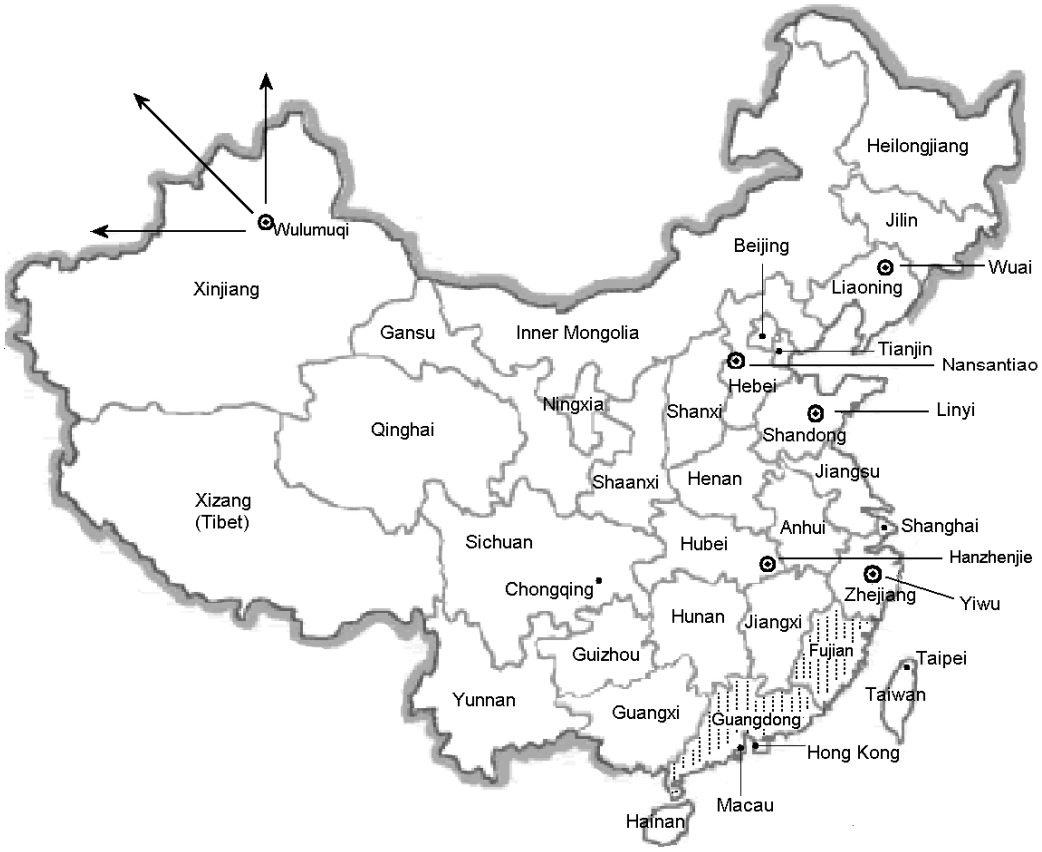
become competitive and dominate in all industries. While China already dominates in some low-technology sectors, China's goal is to dominate not only in low-technology sectors, but also in high-technology sectors. Unlike Japan or Korea, China does not intend to abandon lower-level technology sectors as it moves up the technology ladder. China's goal is to dominate in all sectors – from the lowest, most labor-intensive sectors to the highest and most advanced technological sectors – as quickly as possible. To accomplish these goals, China must have access to advanced technology. FDI gives China this access. Once the advanced technology is introduced into China, China gains access to the technology. Some of this access is lawful, but much of it is through unauthorized copying, theft, and counterfeiting, all of which allows China to obtain technology transfer without the payment of fees.

III. The Manufacture and Distribution of Counterfeit Goods and the Role of Counterfeiting in Supporting China's Local Economies

The manufacture of counterfeit goods in China tends to be concentrated in southern China in Guangdong and Fujian Provinces, among the first areas opened to FDI. Guangdong is the ancestral home of many people living in Hong Kong and Fujian is the ancestral home of many people living in Taiwan. Criminal organizations in Hong Kong and Taiwan, many of which are also involved in smuggling, narcotics, and prostitution, are now involved in the highly lucrative trade in counterfeit goods. These criminal organizations help to finance the start-up costs for the factories manufacturing counterfeit goods and use international borders to create barriers against law enforcement.

The distribution of counterfeit goods takes place through a series of wholesale markets that are located throughout China. The manufacture of counterfeit goods is not of much use if the goods do not reach the end use consumer. Many of these wholesale markets are financed and established by local governments. Retail and secondary-level wholesale distributors travel to these wholesale markets to order counterfeit goods that are then shipped to densely populated urban areas in China, other locations in China, and overseas.

Major Distributors and Manufacturers of Counterfeit Goods in China



The role of counterfeiting in supporting local economies can be seen in a study of Yiwu, well known as a major distribution center for counterfeits and pirated goods in China. In 1982, the Yiwu government invested $10 million in establishing the Zhejiang China Small Commodities City Group (CSCG), a wholesale market specializing in the trade small commodities, such as household products. The CSCG experienced significant growth through the decade of the 1990s. In 1982, the CSCG earned $470,000 in sales. By 1991, total revenue had reached $100 million, and in 1996 – the last year that such figures were publicly available, the CSCG's total revenues reached $2.2 billion, which represents a growth of about 22 times in a period of five years, and is more than the total revenues of many MNEs in China. In 1996, the total floor space of the CSCG was over 500,000 square meters with over 24,000 booths, each a wholesale distributor. In addition, about 6,000 individual wholesalers have established booths or locations outside of the CSCG market. Each day about 200,000 people visit the market to purchase goods from among over 400,000 different varieties of items. About 8,000 foreign buyers visit the market each day. Each day 2 tons of goods are purchased. The highways and roads to and from Yiwu are heavily congested day and night with trucks coming from the South that deliver counterfeit goods to Yiwu and trucks leaving Yiwu loaded with counterfeits that have been purchased and are bound for locations throughout China. Based upon the author's own experience working in Yiwu on behalf of an MNE brand owner, about 80-90% of all goods offered for sale in Yiwu are counterfeit or infringing goods.

The CSCG and the trade in counterfeit goods has become essential to the local economy. In the 1990s, the CSCG accounted for nearly 26% of the entire tax revenues of the city and was the single largest taxpayer in the municipality. The payment of tax is essential because it integrates the CSCG and the trade in counterfeit goods into the local economy. In addition to paying taxes, the CGSC and its illegal trade in counterfeit goods has given rise to a whole host of other legitimate businesses that support the trade. Hotels, restaurants, night clubs, transportation companies, and warehouse and storage facilities all depend on the trade in counterfeit goods.

Shutting down the trade in counterfeit goods in Yiwu would result in shutting down the local economy and would lead to the closing of many businesses and high levels of unemployment. A shutdown may also lead to social chaos and unrest, which the PRC government fears more than anything else. A small town by China's standards, Yiwu has a population of about 650,000, the bulk of which depend upon the trade in counterfeit goods. There are hundreds of other towns like Yiwu in China that depend upon the trade in counterfeit goods to sustain the local economy. All told there are likely millions, if not tens of millions, of people in China who depend directly or indirectly on the trade in counterfeit goods for their economic livelihood and survival. A nationwide crackdown would impose significant costs on the PRC government, as it would need to expend significant resources and political capital to deal with the massive economic and social problems that would likely arise as a result.

IV. Why the Counterfeiting Problem is Getting Worse

Although counterfeiting in China is reaching domestic saturation levels in many industrial sectors, the export of counterfeits from China to countries around the world is a growth area that is likely to increase significantly in the near future. Currently, counterfeits from China are exported overland to countries in Southeast Asia and Central Asia, including Thailand, Vietnam, the Philippines, Indonesia, and Malaysia. Counterfeits also reach Eastern Europe, Russia, and the Middle East, where they are often transshipped to Africa. Some counterfeits reach Africa directly via Nigeria, and more recently Algeria, Morocco, and other northern African states. In addition, counterfeits from China reach Latin America. Brazil and Mexico are key areas through which counterfeits are then transshipped to the United States.

According to some estimates, China accounts for up to 80% of all counterfeit goods in the global marketplace. Not only are counterfeits found in abundance in China, but China is also the leading source of exports of counterfeits. The U.S. Customs Service reported that it seized counterfeit and infringing goods valued at $93 million in 2005, with China (69%) and Hong Kong (6%) – through which many Chinese counterfeits are transshipped) – together accounting for about 75% of the total figure. Of course, the $93 million figure refers to the value of goods seized, and what is seized can represent only a tiny fraction of what actually enters the United States.

Counterfeiters in China have a strong incentive to export. Under China's Criminal Code, criminal liability is possible for sales of counterfeit goods in China that meet certain threshold levels, but it is debatable whether criminal liability exists for exports of counterfeit goods. According to some observers, there might be a loophole in China's Criminal Code that would support an argument that the export of counterfeits – as opposed to a sale within China – is not covered. In addition, while counterfeiters do run the risk of law enforcement if they sell their illegal goods within China, there is much less risk if the counterfeiter ships the goods abroad. Where the goods have been shipped abroad, the boundaries of distance, different time zones, and language make it difficult to trace the origin of the goods back to China or to discover the identity of the counterfeiter. Enforcement authorities within China usually have little interest in the harm or damage that is caused by counterfeit goods from China that are sold abroad.

Although China's exports of counterfeits to the U.S. and other parts of the world are already

significant, it is likely that China's exports will increase significantly for the foreseeable future. Under China's prior law, state-owned trading companies had a monopoly over import/export trading rights. Anyone, including counterfeiters, seeking to export goods had to use the intermediary of a state trading company. Although there were many state trading companies willing to assist counterfeiters, the use of a third-party intermediary did create an additional hurdle and expense in the export of counterfeit goods. To implement some of China's commitments when it entered the World Trade Organization, China amended its Foreign Trade Law on July 1, 2004, to eliminate the state monopoly on trading rights. Under the amended law, except for certain types of goods such as crude oil, cotton, and certain foodstuffs, which must be traded by state-owned companies, any business operator has the right to import or export goods after it has registered with the competent state authorities. The elimination of the state monopoly over trading rights means that any counterfeiter is now free to export on its own, without the need to find a complicit state trading company. As a result, many observers expect that counterfeits exported from China will rise sharply in the foreseeable future.

V. The Reaction of MNEs

In reaction to the explosion of counterfeiting and other theft of intellectual property rights, MNEs doing business in China have adopted a non-confrontational strategy of long term cooperation and informal lobbying. In 1999, a group of MNEs formed what is now know as the Quality Brands Protection Committee (QBPC), consisting of many of the most influential MNEs doing business in China and generally considered to be the most well-known industry lobbying group in the PRC. The QBPC regularly conducts seminars and conferences for PRC government authorities but is careful not to criticize the Chinese government. MNEs that approach the United States government have been careful in the past not to ask the U.S. government to initiate any formal action under U.S. federal trade law. Many MNEs have adopted a strategy of publicly praising the PRC government for improving its IP enforcement regime, while privately these same MNEs lament that the piracy problem is worse than ever. For example, when President Hu Jingtao visited the United States recently, Bill Gates, the Chairman of Microsoft, praised China for improvements in protecting Microsoft's intellectual property in China even though Microsoft, according to its own estimates, is losing $10 billion per year to piracy there.

MNEs pursue a non-confrontational strategy because MNEs are afraid of doing anything that might offend the Chinese government and that might lead to retaliation against their businesses in China. For this reason, MNEs avoid any actions that might be interpreted as hostile or threatening, but instead take every opportunity to praise the Chinese government for any improvements in IP enforcement.

VI. Why China Lacks the Political Will and Has No Real Incentive to Crack Down on Counterfeiting

Although counterfeiting is a massive problem, China is a one-party authoritarian state that can bring to bear the full coercive power of the state to resolve any single economic or social problem. China was able to effectively resolve the problem of rampant smuggling in the 1990s and has used swift and effective measures to control other widespread social and economic problems. There is no doubt that if the political will existed, China could bring counterfeiting under control within a short span of time – a year or two at the latest. However, the political will is currently lacking in Beijing, due to the following.

The discussion in this paper indicates that in approaching the counterfeiting problem, the PRC government is faced with a balance of two competing sets of interests. On the one hand, counterfeiting now supports many local economies and millions of people in China. Any serious crackdown on counterfeiting will result in serious economic losses and social costs that will require the expenditure of a great deal of political capital, as well as economic resources. Of course, China has many pressing problems that demand the attention of its leaders and would prefer not to have to incur the significant costs of a crackdown if they

can be avoided. On the other hand, China's leaders are well aware that MNEs, the worst victims of counterfeiting, are afraid of doing anything to offend the Chinese government. The PRC government knows that MNEs fear retaliation to their businesses in China and will avoid any actions that might cause any offense. Faced with the significant costs and social consequences of a nationwide crackdown on counterfeiting and a group of MNEs that appear to be intent on avoiding any offense to the Chinese government at all costs, China has no real incentive to incur the significant costs associated with a crackdown on counterfeiting. Rather, China has engaged in a strategy of appeasing MNEs through largely cosmetic changes that do not address some of the fundamental underlying issues, i.e. the importance of counterfeiting to local economies, local protectionism and corruption, and the need to find alternative lawful economic activity that can replace counterfeiting. Unless China finds the political will to engage in a meaningful crackdown on counterfeiting, there is unlikely to be any significant improvement in the foreseeable future.

Appendix

China's Strategies in Counterfeiting Auto parts

China employs three main methods in counterfeiting auto parts:

(1) Reverse engineering: Counterfeiters take a product and reverse-engineer it in order to make an unauthorized copy or counterfeit. The simplest and crudest method is to take the genuine part and make a mold based on the existing part itself. Using the mold, the counterfeiter can then make unauthorized copies (counterfeits) of the original, genuine part. A more sophisticated method is to create a template or blueprint of the part and then use the blueprint to create a new mold. Sophisticated computer programs now allow the use of digital photos as a basis for modeling software. If the counterfeiter starts with a two-dimensional digital photo of the part, the modeling software can create a three dimensional drawing or template for the part that can serve as the basis for a detailed template or blueprint.

(2) Refurbishing: Counterfeiters also take used or discarded parts and refurbish them and pass them off as new parts. For example, a used or discarded car filter or spark plug can be cleaned and repackaged using genuine original packaging and then sold or passed off as new.

(3) Internal and External Theft of Information Technology (IT): Many companies that manufacture auto parts in China have poor or non-existent IT security. Often company computers will contain design and product drawings with precise manufacturing specifications for the product. Many companies have no IT security measures in place that prevent these drawings from being taken internally from the computers in the design compartment by copying these files directly on a memory stick. No security measures prevent the transmitting of these files electronically to other computers. Many persons have access to computer companies both on site and through remote access via outside computers at the home or elsewhere. This creates a situation in which these proprietary designs are kept in an "open store" that is easily accessible by unauthorized users, thieves, and counterfeiters. In addition, companies will often transmit these files in intra-company e-mail without any encryption devices. The use of third-party subcontractors to manufacture parts creates an additional security risk. Many subcontractors who receive access to templates, blueprints, and drawings are even less careful than IT owners about keeping proprietary information out of the wrong hands.

Panel VIII: Discussion, Questions and Answers

HEARING COCHAIR HOUSTON: Professor, thank you so much for that incredibly honest and detailed overview. I have a couple of

questions, and then some of the other commissioners have questions for either of you as well.

Congressman McCurdy, you talked about the BlackBerry case where the U.S. manufacturer was held in abeyance for about two years, and then you ended up with the RedBerry. Do you think that that is an intentional way of doing business for some of the counterfeiters, that that is actually their business plan that they get a-hold of something or does this happen accidentally?

MR. McCURDY: No, I don't think there are accidents. I'll break your question down a little bit. I'm not sure there is automatic collusion between manufacturers and local governments or the local authorities that may be licensing or even with the central government.

But it's clear you have to have relationships with those governments, and it's important that you're there. You just can't just fly in and expect to have a system that works similar to the U.S. Patent and Trademark Office here in the United States.

As you know, even in the RIM case, they too have had some experiences, even domestically, in the United States with patents and trademarks and so they've had some challenges on their own front. But it's clear that in any system, if you're sufficiently funded and a large domestic corporation like China Unicom or others has access to an understanding of the bureaucratic system better than many of those who come in from abroad and try to navigate that same system, whether that's absolute collusion or the use of regulatory, bureaucratic roadblocks, it's hard for me to tell, but I again, I can't say that these are accidental occurrences.

HEARING COCHAIR HOUSTON: Thank you very much. Professor Chow, you brought a new wrinkle to this that we hadn't really heard in the last day or so, which I think is very important, and that is the social man on the street aspect of the counterfeiting.

You've certainly demonstrated in your testimony the difference between a passive lack of will and an intentional lack of will, and one of the things we heard about yesterday was China's industrial plan.

I have a two-part question. I hope you'll share your thoughts with us from the social side. One, in previous hearings, we've heard of the social unrest in China. I wonder if Yiwu and other models like that could possibly be part of a plan to keep people content and employed, and is actually a systematic approach rather than a random activity?

Also I'm curious, if you know, how do the Chinese view counterfeiting? Here in America, we all know in this hearing room how we view counterfeiting, that it's theft of property and it's a criminal activity. If a worker in a plant is making Prada bags or Dior sunglasses or pirating software, what is their feeling about what they're doing? Do

they have any sense of our perspective of it or any sense that they're doing something that the rest of the world would consider wrong?

MR. CHOW: As to your first question, I don't think there's any kind of national plan on the part of the central government to use counterfeiting to deal with the problem of unemployment. I believe that the central leaders in China are sincere when they say that they take IP seriously, but they're policymakers, they are lawmakers, and enforcement occurs on the ground at the local level. That's where the root of the problem is because on the ground at the local level, this activity is a very lucrative activity and it supports entire local economies.

So I don't think there is a national intent of some type of national plan to use counterfeiting and then much of it is grown up because the opportunity was there, and it's so lucrative.

Going now to your second question, most of the people who work in these factories in China, they don't really know what they're doing. If you've ever walked into one of these factories, you've got teenage girls mostly who work in these factories, 18, 19 years old. They don't know what they're doing is illegal. They think that what they're doing is perfectly fine.

But the truth is that the attitude I think of most people in China is towards counterfeit goods is that it's no big deal, and this would include also law enforcement authorities. I've talked with them, and they've said to me, Mr. Chow, what is the big deal? No one is being harmed by this. If people are being harmed, they'll do something about it. But they don't see it as a serious problem.

HEARING COCHAIR HOUSTON: Thank you.

MR. McCURDY: Ma'am, can I just tie on to one thing there?

HEARING COCHAIR HOUSTON: Yes.

MR. McCURDY: The professor, I think extrapolates the social impact and economic impact of counterfeiting, and it's true, and I agree totally that enforcement needs to be done at the local level, and that's why the USTR effort to target provinces, I think, is the right approach.

But just to put this a little bit into perspective, when it comes to the issue of political will and national will, when China decided it needed to exercise or implement economic reforms in order to ascend to WTO status, it probably displaced 100 million people. In most countries, in a political system, that would have brought the downfall of the government.

In China, with a population of 1.3 billion, and the rounding error may be about 300 million, so it may be 1.6 billion people. In order to have any social stability, they have to produce about 12 million new jobs a year. So you can see the economic challenge that they face and why it's so difficult.

But at the same time, I think the pressure has to be applied at the

local level, and it's going to take more than just saying here is a rule and a law, you enforce it. There are probably going to have to be social and economic investments at a major level, and that's a huge challenge.

Quite frankly, those of us who deal with China not only from an economic and industrial standpoint but also from a geopolitical standpoint actually think that's the kind of domestic internal focus that they ought to be applying.

The way it's got to be done is that it's got to be at the highest level of governments working together to say this is where our focus is, and you can't get away, you can't continue to skirt the edges of international law and rule by allowing this to occur. But it's a huge fundamental structural, and I think cultural, issue. It is a cultural question.

China historically has been a copying culture. That's not passing a value judgment on them. It's just been the nature of the culture and they've not had a tradition--private property does not have a strong tradition in China. Intellectual property is a further concept that is even more difficult. So that's why I contend that in the economic relationship with China and the rest of the world, this will be the single biggest issue, more than currency, more than others, that will have to be addressed, and that's why we in industry who believe that this relationship is vital for both nations in the 21st century, for the world, believe that this has to have high level focus.

There have to be serious, rational, pragmatic approaches to working with them, and I think it's not just a question of pointing fingers and blaming and accusations. It's actually entering into significant dialogue with them. I think there can be progress, but as the professor says and I think everyone who has been before you in the last two days, it's not an easy step.

HEARING COCHAIR HOUSTON: I appreciate that insight from both of you. Thank you very much. Commissioner Mulloy.

COMMISSIONER MULLOY: I want to thank you, Commissioner D'Amato and also Kerri Houston for putting on this hearing. You've done a great job. I've learned so much about this important issue. Professor Chow, I want to salute you for the testimony that you've given to this Commission, and thank you, Mr. McCurdy as well.

I always wonder why don't we bring these IPR cases, and then now we're told by USTR that they need to really make sure that they have a case that they can win, and the companies aren't really bringing them the type of evidence that they need. Then you wonder why, and Professor Chow, you've really zeroed in on that point today, that these multinationals kind of are held hostage in some way or another, and so they're worried about providing that type of evidence.

So then the Congress, thinking about this, and we advisors to the

Congress, policy-wise how do we deal with it? My thought is that we ought to bring the WTO case the best way we can bring it. We don't care what the multinationals say. Bring the case because it's in the national interest to bring it.

Then if you lose it, and the problem continues, then you got to say, well, that instrument doesn't work, we have to develop other instruments, be very pragmatic, and not to be hostile to China. This isn't personal; this is business.

That's the way I think we ought to approach it, but I wanted to get your judgment, Professor Chow, because of your expertise, on how do you think we ought to proceed to try and move, create the political will. I don't think the political will will be created in China until there's an economic cost.

MR. CHOW: It goes back to the multinationals. I think it really depends on how far they want to push this because from everything that I've seen, and again I used to work for a multinational company, they want to push it, but they will only push it so far, and that is the reality, and where they will draw the line is anything that's going to wind up offending the Chinese government.

This is where the line is drawn today. If they're not willing to back the U.S. government and stand behind the U.S. government, bringing some type of formal action, whether it's a Special 301, whether it's a WTO action, the government is going to be going out on a limb without backup.

So I think to a large extent, we have to figure out how far the multinationals are willing to push this, and if they're not willing to really go out and push this, and if they're saying we're only going to take this so far because we're afraid of retaliation, I don't know where it's going to leave the U.S. government.

COMMISSIONER MULLOY: Let me ask, because we had another hearing about a year ago where we had a witness who said that the multinational's responsibility is to their shareholders and getting shareholder value. They are not in charge of the national interest.

The U.S. government is in charge of the national interest. So if the companies because of their need for their shareholder value are afraid to take action, how do we then incentivize the government to take action regardless of what the companies are telling them?

MR. CHOW: Take, for example, when you're talking about a WTO action, first of all, in my opinion, I don't think it's a clear-cut case that China is in violation of the WTO. I think that if you look at Part III of the TRIPS Agreement which is the part of the agreement which is the most relevant to China's situation, given the way it's drafted, I don't think you can say that there's a slam-dunk case that China is in violation of

Part III.

To bring a case, you're going to need the cooperation of these companies in China to come up with the evidence to make the case. If they're not willing to do that, what's the point of bringing the case?

COMMISSIONER MULLOY: What do you do then? What would you recommend? We've got a huge problem and it's going to get worse, you're telling us, so what do we do policy-wise? If the WTO is a failed instrument, can't really do this, and we got this problem of all these counterfeit goods going into the world market including ours, what do we do?

HEARING COCHAIR HOUSTON: You get a gold star if you come up with a really good answer.

MR. CHOW: If I knew the answer to that question--I think I'd start with the multinationals. I'd ask them, how far are they willing to take this? How serious a problem is this really? And I'd ask them and really make them come up with the goods and get a sense from them how far they're willing to take this because you're not going to go very far no matter what you do without their support.

COMMISSIONER MULLOY: Thank you.

MR. McCURDY: Can I answer that?

COMMISSIONER MULLOY: Congressman.

MR. McCURDY: If you don't mind. I think you nailed the professor, and I think that's the challenge that we all face, is that you have to have evidence. I agree with him, it's not the failure of the WTO as an instrument, and I don't think you can just make that allegation.

The question is, do you have evidence to bring to a case that's credible so that you don't lose all of your international credibility in using this mechanism? It cannot be just a political tool based on anecdotal information or kind of broad-based, sociological and general economic information. There has to be a clear case of failure to comply with these rules.

I will tell you that when we went through the process of building this document, we had a hard time. We had a lot of examples, but there was not a single company prepared to put their name on that document. Now, we gave this to the Chinese government, we're distributing this. Because there is the real potential for retaliation or retribution. It may not be direct; it may not be today. It may not be six months from now, but there is this long-term fear.

So my suggestion to the U.S. government, and I've raised this at multiple levels: This is where the negotiations and the bilateral dialogue - and maybe even multilateral with European Union directly with China has to occur.

You have to insist on them. You have to work to ensure that the climate of retaliation is not there and if they are serious at being a stakeholder, whatever term you want to use, about being part of this global system, if they're serious about doing it, then they have to establish a climate that allows a system of law and rules to actually work, and it can't be two-faced.

That's the initial step you have to take. I don't think it's fair to come to a company and say you have to put your entire company at risk by bringing a case that they have weighed, they've weighed the consequences and believe in their own shareholder or corporate interest, it's not worth fighting. There have been cases in the past, as you know, and some have been successful.

The question is: have you won the battle and lost the war? One other area where I think government can apply real pressure: I don't know--the Professor may know--I heard there are about 300,000 lawyers in China. My God, we graduate that many a year in the United States.

The legal system is nascent; it's immature. There are poor judges; there are poor counsels. When judges are making decisions based on an economic formula or calculation of the value of a product sold locally as opposed to what the value would be when exported, the value would be, then it gets below, it ducks under the threshold of being a criminal penalty.

You have to have actual criminal penalties. There you need enforcement and they need to destroy the equipment and they need to take the bulldozers. When I met with the Vice Mayor of Beijing, who was in charge of intellectual property or the Vice Mayor in Tianjin, when they want to publicly demonstrate that they're serious, they take a bulldozer, they pile a bunch of DVDs and they roll over it.

That's peanuts. Yes, it's a big economic value and that's where a lot of these numbers come from, but if you really want to make a difference, you bulldoze the factory and you put the person behind bars. That's when you really see impact from this.

HEARING COCHAIR HOUSTON: Thank you.

MR. CHOW: Can I just respond, make a comment?

HEARING COCHAIR HOUSTON: Sure.

MR. CHOW: When I worked for a multinational company, we also went to the U.S. government and we said we would like you to bring this issue up with China, but please don't use our name. And that's what is going on here. Because the companies are screaming at the U.S. government, but there's only so much in my opinion that can be done if the companies are not willing to take this, are not willing to do anything to offend the Chinese government. If the U.S. government tries to negotiate with China and says to China you cannot retaliate against these

companies, nothing is going to happen. China is not going to agree to that.

The Chinese government isn't going to say, okay, great, tomorrow we'll pass a law that we will not retaliate against the multinationals. That is not going to happen. So what is happening is this kind of game that's going on in which the Chinese government is saying change takes awhile. It's going to take a decade, two decades. Change is slow and we're going to work on the system, we're going to train our lawyers and train our prosecutors, but please bear with us because that's what's going on. The stalemate is going to go on indefinitely.

HEARING COCHAIR HOUSTON: It sounds like we need to get all MNEs and do it all together, all at once. That might solve that problem. That would be an ideal situation.

We have ten minutes left and we have five commissioners with questions, so everyone gets two minutes. Chairman Wortzel.

CHAIRMAN WORTZEL: Dr. Chow, I'd like to ask you a couple questions about your great map. You have a wonderful description of what goes on at Yiwu in your paper and in your oral testimony. I'm also interested in some of the others--Urumqi, Tianjin, Wuai, Nansantiao, Hanzhenjie and Linyi.

Can you describe whether these other places specialize in certain types of counterfeits? Is there kind of a spatial geography to the counterfeiting? Can you relate these locations to things like rail switch points or inland ports?

One final thing, and the only place you have whole bunches of arrows going out is out of Urumqi. So are you trying to tell us that there's an awful lot going through Pakistan?

MR. CHOW: Well, let me first talk about Wulumuqi, which is the port that you're referring to which is in Xinjiang Province on the northwest corner. That's the jumping point for the Middle East, Eastern Europe. That's the springboard in which the goods will go to Eastern Europe, Russia, the Middle East and from there to Africa. So that, I think, is the reason I put that in there is because of the importance of that particular port.

When you look at Yiwu, Yiwu has over 400,000 different varieties of goods, from everything from plastic Eiffel Towers, plastic Statute of Liberties to other kinds of household commodities. So there's a great deal of this huge variety. Most of these markets don't specialize in anything. I've been to Yiwu myself, spent several weeks there, also been to Wuai, which is in the Liaoning Province, which is also in the north, and I've seen that market up close.

I've also been to the one in Beijing which is the Tianyi market. Most of these markets don't specialize, but when you get into certain

areas, for example, pharmaceuticals or in cigarettes, those are specifically regulated industries in China, and those you won't find in any of these markets. You have to go to specialized areas in which to find those products. So most of these are just simply general commodities.

CHAIRMAN WORTZEL: Thank you.

HEARING COCHAIR HOUSTON: Commissioner Wessel.

COMMISSIONER WESSEL: Thank you to both of you. Mr. McCurdy, it's a pleasure to see you here in cooler climates than Iowa or other places in cornfields. I have to say it's a frightening picture, and I don't think I've ever seen such a graphic or heard such a graphic description. It reminds me somewhat of Mr. Bill on Saturday Night Live who week after week is either flattened or dismembered as he yells "oh no." I think we keep yelling "oh no," and we get flattened or dismembered week after week.

Two quick questions. Mr. McCurdy, RIM is a Canadian company. What is the Canadian government doing, if anything, to protect the interests of one of its constituent companies? And Mr. Chow, from a legal perspective, Mr. Mulloy raised the issue of shareholders. It seems to me that if companies rush to China to create production facilities and bring their higher end production there, they are putting, in fact, at risk shareholder value long-term because of the potential for pirating, counterfeiting, et cetera, that the technology sharing actually may be adverse to shareholder interests rather than promoting them.

MR. McCURDY: Commissioner, it's good to see you again. I can't tell you exactly what the Canadian government is doing. I know that the Alliance, the Legal Alliance that worked with us in producing this is a coalition of both U.S. and Canadian law firms, and they share similar values and concerns based on manufacturing.

Just one quick point. I think he's testified before you, but Tim Stratford at USTR who is now the person in charge of Asian affairs probably has as much in-depth experience personally and individually in dealing with intellectual property challenges as maybe any of us.

He previously worked for a large automotive corporation and has seen first-hand some of the problems there. So it's always a good intellectual conversation and a challenging one, and I think he recognizes it. So we've got people in government, our own government, who recognize the seriousness of this problem and have first-hand experience with it.

Again, I think we have to develop as many channels and push them into those channels as we can, as the government, and it's got to be government-to-government. It just can't be assumed the corporate community--the other quick point--

COMMISSIONER WESSEL: It also can't be that other countries

hold our coats while we bloody our noses so that if it's a Canadian company--

MR. McCURDY: I think Canadians and the European Union have to be with us when you file those cases, yes.

COMMISSIONER WESSEL: Right. Mr. Chow, anything regarding shareholder value?

MR. CHOW: I think basically companies have decided that it's better to be in China and get your technology stolen than to not be in China. That's basically what people have decided. Companies go into China with their eyes wide open. They're willing to put up with things in China they never would put up with in any other country of the world. Why?

Because the dream, ever since the British started this whole thing several hundred years ago with thinking, gee, if we could only sell a shirt to every person in China when they started that back in the 19th century, countries have a dream and everybody is afraid not to be part of the dream.

So they've decided to be in China, get your property stolen than to not be in China, that's why people are going.

COMMISSIONER WESSEL: I believe last year's data showed that there was a $4.2 billion profit of U.S. companies, foreign companies invested in China, so the profits are necessarily yielding.

MR. McCURDY: I would actually challenge that number.

COMMISSIONER WESSEL: Okay.

MR. McCURDY: In our industry, where we consult and work with our companies on a regular basis, most of whom have a global strategy - and it's not just China, it's throughout Southeast Asia, it's around the world - actually are making profits in China.

COMMISSIONER WESSEL: Oh, I'm not saying they're not making profits, but based on the promise versus the reality, I believe one of the accounting firms or one of the consulting firms have done a fairly broad estimate that it was just a little over four billion.

MR. McCURDY: I can name you two companies that probably have that much in profits, but what we advise people and companies, especially the small and medium-sized firms that are looking at this opportunity, you have to go in with your eyes open. If you are trading solely in intellectual property, and these are the crown jewels of most corporate entities in our nation as an innovator, if you're basing it on that, then, you should know and understand the risk fully.

Chinese complain about it--why should we deal with America and all these trade rules because they'll never invest their tier one top IP when it comes to China. And quite frankly it's probably true. They're not going to.

There are also other benefits. At some point down the road if you're interested in hearing, there is a movement towards R&D and other things, which present real challenges, but I think you can also demonstrate some of the other side of that argument that there are some real benefits, usually in the cultural marketing and some of the other areas.

But they are also a rich resource for intellectual talent. I would prefer that we change our visa rules and allow that intellectual talent to remain in school here and work here than going back to China.

HEARING COCHAIR HOUSTON: Thank you very much. Commissioner Bartholomew.

COMMISSION VICE CHAIR BARTHOLOMEW: Thank you very much to both of our witnesses. It's been interesting to see in some ways the tensions and how to approach this problem playing out just with our panelists. Professor Chow, in particular, I think you've given us some of the most clearly thought-out, blunt speaking that we have heard on this issue.

MR. CHOW: That's why I'm in academia and I don't work for a multinational company.

COMMISSION VICE CHAIR BARTHOLOMEW: An observation and then a couple questions. The observation is I think you asked the real question: how serious a problem is this for the multinationals? Now, of course, the fact that they are multinationals changes the definition of how serious a problem is it. One of the things that we are tasked with looking for is the impact on the U.S. economy.

It was probably about ten or 15 years that the CEO of Coca-Cola said, Coca-Cola is a multinational company that just happened to be headquartered in the United States. As we think about how serious a problem and where they think they're defining their future, we need to keep that in mind.

Jay Berman, who spoke yesterday, who had been with the recording industry for a number of years, when addressing this myth of the China market, though he didn't exactly say it that way, talked about fool's gold, and I think that's important to keep that in mind, too.

My two questions are, one has to do with China price, the issue of China price as small and medium-U.S. businesses are trying to produce and trying to compete, and their production is being forced overseas, forced to China by large U.S. companies that are producing over there. What role do you think that counterfeiting plays in terms of driving the price of production down?

I'm particularly interested in whether there's any information as to whether U.S. small and medium-sized companies are up against unfair bidding practices in contracting because counterfeiters are entering into the bidding process and ultimately the Wal-Marts of the world are

succeeding in continuing to drive price down?

Then very specifically, Professor Chow, this disconnect between local authorities and the central government, which we hear about sometimes as an explanation and sometimes an excuse, what do you do with the fact that the Olympic logo is not being knocked off and how do we deal with that disconnect? Where is the power coming from and where is the success in making sure that the Olympic logo is not being knocked off in China?

Thanks.

MR. McCURDY: The China price question: we have a global supply chain within the high tech sector, and it's true that many companies complain about the China price, but I will tell you many will complain about the Wal-Mart price as a customer.

It's in the supply chain. Many of our customers have incredible pricing power and pressure that they can bring to bear on the suppliers throughout that chain. And I've been impressed, though, and I'm pleased that many of those customers and large end-users of the products that many of our companies produce are actually very diligent at looking because they have to ensure through this distribution channel that those products are not counterfeit, that they are safe.

In our area, if you have a knockoff DVDs, with all due respect, it's a major loss, but if I have a battery or if I have a chip, or if it's a component, that has safety and security implications. And we rely on the distribution channel and the supply chain to self-enforce. They test. They have to test because we can't tolerate those kinds of variances.

So there is an enforcement level there. There is within industry. I've not heard personally - and I talk to a lot of people about China in China, within our industry - of a concern about competing on price with counterfeiters. There are other serious advantages, comparative advantages, that they face in that country. That's why a lot of them are there and producing, so that they are playing on a little bit more level playing field within their own country.

MR. CHOW: Let me discuss the central versus local issue question that you raised. Under China's current structure, part of the problem is that local officials, government officials, and I'm talking about judges, prosecutors, other enforcement authorities, the Administration of Industry and Commerce, Technical Supervision Bureau, the Culture of Ministry, all of these authorities report on a functional basis to the central authority so that there's a dotted line between the local authorities and the central authorities, but they report directly solid line to the local government.

So if, for example, you're a local judge, and you enter a judgment against a local counterfeiter, who's powerful and a state-owned company,

powerful, connected and so forth, the local government could transfer you to a very undesirable job because the structure of the government now makes enforcement authorities answer to the local government, which in many cases has a direct interest in protecting illegal activity at the local level.

Local enforcement officials report functionally to the central government so that the central government does not have the power to remove people, to fire people, to put them into less desirable jobs. That's one of the issues, and of course, this is a very serious issue that involves fundamental political reform and these are some of the tough questions that nobody really wants to deal with.

HEARING COCHAIR HOUSTON: Thank you very much. I apologize. We are running a few minutes over. Our panelists have both given us wonderful information, but in deference to the next panel, we need to try to move along a little bit here. So next we have Commissioner D'Amato, and after Commissioner D'Amato, Commissioner Blumenthal also has a question.

HEARING COCHAIR D'AMATO: Thank you, Madam Chairman, and I'll try and be quick, but I did want to make a comment and see if you had a reaction to it. One of the things I'm taking away from this hearing is that the size of this problem is a lot bigger than I thought it was before we began.

It seems to me the scope of the problem and maybe the movement of the problem into a more severe area that is becoming worse rather than better, I think is a system question for us because after all when did a PNTR and brought the Chinese in the WTO, the tradeoff was we opened the American economy up, and lowered our tariffs, but what we were getting from the Chinese was a buy-in to an international rules-based system.

This whole counterfeit thing runs against the question of complying with the dictates of a rules-based system. The problem, as I see it, is if the TRIPS articles are inadequate and we cannot bring cases as we thought we could under TRIPS in the WTO to start solving this problem, it seems to me we are in a situation where we are lacking the kind of mechanism internationally for governments. You can't rely on the multinationals to solve this problem. It's a little bit much. It's governments that have got to solve it. It's governments that signed up to this thing, governments bring the cases to the WTO, governments put the data together based on what they get from the companies.

My question is, we're going to test the WTO system shortly by one or two cases on IPR, and if it doesn't work, do you agree we're going to have to look for another international mechanism to address it because the problem seems to be growing rather than being reduced in its

severity? Is that an accurate characterization of where we are; do you think, President McCurdy?

MR. McCURDY: No, I agree with your statement that it is a serious problem, as I said, starting out. As you know, we may have different views on the geopolitical relationship of the United States and China, but in this particular area, I think there's a large agreement, and that is in the emphasis that between our countries and the global economy as a whole, this is, I think the thorniest and most difficult problem because it's not just in the hands of the government.

You say it's government, but as the professor said, many of us who deal with China know, that these are social, cultural issues that go deep down.

HEARING COCHAIR D'AMATO: Yes.

MR. McCURDY: This is a country that is equal to the size of the United States in geography. It's a country that is multiple in size of population. It's a country where 800 million people still live on about two to $5 a day. There are still 30 million people who live in caves. It's vastly changing in many parts. On the east coast, it's a vibrant economy and growing and yet you see these disparities, and they have deep problems, and so it is a challenge for that government, a fragmented authoritarian central government which can enforce certain things, but this is one that is having a very difficult time getting its hands around.

I will say I was interested when I met with one of the local officials in one of the major provinces that is appearing to make more progress on this front, that within the Communist Party, that they have an incentive-based system in the way they're actually measured, and there is a meritocracy within this system, that one of the measures now is on IPR, and understanding and trying to improve.

So it's not just a question of 'you will enforce,' but the local guy is going to kick you out. There are those political contradictions. We see it in our country quite frankly, I do believe central government is making some efforts. The question is have they put the money, have they put the emphasis? No. And they need to put a whole heck of a lot more attention on this or it will be a further, festering problem.

The reason you're seeing more of it - it was one thing when my wife went to Beijing or something and looks at a purse or something on the street - but we're going up the value chain in technologies and that's where it becomes a fundamentally serious, more than just an economic problem.

HEARING COCHAIR D'AMATO: Yes.

MR. CHOW: Let me just make a couple of comments on the TRIPS issue. When China joined the WTO, it made commitments to liberalize its economy and the purpose of those commitments was to improve trade,

but it is the reality that the same improvements that improve legitimate trade also improve illegitimate trade, and that I think is hopefully a short-term consequence, and that we may somewhere down the line see that as a result of joining the WTO--and this is what most observers hope will be the case, that there will be some improvements in the legal system that are going to stem some of this illegal trade. I just don't see it happening anytime in the near future, and that's one of the problems.

Let me just say that one of the things about China is that China seems to just break the mold for so many different things. Because one of the things that we've never seen before is an economy that is able to continue to grow and continue to prosper even though it has a piracy problem that has no parallels in world history.

We've never seen an economy that can continue to grow and to continue to make improvements. We've always assumed that no government, no economy, can reach high levels of economic and industrial development without a strong regime protecting intellectual property rights.

But China seems to be defying history. It seems to be breaking that mold, and I think what is going on is that China feels that there is no reason to change course given that it continues to progress and all of the economic indicators which are of importance--the influx of foreign direct investment, the growth of the economy--all of that is going in the right direction despite a piracy problem that has no parallels in world history.

HEARING COCHAIR HOUSTON: Thank you.

COMMISSIONER BLUMENTHAL: Yes, thank you both. I'm going to just have a brief question for Professor Chow, and President McCurdy can weigh in if he'd like to also. This is a follow-up to Commissioner Bartholomew's question, and I'd like to put it like this. Who is actually being harmed? Because it sounds like the businesses aren't harmed enough to really do anything about it because basically the profits they're making in China seem to or just the need to be in China outweighs the harm.

You explained very eloquently why the Chinese government, especially at the local level, doesn't want to do anything about it, because actually there will probably be more harm if they do something about it, so there's no incentive to do anything about it, so I'm wondering, who is being harmed?

Yesterday we heard testimony about counterfeiting pharmaceuticals. We heard testimony about pharmaceuticals getting to Nigeria and actually harming people there, some specific industrial counterfeiting, so who's being harmed? If no one is being harmed really enough to actually do anything about it, then this problem is not going to be solved.

MR. CHOW: There are a couple of things about this. One of the questions I really would like to know is how serious is this for the multinationals? It's something that you guys can do. You can have a panel in which you can ask them, how serious is this?

The other point, though, is who is being harmed? China is being harmed by this, and the reason China is being harmed is because the lack of respect for intellectual property undermines the rule of law. If you don't respect intellectual property, you're not going to respect human rights, you're not going to respect labor, you're going to foster government corruption, corruption at the local level.

So China is being harmed by this, but it's very unfortunate in my opinion because it's in their long-term best interest, but nobody can convince China of this right now because the interests at the local level are so strong.

COMMISSIONER BLUMENTHAL: What do you think it would take to actually change the minds of or change the incentive structure so that China can actually see that they're being harmed?

MR. CHOW: I think they have to have an economic incentive. That's the only thing that I think will work, and it's got to come from the multinationals.

MR. McCURDY: I think it's actually an excellent question. I would underscore that question in your hearing minutes because, first of all, there's probably a manageable risk right now, that we use the term "multinationals," but I think you may walk out of here with this vision of the Fortune 100, but that's not the case. There are many, many companies that are far below that level that are doing business there, and they've determined up till now that this is a manageable risk.

We see it in cyber-security and other areas. Banks aren't reporting or doing things because it's below a certain level. When it gets up to a higher level, then maybe. I think when it comes to product safety and impacting the bottom line of some of these companies, maybe you'll see companies willing to step up and take a harder line.

But I totally agree with the professor and the underlying assumption. It's China that is being hurt, and that is the message that many of us take to China. They're the ones undermining their potential to move up the value chain, and I hate to do this to you, but I would tell you, you have to put this in context. We're talking at the most outside limit, since 1978, but really since 1992 that this economy has been liberalized and moving. Put that in context. Our children who use the Internet now assumed it was always that way. Well, we're talking about 1994.

We're talking a very small time line here, and so we're looking at a tiny picture especially in the history of that country of China. So they

are grappling with an enormous, enormous number of very serious problems and challenges for that society and that country, and stability is their number one concern. If you were to stack the environmental issues, the other issues, they are significant, but they are harming themselves and eventually I think they will understand that.

The last comment I would make because the other commissioner and I talked about this: personally I would still rather be doing business in China today and believe it's more open and safer than dealing with Russia.

HEARING COCHAIR HOUSTON: Thank you very, very much, to both of you. You've been just marvelous. We appreciate your input.

In the interest of time, we are only going to take a break to the point as our next panel comes up and sits down. So we're just going to go right along.

[Whereupon, a short recess was taken.]

PANEL IX: IP LAW AND BILATERAL NEGOTIATIONS

HEARING COCHAIR HOUSTON: Our next panel will focus on the legal aspects of IPR protection both in China and in the international arena.

Our first panelist is Terry Stewart of Stewart and Stewart Law Offices here in Washington, D.C. Mr. Stewart's practice focuses on international trade matters and customs law. He has worked with various industries to solve trade matters in the U.S. and abroad including representing agricultural, industrial and service groups.

He has previously served as Chair of the U.S. Court of International Trade Advisory Committee on Rules and President of the Customs and International Trade Bar Association.

Next we have Professor Justin Hughes, Director of the Intellectual Property Program at Cordozo School of Law, Yeshiva University, in New York City.

Professor Hughes is formerly attorney-advisor at the U.S. Patent and Trademark Office. His areas of expertise in intellectual property include the Internet, WIPO copyright treaties, database protection, many more.

Andrew Mertha, our final panelist, is Assistant Professor at Washington University in St. Louis, Missouri. Mr. Mertha's current research and teaching interests include international trade, policy implementation and enforcement, and bureaucratic politics and political institutions, particularly within the context of contemporary China.

His book, “The Politics of Piracy: Intellectual Property in Contemporary China,” was published by Cornell University Press in 2005.

He has worked in Shanghai and Hong Kong where he represents a U.S. toy importer in dealing with Chinese officials and factory managers.

I just want to note to my fellow commissioners as well as to our attendees that these three gentlemen have given us remarkable written testimony with quite a bit of detail, so it's certainly well worth a look at a later time. Gentlemen, I would ask you starting with Mr. Stewart to speak for about six or seven minutes, and then we'll go on to questions.

Thank you very much.

STATEMENT OF TERENCE P. STEWART, ESQ.
MANAGING PARTNER, STEWART AND STEWART
WASHINGTON, DC

MR. STEWART: Thank you, Commissioner Houston. I'd like to start by focusing on some of the questions that were asked, dealing with dispute settlement and the options that exist, just to lay out some options that are there that may not have been focused on.

One of the reasons the United States government has sought improved information on statistics as to the number of cases brought, the disposition of the cases, criminal actions pursued, et cetera, by the Chinese government is exactly to permit the government to determine whether the enforcement levels appear to be of a normal level, that would support not bringing a WTO action or whether the data would support a case that could be demonstrated through statistics, i.e., with no company having to have their name on the line, if you will.

For the central government of China, cooperating with the U.S. and providing that information can be a very positive way to help deal with the problems that you heard earlier about-- control over the provincial and local governments and how you get improved enforcement down at that level.

A second point, you should be aware that in the context of the ongoing Doha negotiations, there is an effort to get agreement--I may be wrong and they may already have agreed--to ban the bringing of nonviolation cases under TRIPS, and if you think about options for the U.S. down the road, if one is not able to either get compliance from the provincial and local governments, and if the activities that are going on are deemed not to be violations, a nonviolation case would be the strongest action the United States could bring because basically the deal that was cut, the benefits that we assumed we were going to get, are not being received.

So that is an important issue, an important recommendation that the Commission could make to the Congress, that this is an area that should be kept open so that the United States is not denied the benefit of the deal

that occurred when China became a member.

Third, as many of you may know, under the WTO, all members that have national, regional and local governments, the central government bears responsibility whether or not legally they have the authority. Hence, our trading partners have sued the United States for actions of states that violate U.S. commitments within the WTO and, hence, the fact that the problem is a provincial or local problem doesn't mean that there is not the capability for the dispute settlement process to focus on that and bring corrective action or at least obtain a victory, which can be helpful to the central government, to the extent it is having difficulty getting the provinces or getting certain local governments under control.

What I review in my paper, and the two issues that I would like to talk about before I stop this morning, really are with the very broad problems that have been portrayed yesterday and earlier this morning in panels, and with the variety of efforts that have been undertaken by the central government in China.

You face a couple of paths. One path is that this is going to be generational and we should come back and visit it in 2030 or 2040 and see if there is any American business left. Presumably that's not an acceptable option for those of you on the Commission and certainly not an acceptable option for American businesses.

A second option is to take a look at those issues that may permit some leapfrogging forward of enforceability, and in fairness to the central government of China, I think that the pressure that the U.S. has brought and the announcements with regard to what they're doing on software, both in terms of the mandate as to purchases within government offices, and the selling of computers that are preloaded with legal software, those are structural types of changes. If you can find other examples of those that could be done that can permit positive movement forward, that is meaningful and that should take a bite out of the extent of piracy that is occurring in particular areas.

Software is one where there has been a lot of focus and obviously the central government in China has taken those actions. Those are positive steps.

Second, there was discussion about exports, and in my paper, I outline the fact that if you are going to effectively deal with the export problem here in the United States from China and in other parts of the world, you have to adopt a policy similar to what we have done in C-TPAT, from a security point of view, which is to increase the inspections of suspect importers, suspect foreign producers and to have a carve out for those who work with the government to secure the transportation lines.

Obviously, there are many bona fide producers in China. There are

many companies that are looking to cooperate and to, in fact, be IP- clean companies. The import community here, most of them obviously are dealing with legitimate businesses. The problem for customs in China, the problem for customs in the United States is lack of resources and the ability to focus the resources on the problem areas.

Professor Chow mentioned several regions in the south where he believes there is a heavy concentration of counterfeiting going on. If you talk to the Custom Service in China, they will tell you that the vast majority of the seizures that they make of counterfeit goods have been in those southern regions, the ports of those southern regions.

Targeting can work but with a lack of resources in both countries at the governmental level, you need to be able to help the Customs Service get more bang for the buck in both places. A system that puts the private sector into play and adds a cost to the import community if they're not cooperating, i.e., additional inspections, is a way to deal with that.

The last point I'd like to make is that in the discussion of intellectual property problems that we face with China, there is one major gaping hole that, in fact, dramatically adversely affects small and mid-sized companies as well as others here in the United States-- and that is the inability to address a fairly pandemic issue in many industries of reverse-engineered knockoff machine tools used in China to produce downstream products.

The downstream producers in the United States who are buying legitimate machine tools usually from the U.S. or Europe or Japanese producers, pay three, four times the amount for machine tools and have no remedy under the IP laws. That is a hole that could be fixed and would permit those companies to use Section 337,or other laws, to, in fact, defend their interest here at home.

With that, I'll stop. Thank you.[6]

HEARING COCHAIR HOUSTON: Thank you very much, Mr. Stewart. Professor Hughes.

STATEMENT OF PROFESSOR JUSTIN HUGHES
DIRECTOR, INTELLECTUAL PROPERTY PROGRAM
CORDOZO SCHOOL OF LAW, YESHIVA UNIVERSITY, NY, NY

MR. HUGHES: Thank you, Hearing Cochair D'Amato and Houston, Vice Chairman Bartholomew, thank you for this opportunity to address the panel. In 1995, William Alford published a book about intellectual property in Chinese civilization, and it had an amazing title. The title of

[6] Click here to read the prepared statement of Terence P. Stewart, Esq.

the book was “To Steal a Book is an Elegant Offense”.

In 1995, that told us a lot about the long road that we would have to go in terms of intellectual property law existing and being enforced in China.

It was accurate in 1995. In fact, by 1995, the United States and China had entered into three bilateral agreements to increase enforcement of intellectual property in China. We would conclude a fourth bilateral agreement in 1996, so the problem even a decade ago was endemic and well understood. What I would like to say, though, is when you take that 1995 title, “To Steal a Book is an Elegant Offense,” we do have to recognize the enormous distance the Chinese have come in a decade, the amazing changes they have made in reforming their intellectual property laws on the books, and the establishment of an increasingly large cadre of leaders in Beijing and Shanghai and other cities who understand intellectual property, support it, and advocate for it.

Just last week, I was meeting the Deputy Director of the State Intellectual Property Office, and I was impressed at how much he and his delegation genuinely care about these issues. So, one the one hand, we must give them credit for the enormous progress they have made, and on the other hand, we have to accept that the enforcement levels are virtually nonexistent in China.

In fact, I was totaling up some of the IIPA's piracy levels, just for copyrighted goods, and if you take their estimates for 2005, the level of copyright piracy in China by itself equals that of all of South America put together. In fact you can add Canada, and you can add the Dominican Republic and Costa Rica to boot, and you won't get their estimates of the level of copyright piracy by itself.

So the problem is huge and in 2005, last year, the Chinese government issued a report, the New Progress Report, and I'd like to quote that. They said, quote:

"A complete IPR protection system cannot be established overnight. China has a long way to go."

Well, I think everyone who is going to testify to you today is going to agree to that: China has a long way to go. The problem is that they are taking awhile to get there, and while they get there, we and our companies and industries are losing billions and billions of dollars.

So the question is what is the case we could bring at the WTO? I understand our role is not that of advocacy but as counselors for you, to advise you on what the legal possibilities are at the WTO.

First of all, a very important thing that has to be a shadow over this entire two-day hearing is our lack of information. Practically everyone agrees in fact, if you search the literature, the word you find to describe copyright infringement in China is “rampant”. That seems to be the

favorite adjective, “rampant” violation, and there is not much that a law professor can add to what industry can tell you.

I have my own particular kind of anecdotal data. Since I started to going to China for the U.S. government around the year 2000, the first time I went there, I walked out of the Embassy, and I walked toward the Friendship store, the department store, the official department store, and about 40 feet from the department store, I was offered a whole bunch of pirated DVDs, and since then I make a point on every trip to Beijing to go to the Embassy and see how far a tall white guy has to walk from the Embassy before he's offered a dozen DVDs for a dollar.

It's never very far. I use that as my indicia because I figure if the Beijing government has command and control problems in the environs of the American Embassy, they probably have tremendous command and control problems in the provinces.

Let me say three things, though, about the infringement level. The first thing is we may really be entering an unusual period when the Chinese can cite statistics of major ramped up enforcement efforts, but the piracy levels remain enormous, and that's not necessarily surprising. It isn't the case always that there would be a lock-step diminution of piracy in relationship to a lock-step increase in enforcement activity.

So there does appear to be increased enforcement activity. But there doesn't appear to be any diminution of the piracy levels.

Second, whatever other people tell you at the panel, we always knew this was going to be a significant problem. This was a significant problem in 1990. It was a significant problem in 1995. It was a significant problem when we agreed to China's admission to the WTO. So anyone who comes to you and says they are surprised and shocked at the current IP infringement levels in China is either naive in a genuine way or engaged in bad theater.

Third, I think we have to emphasize the lack of transparency. If we are trying to do anything at the WTO, it's going to require a lot more evidence than we presently have, and I am an optimist. I think that kind of evidence can be gathered, both through industry and through the WTO process. I think that the USTR did the right thing in conjunction with Japan and Switzerland in asking China under TRIPS Article 63.3 for information about enforcement activities.

I'm not sure I would have interpreted TRIPS Article 63 as USTR did, but I think that was the right mechanism to show in a friendly way that we are interested in gaining information.

In the written testimony I provide to you starting on page five, I go through elaborately some of the different provisions of TRIPS, which can be used in bringing any action.

Most of the enforcement provisions of TRIPS, it's important for

members of the Commission to understand, tell about the kind of judicial system that the country must provide but not the application of those judicial tools, and so a main United States case would be built around a couple Articles which you've probably heard before in these hearings and will hear again, and that is Articles 41 and 61.

Article 41 provides, and this is the most general and most important provision:

Members shall ensure that enforcement procedures as specified in this part are available under their laws so as to permit effective action against any act of infringement,... including expeditious remedies to prevent infringements and remedies which constitute a deterrent to further infringements.

So while I agree with Mr. Stewart that it would be possible if the ministerial moratorium were lifted to bring a nonviolation or what's sometimes called a nullification case, a general case that under the GATT are privileges that are not being enjoyed by the United States at the WTO because of the level of infringement in China, I actually think that that would be a very, very difficult case.

There is no precedent at WTO for that interpretation, and that we'd have a much better time, but hardly an easy road, in making a case under Article 41, that there is not sufficient enforcement procedures to constitute a deterrent to further infringements.

So in questions and answers, I'd love to talk about that more, and the kind of narrow case or the kind of broader case you might be able to build at the WTO to show that China is not providing enforcement procedures that constitute a deterrent to further infringements.

Thank you.[7]

HEARING COCHAIR HOUSTON: Thank you very much, Professor Hughes. Professor Mertha.

STATEMENT OF PROFESSOR ANDREW C. MERTHA
ASSISTANT PROFESSOR, DEPARTMENT OF POLITICAL SCIENCE
WASHINGTON UNIVERSITY, ST. LOUIS, MO

DR. MERTHA: I'd like to thank the members of the Commission for inviting me to share my thoughts on intellectual property in China, and what I'd like to do before I do anything is to echo what Dan Chow said about the role of U.S. industry in terms of providing or in this case not providing the data necessary to pursue a credible case.

I can share maybe a small fraction of the government's frustration in this regard because I've been working on a scholarly article on

[7] Click here to read the prepared remarks of Professor Justin Hughes

precisely this issue. And it's been rejected by just about every peer-reviewed journal based on the comments that, well, can you give us some actual cases of people not coming forward, and of course the answer is, no, I can't, that's the point.

But in any case, my comments are based upon having lived and worked in China for almost seven years, from 1988 to the present, and before returning to academia in 1994, I worked for a U.S. toy and piece goods importer as production manager in China from 1991 to 1994.

And I've been researching the issue of intellectual property in China since 1998, but not from a legal standpoint but more from a bureaucratic politics standpoint.

Before I get into the actual recommendations, and I want to keep those brief because I hope to respond to questions during the exchange part of the testimony, I want to address what I see as a tendency to conflate the notion of political will with the notion of state capacity.

As far as political will is concerned, it's my considered opinion that many of Beijing's elite decision-makers genuinely believe in the importance of protecting intellectual property rights, say for nationalistic or other self-interested reasons, economic growth, the strategic payoffs from a vibrant, innovative and protected knowledge base, et cetera. And I argue that insofar as this problem persists, much of the reason is due to the limitations in state capacity. That is to say China's top leadership can only expend the necessary resources to sustain two or maybe three major campaigns over the long-term. And this, I think, helps explain the paradox of why China can regulate the most intimate behavior of 1.3 billion people through its stringent population control policy, but yet cannot crackdown in a sustained manner on a problem as seemingly straightforward and obvious as copyright.

Therefore, intellectual property and other policy priorities fall under the workings of China's individual bureaucracies, most of which are decentralized and fall under the jurisdiction of local governments, as Professor Chow laid out, and I would like to, hopefully have the opportunity to expand on that point because I think it's absolutely critical to our understanding of patterns of enforcement or patterns of non-enforcement.

Moreover, several of the most important intellectual property enforcement bureaucracies straddle the line between being fully centralized to being fully decentralized bureaucracies and this leads into the first point that I wanted to make, and that is that as I argue in my book, “The Politics of Piracy,” we must understand China's bureaucratic landscape to understand enforcement today and in the medium term.

And this is the context in which intellectual property and other policies are managed and enforced or alternatively neglected and

overlooked. Not all Chinese bureaucracies are the same. In fact, there is considerable variation in their budgets, their manpower, their freedom of action as well as specific incentives they face in enforcing their official mandates or not.

It is only by identifying and understanding the strengths and weaknesses of the specific structures of political bureaucracies that we can propose credible and meaningful solutions to the enforcement of intellectual property in China.

On this first point, I go into I think mind-numbing detail including the various organization charts, which the purpose of which was precisely to provide mind-numbing detail, which is to show how difficult and how intractable this problem really is organizationally.

Second, as I've discussed extensively in my written comments, I believe that we must help China push its criminal prosecution apparatus to take on more of a role to prosecute current intellectual property violations and deter against future ones, and this is another point that I talk about in some detail in my written comments.

So I'll just be brief here. I believe we must encourage China to be increase prosecuting pirates and counterfeiters under the IPR provisions of the existing criminal law because IPR violators will only change their behavior if they anticipate a high probability of being caught, prosecuted, and/or face stiff penalties if they are caught.

This would also help bring about much needed normative change among the ordinary populace by reminding them that intellectual property theft is exactly that, theft.

Third, we need to recognize that intellectual property violations are based first and foremost on economic calculations, not necessarily legal, cultural or political ones. Most Chinese, and I should also add most expatriates living in China as well as the tourists who flock to the Xiushuijie Shichang, which is the Silk Market in Beijing, long before they plan to visit the Forbidden City or the Great Wall, so that they can buy counterfeit goods, by pirated software, motion picture and music CDs because they are cheaper by several orders of magnitude than their legitimate counterparts.

Indeed, it is often extremely difficult to even locate a legitimate product in the Chinese marketplace. I believe that by bringing the legitimate price closer to the black market price, at least temporarily, U.S. companies can use their comparative advantages of providing virus-free software, product upgrades, and support services. This may mean losing money in the short-run, but in the long run these losses pale in comparison to the continuation of the status quo.

Fourth, we should maintain pressure on Beijing because by now it is an accepted, indeed, expected part of the Sino-U.S. relationship.

Stopping or even reducing it, I think, would lead to the conclusion in Beijing that we do not consider the issues sufficiently important and would hurt our credibility.

But we must also recognize limits of such pressure and the fact that it can easily become counterproductive. Beijing responds best to respectful engagement, albeit with a demonstrated degree of backbone on our end.

We should be tough, but we must be careful not to force Beijing to defensively dig in its heels.

Finally, we need to establish and maintain evolving adaptive, but realistic expectations. It is important that we carefully calibrate our demands in terms of what is possible in the short run, the medium term, and in the long term. We must be patient because developing the normative framework necessary for intellectual property protection to take root in China and Chinese society takes time.

Of course, this argument can be and often is used disingenuously, but this does not make it wrong. Therefore, although it may be frustrating, we must continue to have a set of clearly articulated long-term goals as well as realistic expectations of what actual Chinese state capacity is at any given moment along what I see is our mutually beneficial trajectories of bilateral engagement. Thank you for taking the time to listen to my prepared comments.[8]

Panel IX: Discussion, Questions and Answers

HEARING COCHAIR HOUSTON: Thank you very much. I have one quick question and then we'll go to Commissioner Wessel. I think mine is a yes or no answer. Any of you are welcome to answer it.

We've heard a lot of testimony about fake products and particularly pharmaceuticals, auto parts, things that can actually cause physical harm or illness to anyone who is using them. And one of the things that has been brought up in the last couple of days is the use of tort liability as far as this goes.

So if I'm Pfizer and a patient gets a fake pill from China with the Pfizer logo on it, Pfizer gets sued. If I'm an auto repair shop, and I use what I believe is legitimate part in someone's car and then that person is harmed because of that part, but I didn't know it was a defective part, is there anything codified at this point to protect American businesses who would be in some sense the end-user of these pirated or counterfeited parts from general liability claims?

[Panelists shake heads indicating no.]

[8] Click here to read the prepared remarks of Professor Andrew C. Mertha

HEARING COCHAIR HOUSTON: No? Okay. We need to talk to Congress. Thank you very much.

Commissioner Wessel.

COMMISSIONER WESSEL: Thank you and thank you to all of our witnesses. You have tremendous knowledge and we appreciate your sharing it with us and hope we can continue to avail ourselves of that knowledge in the future.

Before I go into a question, Professor Mertha, I want to say that it's the first time I've really heard the challenge of unwillingness versus inability as it relates to China, and it seems their willingness to address the one-child policy, to go after the Falun Gong, to have their Internet cops, they've set their priorities, and as you seem to indicate they can't walk and chew gum at the same time, so they've chosen what they want to proceed against, and that's a major challenge for us.

Mr. Stewart, you seem to raise what I consider to be not only a new issue but would dramatically increase estimates of what the impact is of IPR violations in what I guess would consider downstream dumping.

You talked about the use of machine tools and the inputs that go into manufacturing, that those could, in fact, be pirated or counterfeited so that a textile manufacturer, where our textile manufacturer might have to pay $30 million for a piece of equipment, the Chinese may be knocking it off, getting it for four or five million, that are current laws or current concepts aren't really thinking about that in terms of what the impact of IPR violations are.

Can you talk us through how we might go about addressing this and if the other scholars could talk about what we should be looking at here?

MR. STEWART: Thank you very much for the question, Commissioner. It's exactly that type of situation that has been communicated to me by a number of U.S. companies that have investigated what seemed to be impossible cost structures or pricing structures coming out of China, and one of the things they found was that where they were capital intensive businesses that relied on state-of-the-art technology/equipment, that equipment might run 50 percent of the cost of manufacturing for them, and they were buying, as you would expect they would have to in the United States, from equipment manufacturers whose products were subject to patents, and their investigation suggested that there had been reverse engineering, copying of the patents in China, with the effect that they were facing a 30 percent price differential or cost differential, solely on the basis of the equipment.

Now, if you look at U.S. patent law and you look at Section 337, there is already the authority for upstream holders of process patents to pursue downstream products if they chose to do so.

But to the extent the country views it as important to uphold

intellectual property, it can't say to American industries that you lose not because the other side has a better mousetrap but because they've chosen to knock off the equipment necessary to make the product.

So the TRIPS Agreement is a benchmark; it is the lowest standard that you can have. You can provide greater protections and certainly there are examples already, both in patent law and Section 337, for permitting some downstream use, and so it needs to be debated, whether in the Congress for U.S. law or whether in the WTO in terms of a modification to TRIPS if it's viewed as not permissible.

But in my view, this potentially is an order of magnitude of the counterfeit issue that already exists.

COMMISSIONER WESSEL: This is something the administration could self-initiate in terms of a 337 action?

MR. STEWART: They would have to change the statute.

COMMISSIONER WESSEL: They would. Okay.

MR. STEWART: The statute presently doesn't permit a downstream industry to go after a product where the processing or the equipment used to make it is viewed to violate a patent. I was in China the last two weeks, and I noticed that the German Chancellor was there and one of the issues high on her agenda with the Chinese was IP issues and specifically IP issues as it pertained to machine tools. Obviously, European companies are some of the world leaders as are Japanese companies as are still a number of U.S. companies.

HEARING COCHAIR HOUSTON: Thank you very much. Commissioner Mulloy.

COMMISSIONER MULLOY: Thank you, Madam Chairman. Thank you all of you panelists for being here. Just two quick things to get out of the way and then my main question.

Mr. Stewart, you do mention that need for the change in the law on Section 337. If that is something that you have a suggestion on how that should be done, that would be enormously helpful to have that.

MR. STEWART: Be pleased to supply it.

COMMISSIONER MULLOY: Professor Mertha, this article that you were talking about, if and when you do get that published, could you make sure we get a copy of it because I think, again, that's the area, a real problem in trying to bring a WTO case, the fact that the companies are afraid to bring forth the complaints?

DR. MERTHA: I'll be happy to. I can supply you with a draft, and I imposed it on an unedited volume so it may see the light of day outside the chambers--but I'd be happy to supply that to you.

COMMISSIONER MULLOY: That would be great. Thank you very much. I don't know whether you were here earlier when we were asking the panels how do we bring a WTO case. The concern that this is

the only remedy we have, because Section 301, we gave away when we joined the WTO and, in fact, we can't use Section 301 without first winning a WTO case. So we only have the WTO as the instrument to try and get some relief in this area, at least within the legal framework that we're now in.

And then USTR tells us they can't bring the WTO case because they don't have the evidence and the reason they don't have the evidence is because the companies are afraid to bring it to them because the Chinese would retaliate.

So I was delighted with your suggestion--I hadn't seen it before, Professor Hughes, about a nullification and impairment case under Articles 22 and 23 of the GATT.

Can you and Mr. Stewart comment on that? Does that seem like a realistic way to go ahead if we can't bring just the TRIPS case in the WTO? Terry, you might start and then Professor Hughes because I think we got to do something.

MR. STEWART: Well, when I was suggesting it, I was suggesting it more, I believe, that to the extent the United States does not get the movement from China that it is seeking-- and I believe that there are certainly at the central government level efforts to try to move where they can to improve the situation. But if there is not improvement, I believe that there are likely bona fide violation cases that are out there that USTR has identified, and I believe it was communicated to China where their basic concerns are.

Those can be brought regardless of whether they get the level of cooperation from private industry that you might need in a different situation.

My comment about a nonviolation case, a nullification and impairment case, is that the United States should not permit the Doha Round to conclude and lose that opportunity under TRIPS because if you get to the situation that was described where there is nothing that can be done from a violation point of view, it is very clear that the benefit of the agreement bringing China in is far less than the United States contemplated, and there would be, while difficult to prove, a very interesting and I believe a very important nullification and impairment case.

COMMISSIONER MULLOY: Professor Hughes, you talk about this in your testimony on page ten and 11.

MR. HUGHES: Yes, sir, I do. It's important to remember that in that provision of the GATT, there are three elements. There is element (a) and this is described on page 11 of the testimony, a failure of another contracting party to carry out its obligations under this agreement. That would be a straightforward normal case.

And then (b) the application of another contracting party of any measure whether or not it conflicts with the provision of this agreement; or (c) the existence of any other situation.

And I point out (b) and (c) because in GATT jurisprudence, there have been a few cases of (b) where a country applied positively a measure, and the GATT said no, that measure nullifies another party's advantages under the trade agreement.

But to the best of my knowledge, there is no case under (c) where there was simply a nullification case about a "situation". And the problem would be that this might be cast as just a "situation".

I think that should the moratorium on bringing these cases under TRIPS be lifted, that this would be a very difficult--it's a possible case, but a very difficult true crap shoot kind of case.

Now, may I say something about what it appears you've been hearing for the last couple days that I find troubling? One thing that needs to be explored on this issue about how much evidence USTR needs, and I'm surprised, I haven't heard it in the hallways here and I haven't heard it in this room, is the question of burden of proof. All of you who are lawyers know that the key issue, a issue that really sets a case, is who has the burden of proof and what is the burden of proof?

We have never had an enforcement case at WTO under these provisions. We don't know what they would establish as the burden of proof. So when USTR says we don't have the evidence, I largely concur with that. But I want you think as lawyers think: evidence for what? How much evidence? What burden of proof are you being required to meet?

And the reason I say that is because it's quite possible, and I think we could make the case, that in all of the TRIPS cases to date, the issue has been a positive. It's law on its face. Very easy for a panel, very easy for the appellate body to look at the law on its face.

So the burden of proof hasn't been critical, but there has been in GATT jurisprudence and WTO jurisprudence some movement in where the burden of proof lies. And when you get to an enforcement case, the United States is really being asked to prove a negative. We're being asked to prove that something doesn't exist. Well, when you ask a party to prove something doesn't exist, you quite possibly would establish a very low burden of proof, and then say to the respondent or the defendant can you show that the thing exists?

So I'm not so convinced that we have to take existing TRIPS and WTO jurisprudence and say we use the same burden of proof for an enforcement case.

COMMISSIONER MULLOY: Thank you. That's very important because the WTO just completed their review of China and they cited them in their review in this area as being delinquent. So I'm always

thinking, gee, can't you take judicial notice and then proceed from there, and there should be kind of a burden of proof for them to show the other way.

I think personally that USTR has been much too cautious, that they created this instrument and they love it so much, they don't want to denigrate it in any way by showing that you bring a case, you may lose it, because they people might want to do other things.

So they've created something that they're afraid to use and I think we ought to use it, and if it doesn't work, then we do something else, but we can't let this go on.

HEARING COCHAIR HOUSTON: Thank you very much. Commissioner D'Amato, you had a question?

HEARING COCHAIR D'AMATO: Yes, thank you, Madam Chairman. I have a couple quick questions. First, for Mr. Stewart. What would you think about the concept of shareholder derivative suits with regard to companies that expose valuable IP deliberately in China, reduce their value of their product as a result of counterfeiting?

Do the shareholders have a case here to go after the company for diluting the value of that product through the behavior of exposing the IP in China? That's first.

Secondly, do you have a view on the viability of using Article 41 for cases in terms of the enforcement mechanism?

MR. STEWART: I'm not an expert in shareholder derivative suits, but certainly if the conversation in the last panel, which looked at what is the loss, what is the value, where management wastes assets, there's always the risk that shareholders who perceive that they've not acted in the best interest of the company could bring a suit.

Whether you could set up a situation where that would be true by making a decision to invest and move some of your top technology to China, there would be a lot of facts and there would be a lot of issues in terms of what the company did or didn't do when they got there, what kind of protections they put up.

But a possible type of action would be my uninformed view, Commissioner.

On the second issue, I absolutely believe that there are viable cases that could be brought. There is the policy issue that you always have as to whether now is the time, now is the correct time to bring an action. It is the case that the bilateral approach, pursued not only by the United States but by other major trading partners with China, has gotten China to take affirmative steps.

The action plan that was put together for 2006, the announcements with regard to software, some of the targeting that's been going on to get businesses involved, those are all positive steps.

When I was in China, I had a chance to meet with a number of parts of MOFCOM and, not surprisingly, you're now seeing resources being devoted to preparation for a possible case that the United States might bring against them on TRIPS. So there is always the question of whether you're engaged.

The pressure is important. Where there is no action and where we have stopped getting forward movement, cases can be important, but cases take a long time, as important as they are, and at the end of the day, if you kind of freeze that part of forward movement for the duration of a case, you have to evaluate whether you are getting more forward movement by the result of the case or not.

That's the exercise USTR is charged with evaluating. But I firmly believe that there are bona fide cases that could be brought and the question is will there be enough change, will there be improvements, and I think part of what we have to think about is whether there are things that can move enforcement ahead in leaps like the statutory change to require legitimate software to be preloaded on computers when sold, which, to me, is a very positive thing.

And I think the kind of issues that I identified are possibilities there. That doesn't rule out doing cases, and I think there are meritorious cases.

HEARING COCHAIR D'AMATO: Thank you very much. In the interest of time, I'll withhold my question, but I do have a question for Professor Mertha on the record as to the tension between bureaucracy and the court system. But I will do that for the record, if that's all right with you.

Thank you, Madam Chair.

HEARING COCHAIR HOUSTON: Thank you very much, Commissioner, and I do apologize. Unfortunately, we do have another event coming in this room, and we have to be out right at one o'clock. So I'm so sorry we had to abridge this session.

But thank you very much. We really appreciate all of you coming and giving us your time, and we're only going to take a break up to the point that we have our next panel seated.

So we'll move very swiftly along. Thank you very much.

[Whereupon, a short recess was taken.]

PANEL X: CONCLUSIONS: THE FUTURE OF PROECTING U.S. IP

HEARING COCHAIR HOUSTON: In the concluding panel to this hearing, we are pleased to be joined by Timothy Trainer, President of Global Intellectual Property Strategy Center.

Mr. Trainer founded this IP consulting firm in March of 2005 after

serving five-and-a-half years as President of the International Anti-Counterfeiting Coalition. His IP career also includes several years each with the Intellectual Property Rights Branch at Customs and the Office of Legislative and International Affairs at the Patent and Trademark Office.

Next, we have Dr. Neil Livingstone, CEO of Global Options, Inc. Dr. Livingstone serves on a number of fiduciary and advisory boards in the aviation, entertainment and banking sectors, and I have to say that I am very familiar with your work on importation, and your company did a study a few years back, that my copy of which on importation and the dangers thereof is yellowed and dog-eared. We did have a panel on that yesterday. I'd love to provide that information to you.

During the past two decades, he has served as a corporate equalizer on a variety of investigative assignments, including kidnappings, homicides, industrial espionage, celebrity stalking, missing CEOs--I'm not sure everybody would think that was bad--and threats against top executives.

Finally, we are joined by Pat Choate, Co-Director of the Manufacturing Policy Project. Dr. Choate is a political economist, think-tank strategist, policy analyst and an author, who studies U.S. competitiveness and public policy.

He has held several positions in the U.S. Department of Commerce, the OMB, and in the government of Tennessee and Oklahoma. Thank you very much for joining us this afternoon, and Mr. Trainer, we'll start with you.

STATEMENT OF TIMOTHY P. TRAINER
PRESIDENT, GLOBAL INTELLECTUAL PROPERTY STRATEGY CENTER, P.C., WASHINGTON, DC

MR. TRAINER: I'd like to thank the cochairs, Ms. Houston and Mr. D'Amato for inviting me back, having testified last year and appreciate the opportunity to give you these comments regarding China's counterfeiting and its impact on U.S. industry and consumers, and of course, I'll summarize my full written submission.

The IP enforcement challenges posed by China are, in fact, global challenges to the IP enforcement systems everywhere. My recommendations have both domestic and international components, specifically the following recommendations:

Of course, the U.S. government should continue to insist that China improve its enforcement system by aggressive border enforcement to stop exports and subject individuals involved to criminal prosecution.

Increasing its criminal investigation and prosecution and imprisonment of individuals involved in counterfeiting in China.

And of course, also strengthening the administrative enforcement system and ensuring referral of cases for criminal investigation and prosecution.

And also imposing severe criminal penalties on repeat offenders and, of course, you've heard of many of the other recommendations with regard to China's criminal enforcement system.

In addition, I would recommend that we ask U.S. industry for less burdensome data to gauge the quantity and impact of China's counterfeiting. Also, consider additional training and education approaches to raise the level of receptivity to IP and its use for economic development, both in China and in third countries.

A look at strengthening U.S. laws by eliminating the personal exemptions for arriving persons and consider penalties on consumers like those penalties that are now being used in Europe. Determine whether certain customs and border protection programs that permit inspections abroad and other trade facilitation programs permit counterfeit goods to enter the United States.

Continue pursuing strong enforcement provisions in our free trade agreements, and also insist that our trading partners actually start taking aggressive action against piracy and counterfeiting rather than issuing joint statements that something needs to be done.

With regard to the U.S. impact, in 2005, Customs seized 3,709 shipments at our borders, a 31 percent increase over 2004. This means that China origin shipments resulted in Customs officers averaging over ten IPR seizures everyday of calendar year FY05.

Given the broad responsibilities of Customs to enforce many different laws and regulations, the demands of monitoring goods just from China is a major effort. Looking at the U.S. figures, there may be several explanations why the value of goods seized, nearly $64 million, appears low to some.

First, persons importing into the United States have adapted to U.S. practices by importing goods that appear generic and affixing counterfeit marks after entry and before hitting the streets.

Second, the value of the seized goods reflected by U.S. statistics are not based on the suggested retail price of the goods, but based on a Customs valuation method that is less than the suggested retail price that may artificially reduce the value in the statistics.

Third, the value is limited to what Customs seizes, not those imported goods that may be seized at some later point, when state and local officials seize the goods.

Next, counterfeiters may break down shipments into small quantities, sending more shipments in the hope that fewer smaller shipments will be detected.

Finally, we have no idea about the quantities that are never stopped. One can imagine scenarios where consumers have unknowingly bought a counterfeit battery bearing a well-known mark and after it stops working a few hours or a few days later, just simply trashes the battery.

With regard to the scope of the counterfeiting, China's counterfeiting is an assault on U.S. consumers and IP owners. The industries victimized are expansive. For example, high lead levels in paint on counterfeit Mickey Mouse toys in the UK, counterfeit John Deere combine in China, million dollar seizure of counterfeit GM and Nissan spare parts in Dubai, counterfeit "Bubble Wrap" in Los Angeles, millions of Marlboro cigarettes hidden in trucks in Hong Kong, as well as Latvian Customs finding counterfeit Marlboro cigarettes.

Counterfeit Nike and Timberland products found by Maltese Customs and counterfeit Colgate toothpaste in packaging with Chinese writing found on the Philippines.

Compounding the problem is China's counterfeiting of brands owned by foreign-based companies. Today, although U.S. consumers may not be very conscious of it, they buy foreign-brand autos, cell phones, home electronics, cosmetics and thousands of other products. Therefore, when the counterfeit Nokia accessories or counterfeit Nissan or Kia auto parts, counterfeit Michelin tires and counterfeit Shiseido cosmetics are found here or any other market, U.S. and other consumers are at risk.

We know that border enforcement agencies in the U.S., EU and Japan issue annual statistics that underscores the problem. The U.S. government's efforts to obtain better data from companies have been unsuccessful. In part, this may be due to the request for case specific details.

I offer an alternative that does not require case specific details and may allow companies to aggregate numbers and to perhaps by this industry sectors, collect data, maybe it will help them provide this data.

IP owners might be asked for the total number of raids in China, specifying a time period; if a repeat facility was raided, how many times a particular facility was a raided; Information about the facility. Was it shut down or not? Identify the type of facility, whether it was production facility, warehouse or retail?

Total items seized and/or destroyed; the total number of arrests arising from enforcement actions; disposition of defendants in administrative or criminal cases, whether fines were imposed and paid, whether prison sentences were imposed and served?

Finally, information regarding the equipment used to produce goods and whether the equipment is confiscated, dismantled and destroyed? In addition, the companies might be asked to provide information about seizures of China origin goods in third countries, simply because of the

global impact.

Although it's hard to predict what companies are willing to collect and provide, this is not a case specific approach and may alleviate some of the reporting burdens. It has been a dozen years since my first effort to prompt the trademark industry to start collecting data for the U.S. government.

For small and medium enterprises, the counterfeiting problems are compounded by yet another barrier. Although you've heard of some of those barriers, I'm going to touch upon something slightly different. Because the global intellectual property system has rules, legitimate IP owners who are the victims are also failing to make progress in this battle because of the territorial nature of some intellectual property rules, which help counterfeiters and pirates exploit an established system.

In view of the current system where criminals make, trade and sell in practically every country, IP owners and especially the small and medium enterprises are disadvantaged because they can only protect their rights where governments have granted their trademarks and patents.

In view of the collision between the global scourge of counterfeiting and piracy and the territoriality of some types of intellectual property, perhaps it may be appropriate to consider how a distinction can be made between the territorial acquisition of rights and the ability of IP owners to protect and enforce their rights so that protection and enforcement can be obtained in more countries in a timely fashion even absent the grant of rights in all the countries where one is victimized by counterfeiters.

My last topic really is with regard to the capacity building and technical assistance. For all the innovative energies our industries put forth to be leaders in the marketplace, we need some of that creativity and innovation in our efforts to create partners around the world to promote IP systems with effective enforcement and this needs to be translated into training and education programs.

While government to government training is good, it often fails to address the true local interested parties, the local business sector and how it can be commercially and economically empowered to benefit from IP.

Intellectual property training that is a constant drumbeat of enforcement without more simply appears to be an exercise in self-interest that can plant the seeds of resistance to enforcement and a backlash against intellectual property.

Sadly, we are already suffering from that resistance and backlash. I would simply say that one of the things we have not talked about and I don't think anyone has raised is that while the U.S. government has frankly for many years provided a lot of training sessions abroad, we don't have an equivalent intellectual property training institute, if you

will, that is actually funded by industry so its actual interests can be reflected through their own particular training institute.

So given the limited time, I would say in conclusion, if you think that all is not lost, beware. Last year a warning was issued because many Shanghai taxis had counterfeit electronic maps installed into their GPS systems, so of course the drivers were lost as to where they were going.

This certainly was an interesting development when you read about counterfeiting in China. But the Chinese at that time--this was very recent actually--said that they didn't know how to handle it because this was a modern issue and a problem for them so they were still looking into how to deal with it.

By contrast, we've already heard about how aggressively they can clamp down on the Olympic symbol in China, so clearly we know that there are ways in which the Chinese can be aggressive and effective.

I'm happy to entertain any of your questions and look forward to those. Thank you very much.[9]

HEARING COCHAIR HOUSTON: Thank you very much. Thank you. Dr. Livingstone.

STATEMENT OF DR. NEIL LIVINGSTONE
CEO, GLOBAL OPTIONS, INC., WASHINGTON, DC

DR. LIVINGSTONE: Thank you very much, Chairman Houston, and members of the Commission, I appreciate being here today. My statement has been submitted for the record, and I'm going to try to give you a view from the trenches because as Commissioner Houston noted, that's what I do and that's what my company does.

Some years ago, a fine member of this body, Senator Ernest Hollings, said “there is no education in the second kick of the mule." And we've been kicked by this mule over and over and over again. We're probably on the 200th to 300th kick right now, and I don't see any progress. Let me explain.

Some years ago, my firm was contacted at the recommendation of a government agency to a foreign owner of a company in the defense sector. They said there's something going on here, and would you investigate?

What we found wasn't just industrial espionage; it was the real thing. Chinese espionage. There was so much industrial espionage and pirating going on in Silicon Valley, we called it the "valley of the spies."

There were probably 60 foreign intelligence services working there. The Chinese out in front of almost everyone. Some years ago, Premier

[9] Click here to read the prepared remarks of Timothy P. Trainer

Deng Xiaoping promoted the philosophy of "let foreign things serve China," and they've made good on that. This perspective continues today and obviously China views counterfeiting, the theft of intellectual property, and infringement of trademarks and so on not as serious offenses, but as major sources of income, taxes and employment in China which fuels their economy.

You could say we have the Chinese right where we want them. Our largest trade deficit is with China. We import over $243 billion worth of goods from China every year, and we sell about $40 billion worth of goods. That should give us a lot of leverage with the Chinese.

My clients rarely bring lawsuits against IP violators. It's not going to do you any good because Chinese laws are still applied very arbitrarily and inconsistently. If you'll refer to my statement, I addressed talk about the Chinese court system and describe the flaws that we see today. There's really no incentive for Chinese courts to enforce their laws.

Judges are loyal to local Party leaders and more concerned about the local economy than anything else, and when violators are actively prosecuted, they generally receive minimal punishment which only encourages more intellectual property violations, piracy, and counterfeiting. With respect to tort remedies, the Motion Picture Association has filed ten actions to date. I don't know if they said this in their testimony, but the result of these ten actions is that they've received settlements in six cases for a total of $94,000 in damages.

It takes a great amount of money to bring a case to court today in China because they don't have any enforcement mechanism himself or investigative capability. They're not trained. They lack the will and so the victim has to bring all the information to the authorities, package it carefully, and try to get their attention.

In other words, you have to develop the case for them, wrap it up in a nice neat bundle and put it on the table and then, and only then, maybe they will look at it and consider whether they're going to take steps to bring IP violators to justice.

There are some defensive measures companies can take to reduce their vulnerabilities, but we've got to go on the offense.

The Chinese government has to know that this is a key element in the Sino-U.S. relationship, that they're taking away our jobs, they're weakening our economy, and doing untold harm to the United States through their lack of zeal in enforcing intellectual property protections.

You've been discussing the validity of bringing WTO cases. Well, good luck. I'll see you in five years. Let me know how you're doing. We've got to get very aggressive in going after Chinese malfeasance, and one of the things we need, and I think Mr. Trainer alluded to it is help in establishing the facts in cases.

Today the burden of proof is developed by industry, by the victims. Commissioner Houston referred to a report we did. Industry paid for that, not the government.

After the fall of the Soviet Union, the intelligence agencies of virtually every country in the world, with the exception of the United States, were refocused on economic issues. The main enemy, the Soviet Union, was gone, and there was no longer a need, it was felt in many quarters, to focus on ideological or religious enemies.

And so, the French, British, German, Japanese and Chinese all focused on promoting their economies, because that's the basis of economic and political power in the world today.

I think we ought to look at giving some help to American industry in terms of collecting the information that we need today to bring against IP property violators. I recommend the creation of a new federal agency to conduct this intelligence gathering. Why a new agency? Because the traditional intelligence community doesn't want to collect economic intelligence. They always say, we can do it in a general sense, but we don't want to show favoritism to anyone or any company.

My company works on that kind of issue all the time. We have given information to the USTR, for example, that has been critical to the sale of American products in other parts of the world.

I recommend that agents of the United States government, be given the task of combing the earth and the Internet for violations of intellectual property, for counterfeit products, for trademark, contract and service mark violations. They should go to the Chinese export commodities fair in Canton, other trade shows, to look for IP violations.

They should monitor suspected communications around the world, using standard police and intelligence methodologies to collect the information needed to bring successful cases against offending countries and individuals. We should assemble an international watch list of real and suspected violators. As a private citizen, I make life as tough for counterfeiters as I can.

If I can find a connection, as we did with a case involving the motion picture industry, where I can use the word "terrorism" or "drugs," because some of these guys have gone into other areas, that's often the only way I can get attention of the federal government.

I've got to find that connection. I don't think I should have to do that. I think we should be tracking major counterfeiters and IP pirates as a matter of national interest. They should be monitored and, if the opportunity arises, we should arrest them. We need to modify our extradition treaties to cover IP theft and pirating crimes so we can go after these people who are often now exempted because their crimes are not crimes of violence.

I think companies, individuals and financial institutions associated with piracy and counterfeiting should be barred from doing business in the U.S. and with American firms anyplace in the world. We should apply the same standards against IP violators we're doing now against terrorists and, money launderers. This is criminal activity and in some cases the proceeds support international terrorism.

Terrorists have become increasingly smart. In the report that Commissioner Houston referred to, we found an al-Qaeda bomb-making factory in Pakistan that was sharing space with a firm engaged in counterfeiting pharmaceuticals. Do I think that there was any connection? Of course I think there was a connection. Al-Qaeda would not have co-located with a strange firm lest it jeopardize their security.

This gets to the very heart of our national security. I think that we should deny visas to counterfeiters and put them on a watch list. If we can use the long reach of the American law to grab them someplace, we ought to put them on trial.

The Chinese must learn to respect "foreign things," not just take advantage of foreign things. This is a life and death issue in the long term for our economy. I would urge this Commission to break with the past, to disregard traditional solutions and bring about a sea-change in Congress and the administration with respect to how we deal with this issue, especially as it regards China, where we have our largest trade deficit today.

Thank you.

[The statement follows:]

Prepared statement of Dr. Neil P. Livingstone
President, Global Intellectual Property Strategy, P.C., Washington, DC

The Developing U.S.-China Relationship: Analysis of China's Weak Intellectual Property Rights Protection and Enforcement

Thank you for the opportunity to appear before the Commission on this most important subject. In 2000, my firm, GlobalOptions, was contacted, at the recommendation of a government agency, by representatives of a foreign-owned American defense contractor in California. They had reason to believe that the company's intellectual property was the target of foreign spies. Our extensive investigation conclusively established that their fears were well-founded and that the espionage was being conducted by agents under the control of China. What was interesting is that our conclusions surprised virtually no one in the government. All were acutely aware of China's illegal methods to acquire Western technologies and trade secrets, and to systematically violate patents, copyrights, and trademarks.

For decades China has been targeting Western technologies, initially seeking military and other secrets, but more recently concentrating much of its effort on technologies and intellectual property designed to drive its rapidly expanding economy.

In the late 1990s, Silicon Valley was known as "the valley of the spies" because so many foreign intelligence services were operating there, including many allied services. But the Chinese were, and remain, among the most prominent and aggressive nations engaged in systematic industrial espionage and intellectual property theft.

But the Chinese no longer have to troll the world to steal secrets because the world is coming to them. China has been called the world's factory floor. During the past decade alone, more than 300,000 foreign plants and factories have been established in China. Most are involved in the assembly of imported parts that are then re-exported to wealthier nations. Re-exporting goods from China now accounts for about 55 percent of its total trade.

Thousands of American companies are among those attracted by China's cheap labor and growing market for consumer goods. Based on population, China's market is three times larger than the European Union and four times the size of the United States. Its economy is growing at an average of 8 percent a year.

Many of the products are particularly vulnerable to reverse engineering, design infringement, and counterfeiting due to inadequate protections in China of intellectual property rights. According to the U.S. Trade Representative's office, more than 90 percent of every form of intellectual property--from business software to music, books, and motion pictures--is being pirated by China.

Such piracy costs American companies, and therefore our economy, an estimated $20 to $24 billion a year, about ten percent of the trade between our two nations. The U.S. motion picture industry alone is losing about $6.1 billion a year as a result of pirated movies, of which approximately $300 million is the result of Chinese counterfeiting. Pirated films sell for as little as 60 cents to a dollar in China. Until recently, however, most counterfeit films were made locally for the Chinese market, but this trend is rapidly changing as the Chinese develop export markets for their pirated products. China is shipping illegal copies of the latest American movies to Hong Kong, Vietnam, Russia, and even Europe and the United States.

It has been said that the right to counterfeit goods is ingrained in China's culture. Former premier Deng Xiaoping promoted the philosophy of: "Let foreign things serve China." This perspective continues today and China generally views counterfeiting and other violations of intellectual property not as a serious offense, but as a major source of income, taxes, and employment.

As a member of the WTO and party to other agreements, China is legally required to protect intellectual property rights and crack down on violators. To this end, China has promulgated more than thirty laws to protect trademarks, patents, copyrights, computer software, technology transfer and licensing, and trade secrets. According to the U.S.-China Business Council, "China has created IP laws that generally adhere to international standards." This is hardly a ringing endorsement, and while the Chinese government is taking some steps to expand its legal protections and tighten enforcement measures, these measures have proven, to date, inadequate to stem the tide of widespread intellectual property piracy. According to the American Chamber of Commerce in Beijing, the problem is growing faster than government efforts to control piracy and increase enforcement of the laws already on the books.

American companies continue to push for more aggressive prosecution of violators and new administrative and government measures to address the problem, but the Chinese remain deaf to their entreaties. One of the things the government could do tomorrow, if it had the will, is to end its restrictions on the number of foreign films that can be exhibited in China and abolish what Motion Picture Association of America Chairman and CEO, Dan Glickman, has described as "confiscatory taxes on foreign home video and television content" that fuels the market for counterfeit American films.

Legal remedies

China's Public Security Bureau, the nation's principal police agency, has broad enforcement capabilities. They can make arrests and file criminal charges in the case of counterfeiters. They can also forcibly enter premises in cases where they suspect counterfeiting. However, law enforcement lacks zeal and criminal prosecutions have been, at best, spotty.

China's court system is only about two decades old and consists of four tiers, with the Supreme People's Court at the top, followed by the High People's Court, the Intermediate People's Court, and the Basic-Level People's Court. There are over 3000 local and county courts in China.

Unfortunately, China's laws are still applied arbitrarily and inconsistently, and often with little vigor. The courts have insufficient resources, including a lack of qualified personnel and calendar time to keep pace with the number of piracy cases. Judges are poorly trained and susceptible to bribes. Cases move slowly through the system and decisions vary from case-to-case and region-to-region.

At the local level there is little incentive to spend time and money prosecuting intellectual property cases. Judges are loyal to party leaders and more concerned about the local economy and jobs than enforcement of intellectual property rights. Decisions by lower courts are rarely overturned by intermediate and higher courts. Violators, when they are prosecuted, generally receive minimal punishment, which only encourages continued intellectual property piracy.

Despite these challenges, some marginal improvement has occurred. Beijing has the most modern and efficient court system. Courts in major cities such as Shanghai and Guangzhou are better than average. In 2004, there were 12,205 civil intellectual property cases adjudicated in China, a 32 percent increase over the previous year. The percentage increased again in 2005, although figures are incomplete.

The Motion Picture Association has brought, to date, ten civil actions in China relating to the pirating of Hollywood products, and received six settlements for a total of only $94,000. As must be readily apparent to the Commission, such judgments, while setting some worthwhile precedents, do not begin to cover the costs associated with bringing the cases to court and hardly serve as a deterrent to counterfeiters.

We work with an investigative firm with offices in China that regularly conducts investigations for Western companies that suffer from intellectual property violations. One of the company's clients manufactures a top-quality kitchen appliance in China that sells for about $300 in the U.S. The product design was stolen and now is regularly counterfeited and sold on the black market for as little as $25 to $50. According to the investigation by the investigative firm, 80 percent of all the counterfeit versions of this appliance seized around the world originated in China. To stem the counterfeiting, which is costing the company millions of dollars, the company has succeeded in getting Chinese authorities to conduct more than one hundred raids against illegal manufacturers of the appliance. Despite this massive effort, the counterfeiting continues unchecked.

Defensive Measures

In addition to closing down counterfeiting and infringing operations and prosecuting those responsible, American businesses in China must adopt strict security measures to protect intellectual property. The following recommendations have been offered by the U.S.-China Business Council. They reflect the hostile environment and extreme measures the Chinese will take to steal intellectual property. American businesses in China are advised to:

1) Compartmentalize production processes and design products so they are difficult to copy;
2) Keep vital designs and most recent technologies in home countries;
3) Share IP information on a need-to-know basis;
4) Run background checks on key hires and include non-compete and non-disclosure agreements;
5) Conduct due diligence on suppliers and distributors;
6) Track computer data flows and file transfers;
7) Place IP protection clauses in all contracts and agreements.

The measures above are simply defensive measures and certainly will not solve the problem. At best, they will simply make it harder for the Chinese to steal Western technologies and intellectual property.

As noted previously, civil actions, especially lawsuits, are generally a waste of time in piracy/counterfeiting cases. Not only are companies forced to essentially develop all of the information in a case and package it, but the likelihood of recovering appreciable damages is next to nil. It is also virtually impossible to shut down violators and, in the rare exception when it does occur, the company just changes its name and sets up shop in a new location. And if civil suits are difficult, it is even more difficult to secure criminal and administrative action.

What Can Be Done?

The real need is for China to learn respect for "foreign things." To achieve this it may be necessary to take drastic steps. First and foremost, the U.S. must make piracy and brand infringement the central issue in terms of Sino-American economic relations. China benefits more from this relationship than does the U.S., just as it benefits far more from trade with the U.S. than the U.S. does from trade with China. In 2005, the U.S. exported just under $41 billion worth of goods to China and imported $243.5 billion, resulting in a trade deficit of nearly $202 billion. China accounts for more than a quarter of the U.S. trade deficit, which reached a new record in 2005, and is this country's largest bilateral deficit. China's Vice Minister of Commerce, Liao Xiaoqi, has tried to spin these embarrassing statistics by claiming that "China's low-priced quality products have saved American consumers over $600 billion over the last ten years and $100 billion in 2004 alone." What Liao conveniently overlooks is the number of American firms put out of business and jobs lost in this country as a result of the massive importation of Chinese goods.

Accordingly, the Chinese government should be informed that its trading relationship with the U.S. is dependent on a drastic reduction in piracy and counterfeiting, and a corresponding increase in the zeal with which it protects intellectual property of all kinds. China is not living up to its obligations as a member of the World Trade Organization (WTO) and should be sanctioned or suspended from the organization until it brings its IPR regime into compliance. China's Most Favored Nation (MFN) should also be called into question.

As the theft of intellectual property is a global problem, so the solution must be global in its reach and scope. The federal government should view piracy/counterfeiting, wherever it occurs, as theft which harms American workers and our economy, and use its intelligence resources to monitor those engaged in such activities and to assemble evidence that can be used in prosecutions and to pressure offending nations. Consideration should be given to the creation of a new federal agency, with police powers and intelligence capabilities to spearhead the effort against global intellectual property thieves. Agents of this new agency should monitor the internet and attend the Chinese Export Commodities Fair in Canton and other trade shows to identify and record copyright, trademark, patent, contract, and service mark violations and the theft of trade secrets. Suspect communications should also be monitored and other intelligence and police

methodologies applied to enforcement procedures.

An international watch list should be assembled by the Government, and those on the list should be tracked and monitored, and, if the opportunity arises, arrested and brought to the U.S. to stand trial. To facilitate this, extradition treaties should be updated and refined to give more weight to the extradition of intellectual property violators, who are now often exempted because their transgressions are not crimes of violence. Companies, individuals, and financial institutions associated with piracy and counterfeiting should be barred from doing business in the U.S. or with American firms anyplace in the world. As with terrorists and other criminals, they, and their relatives, should be denied visas to visit this country or have access to our government institutions. More attention should also be devoted to gathering information about terrorist organizations that engage in intellectual property violations or benefit from the sale of counterfeit goods.

Conclusion

In the final analysis, what we have been doing isn't working. It is time to stop talking and to take meaningful actions to bring intellectual property pirates, counterfeiters, and trade secret thieves to heel, and China is an excellent place to begin. Our nation continues to lose tens of billions of dollars every year to IP criminals, dollars that could be used to create jobs here at home, contribute to the nation's tax base, and offset our growing trade deficit. We are currently at war with international terrorism but we are also menaced by threats to our economic well-being. The terrorists that struck at the World Trade Center towers and the Pentagon on 9/11 knew only too well that our political and military power is based on our economic power. If we do not aggressively protect our economy then we will surely be more vulnerable to foreign terrorists and other military threats from abroad, some of them from nations growing stronger by stealing our intellectual property and industrial secrets.

STATEMENT OF DR. PAT CHOATE
CO-DIRECTOR, MANUFACTURING POLICY PROJECT
SPERRYVILLE, VA

HEARING COCHAIR HOUSTON: Thank you very, very much for that testimony. Dr. Choate.

DR. CHOATE: Thank you very much, Commissioner. My testimony is submitted for the record. For two days I have been listening to the testimony and the questions, and what I sense is a certain amount of skepticism as to whether we can actually make TRIPS work with China.

I share that skepticism. TRIPS may not be an appropriate mechanism for China. The U.S. and Chinese cultures are so different. Our culture is such that our Founding Fathers set up a law and order system by which inventors and creative people were given a constitutional right and they were given the private means to enforce that right through a strong judicial system and laws.

China has no history of that form of private rights or judicial enforcement. And even in the United States when we put that system in, it took us 46 years before we gave that right to foreigners for patents, 101 years for copyrights, and we didn't give full rights on copyrights to foreigners until 1986.

Now, times are moving fast. Technology is moving fast. Technology is the heart of our development problem and IP rights are the heart of our technology problem, particularly patent rights.

So let me suggest in my remaining five minutes of the talk that we think about something else. That we think about something that Commissioner Bartholomew raised in one of her questions yesterday. If we cannot get engagement of IP rights in China with the first agreement or the second agreement or a third agreement or a fourth agreement, why do we think we can ever get an effective agreements with the Chinese?

What do we do in that circumstance other than go through the kabuki of the Chinese taking a load of DVDs and putting a caterpillar over it every year? I suggest there are a number of things that we need to do and can do.

And that the United States through the Congress, which has the responsibility to deal with intellectual property matters under Section I of the Constitution strengthen, not weaken, our own patent system.

In my testimony, I show where we've been on a path for 13 years to weaken our patent system, taking it down to the standards of the Europeans and the Japanese. This is good for Europe and Japan. It's good for China. It's good for the large transnational corporations. But I would also note that 45 percent of all the inventions done in this country are done by small businesses, individual inventors, universities, and research institutions and that's where your major innovations are coming from. This weakening is bad for them.

They are part of the economy that we absolutely need to assure that it has strong patent rights, and that means a long patent term. It means that a patent application can make as many claims as an invention has, that it has strong legal protections and that it's not forced to make premature disclosures of their patents.

Secondly, I think we need to recognize that the reform programs that have been brought before Congress over the past two years are really a continuation of 40 years of effort by transnational corporations, large corporations, to weaken the patent system against the individual inventor.

They basically have the same elements. The first to file, rather than the first event. Shorter patent term. Fewer claims. More examinations of the patents, which in effect weaken the effective value of the patents, and this is made under the assertion that America is in a legal crisis with patent litigation.

In the second part of my testimony I think I fairly well demolish that argument. Last year 107 patent cases went to trial in the United States. 107 patent cases at trial is not a legal crisis by any means.

What are some of the other things that Congress can do? We have trade agreements on legal trade but we do not have trade agreements that

cover bringing in illegitimate or counterfeit goods or goods that harm us. We could take, for example, or Congress could mandate that those countries that are so bad in their violations, have another special requirement -- that importers bringing goods in from those countries have a certificate of authenticity.

In other words, you shift the responsibility to the importer and then from the importer back to the manufacturer to certify that it's authentic and then you can put tort liabilities against that. If a country is really bad, you can ask for not only from the importer but from the government itself to endorse that certificate, and the document can be narrowed down to specific product

Many of our retailers, if they have to secure such a certificate just simply shift their suppliers to some other country or some other place. In other words, such a program shifts the responsibility to the infringing country rather than to the United States, and it's a market-based operation.

I would also say given the difficulty that we've had using the WTO and the reluctance of our government to use its authority, we need to think how to use those enforcement authorities. Commissioner Mulloy asked a very telling question of Chris Israel yesterday of who do you report to? The answer was he really reports to the Economic Security Council, which means, as he said, they require a consensus before they will file a legal action dealing with intellectual property rights.

I would suggest that Congress shift the responsibility for the WTO enforcement from the USTR to the Department of Justice where we can make aggressive use of that.

I would suggest that Congress end the 18-month pre-publication rule. The government of Japan announced today as part of their long-term intellectual property program that they are shifting their priorities in examining patents. They're going to take those patents that are the most critical, they're going to examine them first, so they'll fall within the 18-month rule, and the government of Japan is urging its corporations to take its most important innovations and protect them as trade secrets and not file patents against them.

So what I'm suggesting is that the Commission think about an agenda for Congress if these TRIPS and WTO negotiations don't work. There is much that Congress can do to deal with this on its own, self-initiated.[10]

Panel X: Discussion, Questions and Answers

[10] Click here to read the prepared statement of Dr. Pat Choate

HEARING COCHAIR HOUSTON: Thank you very much, gentlemen, and thank you so much for sticking to your time. We all really appreciate that. I have a quick question for Dr. Livingstone. In the report I talked about the importation of drugs. One of the gangs that you mentioned in that report significantly was the Asian Triad, and if I remember correctly, they were bringing Sudafed and other counterfeited drugs over the Canadian border to make money.

Could you give an educated guess on the level of involvement in organized crime in China in counterfeiting?

DR. LIVINGSTONE: I think the Chinese clearly are one of the main producers and suppliers of counterfeit goods, and the thing is you have to disseminate them, find markets for them. What you're seeing today is a tendency to go to criminal organizations to handle distribution issues since they already have distribution networks in place.

Frankly, if you're distributing narcotics, you can make additional money, using the same network, to distribute counterfeit products, including everything from ladies handbags and branded goods to things like pharmaceuticals.

Today, if you're in the business of counterfeiting, you're no longer counterfeiting only one thing; you're producing a variety of things and likely distributing a variety of different goods. Because once you set up a good distribution network, you can pass almost anything through it, especially if you are a criminal gang.

HEARING COCHAIR HOUSTON: Thank you very much. Commissioner Wessel.

COMMISSIONER WESSEL: Thank you and thank you to all of our witnesses. I wish I had a lot more time to find out what a corporate equalizer is as it relates to kidnappings and other things, but maybe we'll ask those questions for the record later. Probably not.

I'm intrigued, Dr. Choate, by your discussion about how we might, in fact, change the burden of proof, if you will. You talked about a certificate of authenticity.

Commissioner Houston has raised issues about the pharmaceutical industry and some of the risks our consumers might face. We saw yesterday with auto parts. Your book Hot Property talks about airplane parts and how many of our travelers might be unwittingly on plans that have substandard parts that actually could have fatal risks to them.

When you look at tort liability, your certificate of authenticity, what would your thought be about the potential of making the importer of record liable not just with a certificate of authenticity but if there is some kind of fatal error here, sickness, et cetera, that they could be brought into court so that we get farther upstream, as you talk about, and have them be the validator of whether these products are safe?

DR. CHOATE: I think that would be of great value. The principal contribution, I think, is once a company or an importer was found in violation of the certificate, then you would have alternative methods of confronting their crime. You in effect would say all of your imports for a certain period of time will automatically go to the back of the line of the cargo to be inspected by our Customs Service.

In other words, you set real penalties, for real market penalties, on those who violate this. Terry Stewart in his testimony was talking about upstream IP violations, where people were using machine tools, et cetera. I think one of the areas that we have not given adequate attention in our IP studies over the past decade has been the patent violations.

Most of the data is on copyright violations, it's on trademark violations. The SPOT report, for example, that Chris Israel presented yesterday, had three words about patent violations. The Special 301 report that was put out in April has two paragraphs on China about patent violations.

It's true that it's easy to see violations on the copyrighted materials, the books, the DVDs, the movies and an enormous value is involved. I would dare say, though, that the greater economic losses to be on the patented items, the processes, the machines, the tools, the things that give instant international competition, and again, if you run a certificate of authenticity and run it upstream, you can knock down an unfair advantage and real theft that's causing us real harm in the country.

COMMISSIONER WESSEL: If I could ask just a quick final question. When somebody goes onto the Internet to the Patent and Trademark Office to look at somebody's patent under the openness of our system--

DR. CHOATE: 18-month rule.

COMMISSIONER WESSEL: Do we notify the inventor that there has, in fact--

DR. CHOATE: No, no.

COMMISSIONER WESSEL: What would your view be of making sure there's an automatic--

DR. CHOATE: I have suggested that in other forums. I think there should be an automatic notice to the inventor. I think also the Patent Office should give weekly reports so that we can find out, first of all, from which countries these inspections are originating, plus see if there is special attention to certain clusters of technologies, if it's a biotech or if it's a special type of a machine tool, et cetera.

That should also be an alert to the FBI and their counterespionage activity. It says foreign interests are giving special attention to a targeted technology. That is valuable information that we need. The risks are so frightened for infringement from this 18-month rule that the

Japanese today announced that they're urging their companies not to put their best technology up to for patent, to keep it as a trade secret.

COMMISSIONER WESSEL: Thank you.

HEARING COCHAIR HOUSTON: Thank you very much. Commissioner Mulloy, you have a question.

COMMISSIONER MULLOY: Yes. Thank you. I want to thank each of you for being here. Mr. Trainer, you have been with us before and we appreciate your continued efforts to help us think through this. Dr. Chow, the import certificate, I'm sure that if we propose that, somebody will say, well, if you say goods imported from China, that's a violation of our Most Favored Nation agreement because we can't put something on them that we don't put on someone else.

So I'm trying to think through how we get around that. Mr. Trainer or Dr. Livingstone, if you have any thoughts on that, because we're caught now in this legal system that if we do things, one, it's an enormous burden to get by our own lobbyists that don't want anything done, and then, two, everybody is worried that we're violating our international agreements.

DR. CHOATE: As I suggested, I would apply it to those countries that go on the USTR's Special 301 list. These are countries that have distinguished themselves as pirate and counterfeit havens.

At the same time, I think it's legitimate as the world's largest trading economy for us from time to time to stress the WTO. It is quite legitimate for us to say an activity such as this merits special attention, it does harm to our citizens, it does harm to our owners of intellectual property rights. I would suspect that other countries, particularly the intellectual property countries, would adopt the same standard.

Again, this is a market-based way to deal with a money-making activity and you're building counter-pressures. I would say something else. I've heard several witnesses talk about how at the national level in China you have people that are committed to an intellectual property system. I believe that. I think that's true. You have the Four Court system.

This would give those officials in China a leverage, a tool, a power, inside their own bureaucratic system to deal with those that support piracy. They could show this is hurting China, this is knocking down these industries, see what this does with the rest of the world.

We need to find ways to find those that support a strong intellectual property system in China, to give them tools and leverage so that they can win their bureaucratic battles.

COMMISSIONER MULLOY: Yes. Mr. Trainer, just following up on that, in your testimony talked about how we need to work multilaterally to get not just us but some of the others, so this may be a

way. The WTO themselves have cited China in this report that was just done on their WTO compliance.

So maybe that would be a basis. I like this import certificate. I think it's a pretty good idea.

MR. TRAINER: One of the things I did comment on, I think that over the last two to three years, whether it's the APEC Summit of the Ministers or the G8, we keep hearing trading partners say, yes, we've got to do more, but I don't see them actually doing more. I think that frankly that's a problem, especially when you talk about G8 countries. These are supposedly our top industrialized countries. Why they're making statements but not actually confronting their trading partners that are presenting problems, I don't understand that.

But with regard to the import idea, I would differ a little bit in this way. One, I wouldn't limit this to just countries on our 301 list. I think that if we gave Customs the resources, the computerization and all, frankly I would do a couple other things.

One is require actually more information on the entry documents, whatever is submitted with regard to the country--the company of manufacture or transport in the country where the goods are originating, and I would also make sure that importers are very clear in knowing that false data on those documents will and can lead to criminal liability.

Now, granted there are already some criminal statutes with regard to false information submitted to the U.S. government. That's already there. I do think then we look at what kind of data is absolutely required on entry documents.

In my view, I don't know if I'm going to support a certification process. Frankly, I'd rather see just typical minimum data requirements on the entry documents. And then Customs, using their computerized databases, targeting and risk analysis system that they've already used, improve it by starting to keep track of who those importers are, and on that entry information, who the foreign manufacturers are, so we actually get a specific list of the importer or the importer of record and that foreign entity and party, and I think we just do it that way.

It may be, hopefully, we have to look at streamlining so that the enforcement can actually occur.

COMMISSIONER MULLOY: Mr. Trainer, could you submit that in a little writing for the record so we have that for our recommendations?

MR. TRAINER: Yes.[11]

COMMISSIONER MULLOY: Thank you.

HEARING COCHAIR HOUSTON: Excellent. Thank you.

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[11] Click here to read the Mr. Trainer's follow-up response concerning the certification process [Letter dated June 13, 2006 to Chairman Larry Wortzel from Timothy P. Trainer]

Commissioner Bartholomew.

COMMISSION VICE CHAIR BARTHOLOMEW: Thanks and just very quickly. All of these witnesses have provided so many interesting things to think about and talk about, but my question actually is for Dr. Livingstone. As you well know, your suggestion about economic espionage is extremely controversial.

To the best of my knowledge, the economic espionage that has been done against us, government funded by other countries, has been really targeted at stealing our ideas rather than at protecting our ideas that have been stolen, and two questions that go along with this.

First, do you think that we even have enough resources and is our intelligence community doing a good enough job on the tasks that they have at hand? For example, the war against terrorism.

Second, what kinds of resources do you think would need to be directed towards some sort of economic espionage? I'm not advocating that we do it. I'm just curious about that.

Third, how do we draw that distinction between what we are trying to do is get information on what has been stolen from us versus going out there and gathering information that our companies could use?

DR. LIVINGSTONE: First of all, let's not characterize it as economic espionage. I think we're talking about monitoring here, just as we monitor terrorism. That doesn't mean we have to practice terrorism to monitor terrorism.

I think the same holds true here. I do believe there is a desperate need to help American business and industry and to support the burden of proof issue with U.S. government resources. It's a little politically incorrect, but coming back to Commissioner Mulloy's point, French President Charles de Gaulle once said that treaties are like young women; they last while they last.

I believe the same should be true of MFN agreements. I don't think we can alter the current MFN agreement, but we should build a case as to why China is in violation of its responsibilities and obligations under the agreement. If we decide to withdraw MFN status from China, there is a process doing so.

As to whether the CIA should be the organization to gather evidence of IP violations, we've witnessed a lot of debate about whether the intelligence community is equipped to handle the war on terrorism and the other traditional challenges facing this nation much less new assignments. So maybe we need to vest the responsibility in a different agency. There's plenty of expertise out there, residing in other government agencies, especially when it comes to monitoring the internet.

This is what we did in part for the study that Commissioner Houston spoke of. We looked, for example, at the whole array of Internet

pharmaceuticals that were being offered to the public. They all had people on their websites in white lab coats, looking very respectable and most said they were located in Canada. In reality, many were ring downs to places all over the world, Pakistan, Luxembourg, South Africa, Paraguay, you name it. My favorite was a ring down to a bar stool at the Swizzle Inn in Bermuda where a guy took orders and then called China and Pakistan to fill them.

In conclusion, I think a lot of this can be done. The NSA, for example, could play a major role in tracking pirates and counterfeiters. I don't think that the new agency, if there is one, has to be huge, but we need to get started. People like Mr. Trainer, myself and those in other private firms that are performing this work today, but I think that it is primarily a government responsibility and should be acknowledged as such.

COMMISSION VICE CHAIR BARTHOLOMEW: Thank you.

HEARING COCHAIR HOUSTON: Thank you very much. Commissioner D'Amato.

HEARING COCHAIR D'AMATO: Yes. Thank you, Madam. I wanted to reiterate my support for this concept of using Customs more effectively. I'm wondering whether or not Customs has the appropriate level of resources to handle this problem? I don't think it does. So if you all, any of you have any suggestions on the kinds of things that we need to do to beef Customs resources up to be appropriate to this problem, I think that's important.

Also, I want to thank Dr. Choate for his usual provocative testimony and--

DR. CHOATE: My pleasure.

HEARING COCHAIR D'AMATO: --I want to point out we had Senator Hatch here this morning from the Judiciary Committee. He's chairman of the Intellectual Property Subcommittee, and I would think that it would be useful to ensure that a good assessment of the legislation that is now pending in both chambers on the question of patent reform, we take a look at that and see how that's coming, and maybe we can make some recommendations with regard to that legislation as it's going through given your concerns over diluting the protections that are in the law.

DR. CHOATE: If you wish, I'll follow it up with your staff and you.

HEARING COCHAIR D'AMATO: Yes, I think so.

HEARING COCHAIR HOUSTON: Thank you very much. We have come to the end of our hearing. I'd like to thank this panel and all our panelists for giving, what Mr. Mertha said in the last panel, mind-boggling information to us. It's just been absolutely fantastic.

Commissioner D'Amato and I appreciate also the help of our staff of the Commission, particularly Carmen Zagursky, who has really helped us significantly in putting this together. I believe Commissioner D'Amato has a closing statement.

HEARING COCHAIR D'AMATO: Yes, I just want to thank the Commission staff as well for their hard work arranging this hearing, including Carmen Zagursky, Nargiza Salidjanova, Cammie Lee and the administrative staff. Cammie Lee particularly has done an excellent job assisting with the hearing as a research intern under the Stanford and Washington Program.

She heads off to Beijing tomorrow for a conference headed by Sandy Schriver, one of our graduates in Beijing, and will defend our interests hopefully, and then will work at the Asia Foundation this summer on human rights issues. We wish her well and look forward to hearing about the conference on her return to Washington, and again thank the staff for their support.

[Whereupon, at 1:00 p.m., the hearing was adjourned.]

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

Remarks of Chairman Donald A. Manzullo
Committee on Small Business, U.S. House of Representatives

Opening

Chairman D'Amato, Co-Chair Houston, and other distinguished Commissioners, and ladies and gentlemen, thank you for this opportunity to discuss intellectual property rights and the dangers posed by pirate goods coming into the U.S. I'm going to focus my remarks on the unique impact of China.

As Chairman of the US-China Interparliamentary Exchange since 1999, I have had the privilege of representing Speaker Hastert on 8 official delegations to China to meet with various NPC parliamentarians and policy makers.

Our next delegation will be Round 9 of the Program in November. I have seen the evolution of China first-hand, and I in so doing I have traveled the length and breadth of this enormous country. How many of you have ever heard of HoHot?

China's Growth

Let me tell you a little bit about China. The country is evolving with enormous speed. It has raised 200 million people out of the depths of poverty. It is now one of the world's largest trading partners. Trade between the United States and China has become increasingly fundamental to the economy of both countries. Chinese exports account for nearly 40% of their GDP, with exports to the United States accounting for a quarter of that, or $243 billion.

Conversely, the US exports $41 billion worth of goods to China. To date, China is the third largest single country exporter and importer in the world, valuing imports at $631 billion and exports at $752 billion.

One of its biggest challenges in the face of this rapid development is to implement a new-

born IP regime that is less than 20 years old. Historically, China has failed to adequately regulate and enforce protections for IPR, despite rampant violations occurring across the country.

But China's role as an emerging major player in the global trading economy carries with it the responsibility to participate on a level playing field with the rest of the world. Many have come to question China's ability to meet this obligation, especially in the area of intellectual property rights

How Counterfeiting has Changed

The piracy that is going on today is not your father's fake tennis shoes. Things have changed. When we talk about counterfeiting and piracy, many people still think about fake ten dollar Fendi handbags or twenty dollar Rolex watches purchased from some sleazy guy standing at a roadside table.

Hey, this is a great deal, they think, I'm going to fool my friends into thinking I wear designer labels without having to spend the money! How could it hurt anyone to wear a cheap Rolex knock off? Rolex is huge and rich, and buying this fake won't hurt anyone but these deep pockets.

Lots of people seem to take this view, because there is a huge demand for fake brands. Obviously if there wasn't such a huge demand, counterfeiters and pirates would not make so many of them.

But the issue has gone well beyond knock off of clothing, shoes, movies and music. Counterfeiting and piracy has become such big business that it now threatens the very livelihood and creative process of artists of every form, whether fashion artists, designers, musicians or movie makers.

And one other thing. The counterfeiters and pirates are very entrepreneurial people. They are aggressively moving up the value-added food chain. Not content with decimating the fashion and content industries, they are aggressively moving into pharmaceuticals, car parts, aircraft engine parts and just about everything you can imagine. They are combining these broader product fakes with advanced supply chain and manufacturing know how. Pirates no longer peddle their cheap wares primarily from roadside tables. Now they replicate entire supply chain, distribution networks and retail outlets. In this respect, it is a whole new ball game. And it is a new ball game that is financing terrorism, supporting organized crime and outright killing innocent people.

It's hard to get too exercised about fake handbags and CD's. But when the market is flooded with fake drugs, fake brake pads and phony aircraft engine parts, using a sophisticated distribution network tied into organized crime and terrorists networks, we must take action!

Recently, Dateline NBC ran an expose on fake drugs imported from China. These included cancer drugs, cholesterol drugs, and life-saving drugs of every type or description. The unscrupulous people who peddle these wares care little for the harm they inflict on innocent people. Piracy and counterfeiting can no longer be considered a victimless crime.

The Scope of the Problem

The problem is enormous. Counterfeiting in China constitutes an estimated one-fifth of all products manufactured in China, accounting for 8% of their GDP. In some industries, namely the motion picture and music industry, piracy levels in China have reached almost 90%. With an annual exchange of goods worth over $285 billion, this creates a bilateral trade issue of the utmost importance between the US and China.

Last year over 69% of the counterfeit goods seized at the border were traced back to China. The value of the confiscated Chinese imports was over $64 million. The total number of counterfeit goods seized by US Customs and Protection last year was valued at over $138 million. By some estimates, that number likely reflects less than 5% of the counterfeit goods actually entering the country. China's share of these goods is more than ten times greater than any other US trading partner.

The effects of counterfeiting on all US businesses are substantial. According to the U.S. Customs Service counterfeiting activity costs U.S. companies up to $250 billion per year and has resulted in the loss of 750,000 American jobs. Of this, small manufacturers are hit the hardest. Manufacturing companies end up paying for the counterfeits with more than just lost revenue. They suffer from loss of good will and reputation. For some companies, this is their most valuable asset. In trying to preserve their reputation, some companies end up repairing or replacing defective counterfeit products out of their own pocket. All of this drives the cost of doing business up and some companies are forced to either pass it on to their customers or close up shop.

As Chairman of the House Small Business Committee, let me give you some real world examples of the effect that counterfeiting has on my small business constituents.

Philadelphia Arts and Crafts Show

Several months ago I went up to Philadelphia to attend the largest trade show on the East Coast for home-made American arts and crafts. The arts and crafts industry is made up almost entirely of small businesses. They pay well above the national average in terms of wages, are primarily headed up by women, and on aggregate are an almost $6 billion dollar industry. Thousands of small American artists with 2, 3 or 4 employees earn their living celebrating uniquely American styles and crafts. Perhaps you've seen some Navajo silver or a Shaker style rocking chair from Pennsylvania by Amish craftsmen.

During the show I talked at length with a small company that was producing hand-made whimsical art sculptures for the lawn and garden. We talked about the thousands of dollars this small businessman had to pay in lawyer's fees to fend off the Chinese knock offs. Well, the next day one of my staff flew to Beijing as part of my China program, and while walking in a Beijing market he came across an entire stall of identical sculptures. The Chinese had completely copied this Illinois' businessman's designs and were selling the sculptures for 1/10 the cost. There was virtually nothing that my Illinois small business could do to stop it.

Our Experience in Kunming, China

Last summer I took a large Congressional delegation to China as part of my China Interparliamentary Exchange program. I ended up in Kunming, China with my dear friend Congresswoman Marsha Blackburn. While there, we found many examples of counterfeit goods just about everywhere we went, but we were surrounded by massive security and they would not let us explore around. So even though Marsha took lots of pictures, I had to lure off the security one night so that my staff could pealed off from the group. They went back into the back rooms and ally ways and collected hundreds of hours of videotape documenting the open sale of any kind of product you can imagine. Pirated Nikes, clothing, Zippo lighters, Rolex watches…you name it. We have the tape if anyone wants to stop by and see it.

The Car Industry

Some counterfeiters have matured beyond consumer goods and have started recreating entire cars. Last year, General Motors settled a lawsuit against Chinese automaker Chery Automobile Co. after alleging that Chery's model QQ compact car was an exact copy of the Chevy Spark, which GM sells in China. GM alleged that Chery stole its trade secrets to make the QQ. At $1,000 less, Chery's car outsells the Chevy Spark by nearly five to one.

Cheery just announced that it intends to introduce its first car into the US market this coming fall. They can easily undersell anything Detroit has to offer because they can use stolen technology and don't have to bear the costs of having to do original research and development. This is not fair trade!

How Sophisticated Have the Chinese Become?

Counterfeiters have now grown into a higher level of sophistication, taking piracy to a new level - counterfeiting entire companies. After complaints about fake CD and DVD products on sale in Beijing and Hong Kong, officials from the consumer electronics firm, NEC, set out to expose the counterfeit operations. After two years of investigation, the company discovered not only that their products being duplicated, there was an entire NEC company impersonating them inside of China. They had hijacked the entire company!

The phony NEC had set up networks with over 50 electronics factories to produce NEC products including entertainment systems, MP3 players, CDs, DVDs, batteries, microphones, even creating their own versions of the electronics. The New York Times reported that the counterfeiters carried NEC business cards, commissioned product research and development in the company's name and signed production and supply orders. The scheme covered everything from product design, to manufacture and distribution, all diverting profits from the real NEC.

What can we do?

This is obviously a very difficult issue. As I've said, the Chinese only have about 20 years of history with IPR. I genuinely believe that the Central Government gets it. Vice Premier Wu Yi is a formidable lady, and she has staked her personal reputation on making changes regarding IPR inside of China. For them, it's the smart thing to do. They realize that they are never going to develop Chinese home-grown technology in an environment of rampant IPR theft and piracy. And growing their economy up the value-added food chain is a top priority for the Chinese leadership.

So in my view we should help the Chinese help themselves.

First, we need to secure our own borders. We must make it impossible for counterfeits to get into the U.S. I am proud to have partnered with my friend Congressman Knollenberg on HR 32, an important bill that plugs some loopholes and beefs up remedies against trademark thieves.

Second, we should beef up internal government enforcement resources on the domestic front. I strongly support the good work of the interagency government program called the STOP initiative. I think this initiative shows how effective a well-coordinated interagency task force can actually be when all the right pieces fall into place. Chris Israel is to be commended for his leadership in reinvigorating this and other government-wide IPR enforcement measures.

Third, we should engage the Chinese in greater law enforcement capacity-building. In other words, we should help them to develop a more-effective criminal enforcement regime. It is key that the Chinese aggressively criminalize counterfeiting behavior. In this regard, I want to urge the USPTO and the Commerce Department to get their "boots on the street" inside of China by placing additional IPR Attaches throughout the country. I know they are busy recruiting for those positions and these can make a great deal of difference.

As for myself, Congresswoman Marsha Blackburn and I have formed the first-ever US-China Interparliamentary IPR Working Group with the Chinese National Peoples Congress. We have contacted a famous Chinese singer and songwriter, Madam Gu (Goo), who is an outspoken advocate for singer/songwriter rights, to join with us in

November to kick off the Working Group in Beijing. This Working Group is the first ever Member-to-Member dialogue between lawmakers on both sides about this important problem.

This is going to be a long and tough road. But it is essential that we keep at it. Thank you for this opportunity to state my views.