



**PUBLIC HEARING ON
CHINA AND THE WTO: COMPLIANCE AND MONITORING**

**TESTIMONY OF
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INTRODUCTION

My name is Eric H. Smith, and I am President of the International Intellectual Property Alliance, or IIPA. I am pleased to have this opportunity to share with you the perspectives of the U.S. creative industries on China's WTO compliance.

ABOUT IIPA

IIPA is a coalition of six trade associations¹ representing the copyright industries, which now contribute well over 5% to the total U.S. economy.² IIPA's members produce the nation's books, recorded music, films, videos and TV programming, and computer software for business and entertainment uses. Since 1984, this diverse range of industries has worked together, individually and under the IIPA umbrella, to strengthen the copyright laws and enforcement regimes in over 100 countries around the world. IIPA has also represented the copyright-based industries in the negotiation of key bilateral and multilateral agreements (including of course TRIPS) to raise international minimum standards of copyright protection and, of increasing importance, enforcement.

Specifically with respect to China, IIPA's members were at the forefront of discussions in 1992 that led to the signing of a Memorandum of Understanding between the United States and China. That MOU obliged China to protect copyright in line with international standards in place at the time. IIPA's members

¹ IIPA's members are: [the Association of American Publishers \(AAP\)](#), [AFMA](#) (formerly the American Film Marketing Association), [the Business Software Alliance \(BSA\)](#), [Entertainment Software Association \(ESA\)](#), [the Motion Picture Association of America \(MPAA\)](#), and [the Recording Industry Association of America \(RIAA\)](#). IIPA's members represent over 1,100 U.S. companies.

² Economists Inc., Copyright Industries in the U.S. Economy: the 2002 Report (2002).

were again at the forefront of USTR-led negotiations in 1995 and 1996, resulting in yet another Memorandum of Understanding, Action Plan and exchanges of letters, by which China averted at least \$2 billion in Section 301 trade retaliation by closing down factories producing and exporting massive quantities of pirate optical media product with impunity (causing catastrophic disruption of global markets). In 1996, China committed to commence a nationally coordinated enforcement regime to significantly improve protection for all intellectual property rights. Thereafter, IIPA and its members were deeply involved in a number of sectoral negotiations in connection with China's WTO accession (seeking immediate TRIPS compliance upon accession and improved market access for copyright-based industries) that led to China's entry to the WTO effective December 11, 2001. Our goal was to have each of these milestones result in significant commercial gains for the U.S. copyright industries.

WTO COMPLIANCE ISSUES

We thank the Commission for giving us the opportunity to examine where China stands just over two years after its entry to the WTO with respect to copyright protection and enforcement against piracy, and with respect to barriers to entry to the Chinese market. Our conclusion is that two primary problems have kept China's market largely closed and have prevented copyright owners from benefiting from China's accession to the WTO. The first is copyright piracy, which dominates the local market for copyrighted materials and, as in the 1990s, has become an export problem again.³ The second is a set of continuing market access restrictions which not only prevent the industries we represent from obtaining the commercial rewards that the WTO was intended to bring but also, by

³ As examples of anecdotal evidence, IIPA knows of one seizure by Hong Kong Customs on June 10, 2003 in which over 5,000 pirated DVDs were seized in a transshipment originating from Fuzhou, China. In another example, on June 6, 2003, Macau Customs intercepted a suspected shipment from China, seizing almost 13,000 optical discs including 3,600 VCDs, 3,200 DVDs and more than 5,000 music CDs.

limiting the entry of legitimate product, exacerbate piracy and make it even more difficult for China to combat it effectively.

On the issue of piracy and copyright protection generally, we have said repeatedly that China has yet to come into compliance with its TRIPS obligations, particularly in the area of meeting its enforcement commitments under Articles 41 and 61 of the TRIPS Agreement. It also has been slow to meet its otherwise restricted market access commitments. Many of these commitments will come fully into effect on December 11, 2004. My remarks today will focus on these two critical issues and what China needs to do. In closing, I will note some positive developments, particularly regarding the areas of academic journals publishing, and in the growing expertise of the specialized intellectual property panels of the courts in China – two areas which at least offer narrow rays of hope for copyright owners wishing to achieve commercial progress in China.

PIRACY AND CHINA'S RESPONSES IN 2003

The market in China remains dominated by piracy. Piracy levels (which reflect the percentage of product sold in a market that is illegal) remained at over 90% or above in 2003 for all copyright industries. For the motion picture industry, for example, despite massive raiding and seizures of pirate product throughout China, the piracy rate actually increased to 95% of the market! Put simply, the Chinese enforcement system has failed to significantly lower piracy levels in any significant way over the last 15 years since it passed a modern Copyright Law, despite this massive raiding and seizure activity. Because TRIPS requires China to provide adequate procedures and effective legal remedies to protect copyright “in practice” (not just in its statutory law), its failure to make any dent in piracy rates establishes, in effect, a *prima facie* case for a violation of its WTO TRIPS

commitments. Estimated losses due to piracy of copyrighted materials (excluding entertainment software) in 2002 (we are now awaiting new 2003 numbers) were over \$1.8 billion dollars in 2002. But beyond China's TRIPS commitments, this combination of debilitating levels of piracy and huge economic losses to America's creative industries serves as a tremendous *de facto* barrier to entry into the Chinese market for U.S. firms.

Optical media plants in China, including plants licensed by the government, continue to produce pirate CDs, VCDs and DVDs, and there is now clear evidence that underground pirate producers in China have once again begun exporting product out from China, disrupting market in Asia and Europe. The return of pirate exports is a very disturbing development. Imports of pirate product from other territories in Asia also constitute a significant problem. But primarily, piracy in China is homegrown, with a huge demand for U.S. products and little incentive or ability of U.S. firms, or even Chinese firms – legitimate firms – to meet it.

Internet piracy is an ever-growing phenomenon in China today. An example is the so-called 'cyber-cafe'.⁴ The legal framework for fighting Internet piracy is still inadequate, but recently the Supreme People's Court issued new "Interpretations" of the Copyright Law's application in the Internet environment. We do not yet have these in English. We hope they show an improvement in this critical area. China now has 78 million Internet users – reportedly the second highest in the world. When broadband comes to China, the future for our industries will indeed be grim unless that legal and enforcement infrastructure is repaired.

⁴ The Chinese government has recently directed greater attention on the activities occurring at Internet cafes. While content blocks (i.e., on pornography, news sites, and the like) have been commonly required in such premises, less attention has been paid to possible infringing uses of copyrighted materials, including illegal uses of pirated entertainment software. IIPA hopes the Internet regulations will address this legal deficiency and ensure that Internet cafes strictly adhere to the copyright law, including ensuring that its customers do not engage in the unauthorized use of copyrighted materials, including entertainment software products.

The Chinese enforcement system is unlike what exists in the rest of the world. China relies on administrative fines and actions to deal with piracy. Unfortunately, those fines are virtually always too low to provide a “deterrent to further infringements” – a TRIPS requirement. Under TRIPS, acts of “piracy on a commercial scale” must be subject to criminal remedies. While certain acts of piracy are covered by the Chinese criminal code, it is a fact of life in the Chinese system that piracy simply is not prosecuted as a crime. IIPA members are aware of less than 10 criminal prosecutions directly for commercial piracy in the last few years. While there are criminal prosecutions for operating an “illegal business” and this has included engaging in piracy, true deterrence will only enter the system when the penalties are publicly directed at piracy per se and high enough to deter this very lucrative criminal conduct. The plain fact is that we know of no country that has been able to effectively reduce piracy rates significantly without using the criminal law to do so. Piracy is immensely lucrative. To give an example: Time Europe,⁵ has reported that a drug dealer pays about \$47,000 for a kilo of cocaine, and can sell it on the street for about \$94,000, a 100% profit. But for \$47,000 and with a lot less risk, a pirate can buy or produce 1,500 pirated copies of Microsoft’s Office 2000 Professional and resell them for a profit of 900%! It now costs less than \$0.10 to knock off a pirate VCD or DVD, which then sells at retail for as low as \$0.95 – usually more.

Part of the problem with China’s criminal system remains the excessively high thresholds set for bringing criminal actions. The high thresholds translate to difficulties convincing Chinese authorities to prosecute commercial piracy cases under the copyright provisions of the Criminal Law. Because of high thresholds and a lack of prosecutions in practice, it is clear that foreign right holders do not enjoy a WTO-compatible criminal remedy in China. One very recent conviction

⁵ “Busting Software Pirates” Time/Europe, November 18, 2002.

in Shanghai involving U.S. motion picture product resulted in strict penalties being meted out against several defendants. However, as noted above, this prosecution was brought for commission of a crime other than criminal copyright infringement – 'illegal business operations.'

For foreign right holders, enforcement in 2003 continued to involve, almost totally, administrative actions, chiefly aimed at seizing infringing materials, but such efforts remain largely *ad hoc* and lack coordination. The principal agency in charge of enforcement against piracy of motion pictures on VCD or DVD is the National Anti-Pornography and Piracy Working Group (NAPPWC). In 2002, this agency seized almost 115 million pirate disks, yet the piracy rate in China increased in 2003. For one thing, we do not know what penalties were set for these pirates; the system lacks the kind of transparency necessary to be effective.

In another example, one entertainment software company reports that some Chinese factories engaged in the illegal manufacture of counterfeit entertainment software products have been able to continue their operations even after their premises have been raided and infringing goods seized. In addition, shutting down a factory often does not deter further piracy, since in many instances, the same entity merely shifts operations to another location under a different corporate name.⁶ As I have noted, the Chinese government must carry out criminal investigations, focusing on organized criminal operations such as those mentioned, and must initiate prosecutions with deterrent penalties against egregious pirates in order for China to meet its TRIPS enforcement obligations.

⁶ For example, in October 2002 and January 2003, Chinese administrative agencies raided the "Electronic Dragon" production facilities at which over 49,000 counterfeit *Game Boy Advance* cartridges and components were confiscated. During post-raid surveillance, the company found that the factory had resumed operations in a different location under a new company name. A subsequent raid on the new location was conducted in July 2003 and more than 78,000 counterfeit *Game Boy Advance* cartridges and semiconductor chips were seized. The principals all fled China and authorities have been able to take no further action against them. Such actions by the pirates and difficulties enforcing against them indicates how well developed and sophisticated these manufacturers and distributors have become. Such organized criminal behavior demands a coordinated national response from the Chinese government.

Another example comes from the experience of the business software industry, the National Copyright Administration of China has principal responsibility for enforcement but has been very reluctant to run raids and seize infringing software in the area that causes the greatest losses to the software industry, unauthorized use of business software in government and business contexts. In 2003 there was one case which concluded in a fine of \$32,000, which we believe to be the highest fine ever, levied by NCAC for piracy of U.S.-origin software. The company involved then went to civil court and got damages of over 6 times that amount! Fines must be imposed at a level that deters this kind of conduct or there will be no disincentive to stop it. Furthermore, NCAC does not have sufficient resources available to it to make a difference in this area.

MARKET ACCESS: A NECESSARY INGREDIENT TO FIGHT PIRACY IN CHINA

Providing market access to allow more legitimate product into China is an essential element of an effective anti-piracy strategy in the country. It is significant that China, through its WTO commitments, has agreed to open its market in various ways to different copyright industry sectors. For example, it is noteworthy that China has agreed to open its market to wholesale and retail distribution by foreign book publishers. However, the market opening measures for other sectors, particularly in the audio and audiovisual sectors, are much more restrictive. It is now of paramount importance that the U.S. government work not only to secure the commitments made through any necessary changes to China's legal system, and to ensure that the gains that were promised are not stymied by continued restrictive commercial practices in China but also that it begin now to

urge China to undertake further market opening measures by eliminating existing restrictions.

For example, policies such as China's WTO commitment to allow in a minimum of 20 films annually under standard commercial terms (revenue sharing) essentially provide pirates with a monopoly in the Chinese market for the six-month period between theatrical release of a motion picture and the release of the product in home video formats. If delays are permitted to occur in the censorship process for home video entertainment, then pirates have an even longer period in which they can operate before legitimate product enters the market. For other industries, for example, the book publishing industry, the WTO commits China to gradually open retail (beginning in December 2002) and wholesale distribution to foreign entities (both without restrictions except as to "chain" retail stores no later than December 2004). Unfortunately, continued severe restrictions on activities of paramount importance to U.S. publishers, such as printing (which is "restricted") call into doubt whether China can meet its WTO obligations under the current system.

The record industry faces serious market access hurdles (for every essential activity to their business in China) that result in limiting China's ability to effectively fight piracy. The WTO commitments oblige China to open wholesale and retail distribution to foreign [record] companies in contractual joint ventures with Chinese firms (but not wholly-owned foreign entities).⁷ Other essential activities such as the signing of recording artists, artist management, and producing sound recordings, are left out of WTO commitments. Chinese guidelines make it clear that "publishing, producing, master issuing and

⁷ World Trade Organization, Report of the Working Party on the Accession of China, Addendum, Schedule CLII—The People's Republic of China, Part II—Schedules of Specific Commitments on Services, List of Article II MFN Exemptions, WT/MIN(01)/3/Add.2, Nov. 10, 2001.

importing” of records in China are prohibited foreign investment activities, as is broadcasting,⁸ while distributing and selling records is a “restricted” activity. In practice, certain “cooperative” agreements (not joint ventures) may allow foreign entities to publish and produce in China, and there also apparently are no restrictions on a foreign entity signing and managing artists as long as they have proper permits. Nonetheless, the overall restrictive nature of the recording business in China makes it impossible for China to effectively fight piracy of foreign content. More important to the Chinese people and the Chinese economy, failure to open the Chinese market to those with the wherewithal and know-how to make records and distribute them makes it impossible for the vast majority of record producers worldwide to bring local Chinese content to the Chinese people and to make those artists and the music known to the world.

Our government must seek greater market opening measures for all U.S. copyright owners in China, as a necessary step in addressing the problem of piracy in a fundamental way and to make China the meaningful market that it could be.

BUT THERE HAS BEEN SOME PROGRESS

Despite the many problems and deficiencies in the enforcement system in China, the Chinese government continuously expresses that it is serious about reducing piracy and many government ministers do appear to be sincerely concerned about the problem. Indeed, Chinese government officials have admitted in recent years that piracy is serious, and both the problem and the

⁸ The chief piece of legislation governing the record industry in China is the Administrative Regulations on Audio-Visual Products, State Council Order No. 341, Approved December 12, 2001 at the 50th session of the State Council's Standing Committee, signed and promulgated December 25, 2001 by Premier Zhu Rongji, and effective from February 1, 2002).

government's awareness of it have been reported in the Chinese press.⁹ Periodic crackdowns during 2002 and 2003 have resulted in seizures of tens of millions of pirated products. In addition, between January of 2002 and July of 2003, 18 VCD/DVD factories (2 of which were registered) were raided, yielding seizures of 45 VCD/DVD production lines. Regarding retail raids, the Ministry of Culture has stated that in the same time period, more than 5,000 retail shops were raided nationwide. The seizure numbers indicate both the resolve of Chinese authorities to continue trying to rid the markets of some product but also the sheer magnitude of the problem. Simply stated, it will be impossible for the Chinese government to rid the market of piracy based on periodic anti-piracy campaigns and without a more coordinated, sustained effort, accompanied by deterrent penalties.

An example of real progress involves journal publishing. Through immediate implementation of a State Council Decree issued in late 2001, the pirating of academic journals has been largely diminished. As a result, foreign publishers have been able to negotiate arrangements with customers to legitimately purchase or license use of academic journals. This positive development is an excellent example of how the Chinese government can open a market that was previously closed due to piracy. We sincerely hope that the progress made with regard to academic journals will be mirrored in future efforts to combat piracy of other types of products, both within and outside the field of publishing.

⁹ See, e.g., Weifeng Liu, *42 Million Discs Smashed in Nationwide Crackdown, Guangdong Key Target in Drive Against Audiovisual Smugglers*, China Daily, August 13, 2003 (in which Gui Xiaofeng, Deputy Director of the Press & Publications Administration and Deputy Commissioner of the National Anti Piracy & Pornography Working Committee said that pirated products have become a big problem for China, adding that the smugglers were not only breaching China's copyright laws but are also tax evaders); see also *Copyright Law Solid But Needs Fortifying*, China Daily, Sept. 14, 2000, at http://search.chinadaily.com.cn/isearch/i_textinfo.exe?dbname=cndy_printedition&listid=15654&selectword=COPYRIGHT%20PIRACY (quoting then National Copyright Administration Commissioner Yu Youxian as saying that the Copyright Law in China needed amending because "[a]nti-piracy regulations are not strong enough, since piracy was not serious when the law first took effect," and that "more provisions must be added because piracy has become rampant [in China] today").

China should also be acknowledged for the continued development of their specialized IPR courts. These courts handling IP cases in China continue to mature in their expertise with copyright issues and appear to be working well in deciding copyright cases.¹⁰ In the most recent cases, relatively large civil damages – in a software case, over \$180,000, were awarded to foreign plaintiffs for infringement of plaintiff’s copyrighted materials, in addition to the court enjoining further infringement and requiring the defendants to issue public apologies and be subject to severe sanctions if they repeated the infringement. We are also pleased to be able to report that foreign copyright owners are generally receiving good cooperation from government and judicial authorities in bringing civil cases. In some instances, foreign right holders are also receiving positive press regarding their actions against alleged infringers. These developments are noted by those on the ground in China as fundamental changes in the legal landscape in China since it joined the WTO.

CONCLUSION

Despite this progress, and the enormous seizures of pirate product, and periodic “campaigns” by local governments against piracy, the piracy situation in China remains largely unchanged since it joined the WTO – that is, it remains dire. With the timetable for China’s other WTO commitments (as distinguished from its TRIPS commitments which were immediate upon accession to the WTO) drawing close, the time is now for the Chinese government to acknowledge the nexus between practicable market access and the ability to effectively fight piracy. Piracy in China cannot be defeated or effectively deterred by enforcement alone –

¹⁰ For example, on March 24, 2003, the Shanghai No 2 Intermediate People's Court ordered three copyright violators to pay a combined 500,000 Yuan (US\$60,241) in compensation to the Shanghai Lexicographical Publishing House for pirating "Cihai," the most popular encyclopedia in the Chinese language. Some recent cases involved uses of copyrighted works in the digital environment, and were decided in accordance with the laws and with reasoned decisions in writing. *See, e.g., Guangdong Taixin Co Ltd. v. EMI (HK) Group Ltd., Guangdong Province People's High Court Civil Judgment (2001, Guangdong Province People's High Court IP Case No. 153).*

it must be accompanied by market-opening measures. Some of the necessary steps are reflected in China's WTO commitments. Others, such as allowing greater distribution of motion pictures in China by foreign companies, or allowing essential activities related to record production or book publishing by foreign companies, have not occurred, but must begin to occur if China is to have any hope of effectively curtailing copyright piracy. The continuous vacuum left by China's closed market will always be neatly filled by pirates who, by the very nature of their illegal activities, do not adhere to legitimate market rules. The time is now for the U.S. government to engage with the Chinese government to expand understanding of the nexus between increased market access and effective approaches the enormous piracy problem in China.

Again, I wish to thank you for giving IIPA the opportunity to share the copyright industries' experiences in China, and to chart a road forward to tackle copyright piracy.