



**Testimony of**

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**Before the**

**U.S.-CHINA COMMISSION**

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**On**

**CHINA'S COMPLIANCE WITH WTO OBLIGATIONS**

Chairman D'Amato and Members of the Commission, on behalf of the members of the International AntiCounterfeiting Coalition, Inc. (IACC), I thank you for the opportunity to provide you with our comments regarding intellectual property protection and enforcement in China.

The IACC is a Washington, D.C.-based non-profit organization that represents intellectual property owners from diverse industries, including auto, entertainment, consumer goods, apparel, luxury goods, pharmaceuticals and many others. In addition, our corporate rights holder companies are both U.S. and foreign-based multinational companies. The IACC focuses its efforts on the protection and enforcement of intellectual property rights. Our members' combined revenues exceed \$650 billion.

The IACC, on behalf of its members, has been providing U.S. Government agencies with comments regarding China's intellectual property (IP) protection and enforcement activities for a number of years. Through official submissions related to Special 301, the annual WTO Review mechanism and informal meetings and discussions on China, the IACC has addressed this issue many times in different fora.

Through this submission, I will attempt to respond to the Commission's specific inquiries and to provide additional observations, comments and recommendations.

## **I. China: WTO Compliance**

For purposes of assessing WTO compliance with intellectual property protection, we typically look to the WTO's Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS). TRIPS Articles 41 through 61 obligate China to implement *effective* enforcement procedures and provide remedies that have a *deterrent* effect. Our members report that:

- Many raids have been conducted;
- Significant quantities of counterfeit goods have been seized;
- Criminal prosecutions have been initiated;
- Shipments have been stopped by Chinese Customs; and
- Prison sentences have been imposed.

Despite a lot of enforcement activity, little has fundamentally changed in the market since the IACC's most recent submission in September 2004 concerning China's compliance with WTO commitments. China continues to pose the greatest threat to IACC members' intellectual property assets as compared to other countries in the world. Based on available statistics and reports from our members, China has no equal either as a source of counterfeit and pirated goods to the world or as a market in which fakes are produced and sold locally. Despite significant improvements in China's IP legal regime over the last few years, which the IACC has noted in previous filings, the enforcement system continues to be fraught with weaknesses and inefficiencies that facilitate massive counterfeiting and piracy.

The exports of counterfeit and pirated products continue to flow from China to every corner of the world causing lost sales and damage to brand image. China sourced counterfeits range from counterfeit medicines and auto parts to home electrical products to apparel and footwear.<sup>1</sup> In addition to the impact on IACC member companies, China's counterfeiting industry has a direct impact on foreign governments. For FY 2004, the U.S. Department of Homeland Security's Bureau of Customs and Border Protection (CBP) reported the seizure of 2826 shipments from China containing counterfeit and pirated product, having a domestic value of over \$87 million dollars.<sup>2</sup> Based on these statistics, China accounted for 63% of the total monetary value of intellectual property seizures in FY 2004. The types of products coming from China seized by the Bureau of Customs and Border Protection included, but were not limited to, wearing apparel, cigarettes, consumer electronics, toys, batteries, watches, sunglasses, and automotive components. Thus, the export of counterfeit and pirate product places significant pressures on foreign customs administrations and law enforcement entities to combat China's counterfeit exports.

While China's counterfeiting industry churns out massive amounts of counterfeit goods, the government has made changes to the legal regime. Two sets of changes involve the customs regulations and the recently issued judicial interpretations regarding criminal cases, the latter being issued in late December 2004. Both are recent and it is too soon to predict the overall long term impact of the changes.

The most recent amendments to the Customs regulations went into effect on March 1, 2004, and replaced earlier regulations from 1995 on the protection of IP rights by local customs offices. As a result of the regulatory changes, Customs issued new implementing rules that took effect July 1, 2004. While we commend the effort, several issues remain problematic. The issues that continue to cause right owners problems are:

- The monetary range of the value of the bonds that can be required when ex officio action is taken (0% to 100% of the value of the counterfeits);
- Long term storage costs of the goods during the pendency of legal actions, which right holders believe should be paid by the infringers; and
- Auctioning of counterfeit goods rather than destruction of counterfeits as the routine remedy.

The result of some of the procedures now in place can deter right holders from using the enforcement system because it ties up valuable revenues. Given some of the expenses involved, e.g., storage, the right holder, not the infringer, continues to be subjected to additional further damage as the result of its effort to protect its rights.

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<sup>1</sup> The most recent media piece underscoring this point appears in the February 7, 2005 issue of *Business Week*. See *Fakes!* at p. 54.

<sup>2</sup> Both of these statistical measures were increases over FY 2003 when CBP seized 2,056 shipments with a domestic value of over \$62 million.

Turning to the judicial interpretations concerning criminal thresholds, these were recently issued by the judicial authorities. It is far too early to say whether they will have any real deterrent effect on the levels of counterfeiting and piracy. The criminal enforcement system—police, prosecutors and the courts—will have to demonstrate a willingness to impose higher level penalties on counterfeiters and pirates. Any assessment of the future effectiveness of the new judicial interpretations should be accompanied by greater transparency of the judicial process so that right holders can more easily learn whether defendants receiving prison terms do, in fact, serve the prison sentences or pay monetary fines that are imposed.

While the problems in China's enforcement system are many, a basic starting point should be a consistent application of the enforcement mechanisms at all levels, city, provincial, and national. At these levels, the system must impose a level of penalty that will deprive the individuals involved of any economic benefit and impose a monetary fine or prison sentence so that the penalty is greater than the rewards of returning to the illegal activity of counterfeiting and piracy.

In order for the system to have the desired effect, the national government will have to ensure that its stated policy is implemented at all levels. Thus, greater political will should be demonstrated to ensure that IP crime is punished.

## **2. JCCT: Results?**

Central to the concern of IACC members was the judicial interpretations involving criminal counterfeiting and piracy. The IACC welcomes the lowered criminal thresholds that have been announced by China. This was one of the hoped for results of the 2004 JCCT. However, because it has only been a matter of weeks since the announcement of the new thresholds for criminal liability, we can not yet assess whether they will lead to reduced rates of counterfeiting and piracy. Rather than a wholesale review of the interpretations, only a couple of points are made below.

Based on an unofficial translation, we provide initial observations regarding the judicial interpretations. Initially, it should be noted that the 2001 joint prosecution guidelines, issued by the Supreme People's Procuratorate and the Ministry of Public Security were hopelessly ambiguous, illogical and provided little practical guidance, which led to the issuance of the December 2004 judicial interpretations.

In view of the new December 2004 judicial interpretations, it is difficult to say that improvement occurred. The new judicial interpretations still leave many previous questions unanswered and contain vague, ambiguous and undefined terms.

A reasonable argument can be made that TRIPS outlaws the use of numerical standards. TRIPS Article 61 requires that any counterfeiting or piracy on a commercial scale shall be eligible for criminal penalties. Under the new interpretations, counterfeiters must still be caught with approximately \$6,000 worth of counterfeit goods to be eligible for criminal penalties. For many products, one would have to have a significant number of

units, easily a commercial quantity, to reach the sum of \$6,000. As a practical matter, such numerical thresholds are likely to impede enforcement efforts. Chinese police are often unwilling to commence investigations until the trademark owner and/or admin authorities have provided convincing evidence that the necessary numerical thresholds have been met. Police should be permitted to investigate based on mere suspicion of “serious” infringements and then investigate themselves to build the necessary evidence. If they are already allowed to do this, then this should have been made clear in the guidelines.

In the first three articles of the new interpretations, the Court attempts to define and clarify what specific circumstances will qualify as “serious” under Articles 213 and 215 of the Criminal Code and what illegal sales amounts will qualify as a “relatively large” under Article 214 of the Criminal Code. In addition, with respect to the language in the interpretations, the IACC notes that the vague phrases such as “other circumstances of a serious nature” and “other circumstances of an especially large nature” used in Articles one and three are left wholly undefined.

Articles one through three of the new interpretations appear to take a significant step backwards with respect to violations committed by repeat offenders. Articles 61 and 63 of the 2001 guidelines, (implementing Articles 213 and 215 of the Criminal Code, respectively), provided that where an alleged infringer had received administrative punishment on two or more prior occasions, the accused was eligible for criminal investigation and penalties regardless of the value of the counterfeit products sold/manufactured/possessed. Although these older provisions left certain questions unanswered, they represented one of the stronger provisions of the guidelines.<sup>3</sup> The repeat offender provisions were removed from the new interpretations in their entirety.

At first glance, the new judicial interpretations (Article 12) appear to do away with the requirement of having prior sales in counterfeiting cases. The IACC welcomes removal of this cumbersome method. Article 12, however, is still somewhat confusing and ambiguous regarding exactly how the value of finished and unfinished products and sold and unsold products will be calculated. It appears to provide that for items actually sold, the value of such goods, (for purposes of determining if the new threshold is met), shall be calculated according to the actual sales price of the counterfeiter. This method of calculation fails to impose any real penalty because by using the sale price of a counterfeit product, the courts will use a deflated number that may not meet the minimum thresholds in many cases. Problems also arise with respect to how the infringer’s price will actually be determined – e.g., what types of evidence will be used or permitted to be used? Will mere declarations by the infringer be accepted?

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<sup>3</sup> For instance they failed to clarify whether all three violations had to involve the same trademark or whether two or all three of the offenses could have involved different trademarks. The provisions also failed to explain what would happen when the required three administrative actions were brought by a combination of different administrative enforcement agencies (e.g., AICs and TSBs).

For unsold products, Article 12 provides that the value shall be calculated according to the “indicated prices.” Unfortunately, the term “indicated prices” is not defined. Does the term refer to the actual price appearing on the packaging or price tags attached to the goods? (Counterfeiters could obviously “indicate” an extremely low price on all the products they store in warehouses for future sales as a means to avoid criminal liability). What if the products contain no indicated price? Will they be valued at zero?

If the products have no “indicated price” or the actual sales price cannot be verified then Article 12 provides that their value will be calculated according to the “median market prices of the infringed goods.” Unfortunately, this term is also not defined. Does this term refer to the price of legitimate goods in the same market? Trademark owners have no idea how Article 12 will work in practice.

Article 15 provides higher monetary criminal thresholds for enterprise operations, as opposed to individual natural persons. To qualify for criminal penalties, an enterprise operation must engage in counterfeit operations at least three times greater than the value/threshold required for individual persons. The IACC has long held that this distinction is arbitrary, makes little sense and hinders effective enforcement. The damage done to IPR owners is the same regardless of who commits the crime. Enterprise standards should be lowered to meet the lower monetary thresholds used for individuals or eliminated entirely.

Another significant gap in the interpretations is the absence of language addressing the problems caused by counterfeiters who operate underground factories/facilities without the necessary business/commercial licenses from the government. There should be no minimum monetary standard required for criminally pursuing counterfeiters who operate these types of underground facilities. Article 225 of the Criminal Code provides up to five years imprisonment for engaging in “illegal operations.” It is the understanding of the IACC; however, that Article 225 only applies to parties that deal in products specially regulated by the government (such as cigarettes, telecommunications and publishing).

The text of the new interpretations, while important, should not be the sole focus of our efforts. Whatever steps the Chinese take – new regulations/interpretations, increased training, more funding, IP specialized PSB divisions, etc. -- such steps must result in more criminal prosecutions, heavier fines, more jail sentences and a reduction in the overall counterfeiting levels. The natural solution is for Chinese police to take a leading role in the investigation of counterfeiting cases. Additionally, the AICs, Customs, TSBs and other administrative enforcement bodies need to cooperate more closely with Chinese police and Public Security Bureaus (PSBs) and promptly transfer those cases that meet the standards for criminal investigation and prosecution.

### **3. WTO: Dispute?**

Because of the divergent membership of the IACC, we have no member consensus supporting a WTO case. The different intellectual property communities, i.e., copyright, trademarks and patents and the types of industries in each of these IP communities have

different viewpoints. Our members have indicated that they have differing opinions. While counterfeiting and piracy continue to plague many companies, some companies point to the slow, but forward steps toward criminal prosecutions for counterfeiting, reflecting China's positive efforts.

#### **4. What Next?**

There is no expectation that the current onslaught from China will ease in the near future. In addition, the IACC members' lack of consensus on the pursuit of a WTO case should not be interpreted to mean that there are no steps to take. In fact, the wave of Chinese counterfeit and pirated product has significant lessons for industry and government.

##### **a. Strengthen U.S. Laws**

The U.S. Government should continue to look at ways to strengthen its domestic laws to protect IP. For example, H.R. 32,<sup>4</sup> which is currently being considered in the House of Representatives, is the type of legislation that should be part of U.S. law in order to close loopholes in our criminal laws that punish those who traffic in counterfeit goods.

Once law, the provisions in H.R. 32 can then become a part of the bilateral free trade agreements so that trading partners can be encouraged to adopt stronger criminal provisions in their domestic legislation.

##### **b. Free Trade Agreements**

Having previously recognized TRIPS as the international minimum level of IP protection, the U.S. should continue to seek strong IP protection through negotiations of free trade agreements with trading partners. The challenge of combating the international trade in counterfeit and pirated products can be, in part, met through effective implementation of the provisions of FTAs, which now seek to have trading partners take actions at their borders against goods intended for export and goods in-transit. Moreover, it must be made clear to our trading partners that the activities within free trade zones are also subject to enforcement action in order to seize counterfeit and pirate products in these areas. Enhanced levels of criminal enforcement will also add to the IP owners' abilities to protect their assets.

##### **c. National Success/Global Problems**

Companies that have any great national success within an industry and have risen to be a leader within an industry must increase their awareness of the possible threats posed by counterfeiters and pirates. Those that may not be active in multiple global markets may still be victims of IP theft simply due to their success. Thus, a U.S. company that may not view itself as a global "player" can still have parts of its IP portfolio stolen and its future market taken.

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<sup>4</sup> H.R. 32 was introduced in the House of Representatives on January 4, 2005 and is known as the "Stop Counterfeiting in Manufactured Goods Act."

Along these lines, the U.S. Government should increase its efforts to raise awareness among small and medium enterprises. Many successful SMEs may not be aware of the IP assets they have or how they might protect those assets. Thus, this requires a proactive education program. Because of today's technology and instant communication, a successful national enterprise can easily become a global target of counterfeiters.

#### **d. IP System Exposed**

The technology and communications that jeopardize the success of SMEs also pose threats to larger enterprises. The challenges posed by the massive quantities of counterfeit and pirated products made in China and elsewhere and exported throughout the world expose the IP system to a collision that has occurred. Counterfeiters and pirates operating in China have swamped markets with substandard and dangerous products with no regard for national borders and with no respect for the rule of law. The speed with which IP criminals can be on the market has placed law abiding companies at an extreme disadvantage in combating IP crimes.

Because the global IP 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 IP rules,<sup>5</sup> 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 are disadvantaged because they can only protect their rights where Governments have granted rights. 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 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.

#### **e. IP Capacity Building/Technical Assistance**

The IACC encourages the U.S. Government to consider a more systemic approach to IP training. IP enforcement training is often aimed at law enforcement officials (customs officers, police, and prosecutors). In view of the importance of having "allies" in our efforts to combat IP crime, the approach to IP training that is aimed wholly at enforcement officials seems to ignore a critical element of the population that could be enlisted to benefit our overall objectives. Technical assistance/capacity building should also target the business community of the countries where we seek to improve IP enforcement. By improving the business community's awareness of the importance of IP to their businesses and local economies, it may accelerate our efforts to engage both the business and law enforcement communities to advocate for better IP protection overall.

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<sup>5</sup> The territoriality of some types of intellectual property, e.g., patents and trademarks, hinder the ability of owners to seek protection and enforcement against counterfeiters.

The IACC has been involved in such efforts and believes that increased efforts should be made to broaden the reach of IP training in order to enlist a wider group to support our efforts and to meet our objectives.