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Hearing on China's Intellectual Property Rights and Indigenous Innovation Policy

Good morning. My name is Michael Schlesinger, and I appear here on behalf of the International Intellectual Property Alliance (IIPA), a coalition consisting of seven trade associations representing the U.S. copyright industries. IIPA is pleased to appear again before the U.S. China Economic and Security Review Commission, and this year marks a critical juncture in addressing the concerns of the U.S. creative industries in China.

At the outset, we note that the IIPA's seven member associations, comprised of 1,900 companies in the business software, recorded music, filmed entertainment, book publishing, and entertainment software industries, make up the large proportion of the creative industries in the United States. These industries in turn contribute mightily to the U.S. economy, contributing nearly 6.5% of the total U.S. gross domestic product (GDP), employing more than 5.5 million workers, providing good, high-paying jobs outpacing other industries, and contributing more than $125 billion in foreign sales and exports, based on the latest figures. Yet, these industries continue to suffer harm due to high copyright piracy levels in China, from pervasive use of unlicensed software by businesses and pre-installation of unlicensed software (hard disk loading piracy) at the distribution level, to widespread online piracy of

music, films, television programming, videogames,[1] and other copyright materials, and piracy of hard goods. China's many notorious online piracy sites and services, its failure to effectively lower enterprise end-user software piracy or legalize government and state-owned enterprise (SOE) use of software or publications, and its market access barriers are effectively shutting U.S. content industries out of one of the world's largest and fastest growing markets.

Today's testimony will focus on two industry sectors, business software and recorded music, providing case studies for the Commission in the severity of the problems faced and the unique approaches required to address them.

Business Software Industry Concerns

The business software industry faces growing IP and market access challenges in China that undermine its ability to expand exports and sales in the world's second biggest market for personal computers.

Let me highlight the scope of the problem:

- According to market research firm IDC, 79%, or nearly 8 out of every 10 copies of software deployed on personal computers in 2009 was unlicensed. The commercial value of this unlicensed software was a staggering $7.6 billion. This represents an enormous lost market opportunity for US and other software firms.
- China has made commitments in bilateral negotiations with the US dating back to 2004 to curtail software piracy; yet the value of unlicensed software use in China more than doubled from $3.6 billion in 2004 to $7.6 billion in 2009.
- Software piracy in China harms more than just US software firms. Software is a critical input in production for business in many sectors. The unlicensed use of software by business in China across a wide array of sectors results in products from these firms competing unfairly against products made by US firms that pay for the software they use.

[1] The Entertainment Software Association (ESA) reported that during 2010, ESA vendors detected 16.7 million connections by peers participating in unauthorized file sharing of select member titles on P2P networks through ISPs located in China, placing China second in overall volume of detections in the world, and comprising 11.57% of the total number of such connections globally during this period.

- While the market for software sales in China is significantly undercut by piracy, there are a growing number of policies being rolled out by the Chinese government that can severely restrict access to the legal market in China for foreign software companies. These so-called "indigenous innovation" policies seek to use government procurement, standard-setting and other levers to bolster domestic technology companies by shutting out foreign competitors and compelling transfers of technology to them.

The mechanisms available in China to address this massive problem have proven to be insufficient:

- Criminal enforcement against businesses that pirate software is not available
- While China has an administrative enforcement system, penalties issued against businesses pirating software are low and do not serve as an effective deterrent
- There has been some progress using civil actions, but not nearly enough to send a signal that software piracy is unacceptable and carries significant risks.

In short, IP infringement and market access restrictions are stifling the ability of the US software industry to see sales and exports in China in line with the dynamic growth of this market. At the same time, products made with unlicensed software in China compete unfairly against the goods of other US sectors. This has broad and increasingly harmful impacts on the US economy.

End-User Piracy Concerns

The business software industry continues to face unlicensed software use by enterprises – including private businesses, state-owned enterprises and government agencies – on a massive scale in China. A significant hurdle to effectively dealing with enterprise end-user piracy in China is the lack of availability of criminal enforcement. While the Supreme People's Court indicated in a 2007 Judicial Interpretation that under Article 217 of the criminal law, unauthorized reproduction or distribution of a computer program qualifies as a crime, authorities will not bring criminal end-user cases on the grounds that they do not meet the "for-profit" requirement in Article 217. The Chinese Government should make a clear commitment to criminalize enterprise end-user piracy, providing details on the timing, framework and approach, including issuance of a Judicial Interpretation by

the Supreme People's Court (SPC) and the Supreme People's Procuratorate (SPP) and corresponding amendments to the Criminal Code and Copyright Law and case referral rules for the Ministry of Public Security and SPP as needed. The 2011 Criminal IPR Opinions could be helpful in this regard, since they define in Article 10(4) the criteria of "for profit" as including "other situations to make profit by using third parties' works." Since the unlicensed use of software in enterprises involves reproduction and/or distribution, and since use of unlicensed software lowers costs and allows enterprises to "make profit," the Opinions appear to support criminalization of enterprise end-user piracy. Another key hurdle is meeting the applicable thresholds, i.e. calculation of illegal revenue or illegal profit, even if determined to be "for profit." In the meantime, the only avenue for seeking redress over the years have been the administrative and civil systems, which are under-funded and under-resourced, and which generally result in non-deterrent penalties. For example, in 2010, BSA lodged 36 complaints against end-users, including 13 with the local authorities and 23 with the National Copyright Administration for Special Campaign. Only ten administrative raids were conducted in 2010. BSA brought nine newly filed civil cases in 2010, five against enterprise end-users, and one involving Internet piracy.

There is similarly a need to clarify criminal liability for hard disk loading of unlicensed software. There have been a few such cases and at least one is in the preliminary investigation phase by a local PSB. Clarification will be helpful to building a pilot case and developing best practices.

Government Legalization of Business Software and Related Issues

Another important issue for the software industry is the need for the Chinese Government to ensure that government agencies at all levels use only legal software. At the December 2010 JCCT and in the joint statement from the summit between President Obama and President Hu in January 2011, the Chinese Government made several significant commitments on software legalization for government agencies and SOEs. These included: 1) treating software as property and establishing software asset management systems for government agencies, 2) allocating current and future government budgets for legal software purchases and upgrades, 3) implementing a software legalization pilot program for 30 major SOEs and 4) conducting audits to ensure that government agencies at all levels use legal software and publish the results. These bilateral commitments have been followed by a number of directives

from the Chinese Government implementing processes for software legalization in the government and SOEs. While these commitments and directives are welcome, it remains unclear whether they will be implemented in a meaningful and sustainable manner that results in a significant increase in legal software procurements. Using accounting firms and other credible third parties to conduct software audits of what software is actually running on government and SOE systems and implementation of internationally recognized software asset management (SAM) practices can help achieve this result. The Chinese Government must also follow through on its commitment in prior years to ensure that all computers produced or imported into China have legal operating systems. Implementation in recent years has been spotty.

Procurement Preferences

The business software industry remains concerned that Chinese government efforts to legalize software use in the government and enterprises will be accompanied by preferences favoring the acquisition of Chinese software over non-Chinese software. In some instances, government agencies or enterprises may "legalize" by purchasing domestic software while still running pirated copies of US-made software. With regard to influencing SOE and enterprise procurement, this would be inconsistent with China's commitment in its WTO working party report that the government "would not influence, directly or indirectly, commercial decisions on the part of state-owned or state-invested enterprises, including the quantity, value or country of origin of any goods purchased or sold . . . ," and its JCCT commitment that software purchases by all Chinese private and state-owned enterprises will be based solely on market terms without government direction. The Chinese government should, consistent with its WTO and JCCT obligations, refrain from instructing or encouraging state-owned enterprises to implement preferences for Chinese software in carrying out its legalization efforts, and should communicate this policy to relevant government agencies at the central, provincial and local levels.

In addition, fair and non-discriminatory access to China's vast government procurement market is a critical issue for the IIPA. China has repeatedly committed to join the WTO's Government Procurement Agreement (GPA) yet has been slow to move this process along. This past July, China released a Revised Offer to join the GPA that, while improving somewhat on prior offers, has significant shortcomings that will not make it an effective agreement for ensuring meaningful market access for our members and many other U.S. industries. The deficiencies include: (1) the

lack of express coverage for software and related services; (2) monetary thresholds that would be too high to reach a significant share of procurements; (3) an unacceptably long transition period for full commitments to take effect (*i.e.*, a five year stand-still followed by a five-year transition period); (4) limitations on coverage of central government agencies and an absence of coverage for "sub-central" agencies; (5) lack of clarity regarding coverage of state-owned enterprises; (6) a broad, undefined exception for "national policy objectives," and (6) the ability to require domestic content, offset procurement and transfers of technology. We also believe that China's GPA offer should include a provision reaffirming its commitment to ensure that government agencies use legal software and that government contractors use only legal software as well. We urge the U.S. government to raise these concerns with China and press the Chinese government to develop an improved GPA offer on an expedited basis.

Indigenous Innovation

Over the past several years, China has been rolling out a series of policies aimed at promoting "indigenous innovation." The apparent goal of many of these policies is to develop national champions by discriminating against foreign companies and compelling transfers of technology. Of particular concern are policies that condition market access (including the provision of government procurement preferences) based on local ownership or development of a service or product's intellectual property or aim to compel transfers of foreign intellectual property and research and development to China. A broad array of U.S. and international industry groups have raised serious concerns that these policies will effectively shut them out of the rapidly growing Chinese market and are out of step with international best practices for promoting innovation. IIPA has shared its concerns as well and strongly believes that the best ways for China to further enhance its innovative capacity are to: further open its markets to foreign investment; provide incentives to innovate by ensuring full respect for intellectual property rights including patents, copyrights and trademarks; avoid policies which establish preferences based on nationality of the owners of the intellectual property rights; and act forcefully and promptly to prevent misappropriation of such rights. In this regard, it is noteworthy that following the summit between President Obama and President Hu, the joint statement issued on January 19, 2011 indicated that "China will not link its innovation policies to the provision of government procurement preferences." The

accompanying White House "Fact Sheet" on "U.S.-China Economic Issues" issued the same day indicated that:

> The United States and China committed that 1) government procurement decisions will not be made based on where the goods' or services' intellectual property is developed or maintained, 2) that there will be no discrimination against innovative products made by foreign suppliers operating in China, and 3) China will delink its innovation policies from its government procurement preferences.

These are all welcome commitments, and follow on JCCT commitments regarding "IPR and Non-Discrimination," and "Government Procurement." They should be communicated to all levels of the Chinese Government and should be effectively enforced to avoid both express and implicit means of discriminating against U.S. and other foreign products in government procurement based on ownership or development of IP.

Recorded Music Industry Concerns

The combination of mostly online music piracy and market access concerns has stifled the development of a legitimate online marketplace for music in China.

As backdrop for the discussion, it should be noted that development of online and mobile connectivity in China is truly staggering. According to the China Internet Network Information Center (CNNIC) (which "takes orders from MII" – the Chinese Government – according to its website), China's Internet population stands at 457 million Internet users as of December 2010, with over 66% of them using mobile phones to surf the web, by far the largest number in the world. More spectacular is the percentage of those users with high-speed broadband interconnections, at an estimated 450 million users. Of mobile users, 303 million now have mobile Internet access, and there is growing evidence that piracy is taking place directly on mobile devices over wireless broadband networks (3G), and the pre-loading of infringing files on mobile devices is a problem for copyright industries. Of all Internet users, according to CNNIC, 79.2 % use the Internet for "Web music," 66.5 % use the Internet for "Web game," 62.1% use the Internet for "Web video" and 42.6% use the Internet for "Network literature." These statistics speak volumes, since for most of the copyright sectors, legitimate content is not made available in significant quantities

online in China due to the prevalence of piracy, market access restrictions, or other discriminatory measures which effectively keep legitimate content out.

Internet Piracy of Music

The music market in China for U.S. companies is in crisis. Internet piracy of music is estimated at 99% piracy and fueled primarily by businesses like NASDAQ-traded Baidu, that direct users to infringing content and are supported by advertising. The harm caused by Internet piracy of music can perhaps best be understood in numbers by comparing the values of China's legitimate market with that of other countries. The value of total legitimate digital sales in 2009 in China was US$94 million, and total revenue (both physical and digital) was a mere US$124 million. This compares to $7.9 billion in the U.S., $285 million in South Korea and $142 million in Thailand — a country with less than 5% of China's population and with a roughly equivalent per capita GDP. If Chinese sales were equivalent to Thailand's on a per capita basis, present music sales would be US$2.8 billion, and even that would represent under-performance and reflect significant losses to piracy. It is fair to say that China's lack of enforcement against music piracy—particularly on the Internet, amounts to more than US$2 billion in subsidies to Chinese Internet companies who can provide their users with access to music without negotiating licenses therefor.

In addition to serious infringement problems with sites like Baidu, Sohu, Sogou, and Xunlei's Gougou, there are many other websites such as 1ting.com, sogua.com, qq163.com, haoting.com, 520music.com and cyberlocker sites such as Rayfile, Namipan, and 91files which have been implicated in music piracy activities in China. A wide range of recordings have been found on web "forums", such as pt80.com and in-corner.com. These forums direct users to download or stream unauthorized sound recordings stored in Chinese cyberlockers. An increasing number of prerelease albums have been shared by postings at forums which have registered users in the hundreds of thousands – decimating the market for those recordings. Although cease and desist notices have been sent to the administrators of the forums and cyberlockers identified, immediate takedowns of such "URLs" and/or postings are rare. Illegal P2P filesharing remains prevalent in China. Many Chinese-based P2P services, such as Xunlei, VeryCD,13 etc., assist in large scale illegal file-sharing activities that have caused serious damage to the recording industry. Most of these illegal services offer songs for free, generating income from advertising and

other services. We note for that Xunlei has announced its intention of holding a U.S.-based IPO, and therefore the Commission might be interested in providing its views to the SEC.

Update on Internet Piracy Enforcement – A Few Signs of Positive Movement, But Much More Needs to Be Done

While significant challenges remain, there are at least some signs that the Chinese Government is becoming more active in dealing with online infringements. The outcomes of the recent JCCT plenary session (December 15, 2010) and the subsequent summit meeting between President Obama and President Hu (January 19, 2011) contain important commitments aimed at addressing massive online piracy in China. Specifically, China committed in the JCCT "to obtain the early completion of a Judicial Interpretation that will make clear that those who facilitate online infringement will be equally liable for such infringement." On January 19, 2011, the U.S. "welcomed China's agreement to hold accountable violators of intellectual property on the Internet, including those who facilitate the counterfeiting and piracy of others." Just days before President Hu's visit to the United States (January 11, 2011) the Chinese Government issued new "Supreme People's Court, Supreme People's Procuratorate and Ministry of Pubic Security Promulgated Opinions on Certain Issues Concerning the Application of Laws for Handling Criminal Cases of Infringement of Intellectual Property Rights," hopefully leading to stronger and clearer criteria for criminal liability for Internet-based infringements.

These high-level commitments resulted in some progress by the Chinese Government against Internet piracy in 2010, both in terms of administrative measures and seeking criminal prosecutions against infringing sites and services supporting and benefiting from infringement. For example, the Ministry of Culture on December 15, 2010 announced a Notice by which illegal websites not acquiring approval from or registering at provincial cultural departments, would be shut down. The list included 237 music websites, including yysky.com and cococ.com. As of 2009, 89 of these sites had closed. The websites were given a deadline of January 10, 2011 to delete illegal music. While the recording industry welcomes these enforcement actions, the industry hopes that moving forward the Chinese Government takes meaningful action against Baidu and others for their role in promoting and facilitating the distribution of infringing materials rather than basing enforcement actions on the basis of censorship. Regarding case law developments, meanwhile, a couple of cases in

recent years suggests that progress can be made against music download and streaming sites (7t7t and Qishi) through criminal prosecutions. There has also been some evidence of increased referrals by the administrative authorities. Yet, the largest services like Baidu (an estimated 50% of all illegal music downloads in China takes place through Baidu) continue to be shielded even from civil liability for their involvement in music piracy. The recent complaints against Baidu's library filesharing service and Baidu's takedown of unlicensed publications notwithstanding, Baidu's "mp3" search functionality for illegal music files remains intact.

Market Access Concerns, Including Discriminatory "Content Review" (Censorship)

The last topic I would like to discuss is market access as related to the recorded music industry. There is a direct relationship between the fight against infringement and the need for liberalized market access to supply legitimate product (both foreign and local) to Chinese consumers. Unfortunately, there are a range of restrictions affecting the recorded music industry which stifle the ability of U.S. rights holders to do business effectively in China.

The single most damaging barrier is the application of onerous and discriminatory censorship provisions. Foreign recordings must go through a very cumbersome censorship process before they can be released to the online market. Local content, by contrast, can be self censored. The cumbersome process for U.S. music to receive government clearance results in long delays for release during which time infringing versions are broadly available. This is most damaging in the online environment where delays of even days can completely undermine the legitimate market. The maintenance of requirements for censorship approval prior to legitimate digital offers only serves to hinder legitimate commerce while having practically no impact on the content being made available to Chinese users.

China's discriminatory regime is both unfair and highly suspect under WTO rules. China further complicated an already unsatisfactory situation by issuing the September 2009 *Circular on Strengthening and Improving Online Music Content Examination*. This Circular puts into place a censorship review process premised on an architecture already determined to violate China's GATS commitments—by allowing only wholly-owned Chinese digital distribution enterprises to submit recordings for required censorship approval. Especially because of the large number

of titles involved, this imposes virtually impossible delays on these foreign businesses and the right holders who license their product to them. The *Circular* significantly hampers the development of a healthy legitimate digital music business in China, while making it easier for those who infringe to thrive, since they would never comply with these rules.

When China joined the WTO, it agreed to allow foreign investment in all music distribution ventures on a non-discriminatory basis. That includes online music distribution. By excluding foreign-invested enterprises (FIEs) from submitting imported music for censorship review, the Circular denies bargained-for market access and discriminates against FIEs thereby violating China's national treatment obligations. It violates China's accession commitments under the General Agreement on Trade in Services (GATS) and the General Agreement on Tariffs and Trade 1994 (GATT); it also violates China's Accession Protocol commitment to authorize trade in goods by any entity or individual. China must revoke or modify the Circular to fix these problems relating to the rights of FIEs to distribute music online, and to remove the discriminatory censorship processes for treatment of foreign as opposed to local content.

Record companies are also prevented from establishing a meaningful commercial presence that would permit them to develop talent in China, and from getting legitimate product quickly to market. That U.S. record companies cannot distribute a recording in physical format except through a minority joint venture with a Chinese company (and may not "publish" a recording at all—a stage in the process of bringing materials to the market left entirely to state-owned companies) artificially segments China's market, making it extraordinarily difficult for legitimate companies to participate effectively in the market in China. U.S. record companies are skilled at and desirous of developing, creating, producing, distributing, and promoting sound recordings worldwide. The universal experience of nations in which the international record companies do business is that local artists have expanded opportunities to have their music recorded and distributed widely. The in-country presence of U.S. companies also has brought jobs and expertise in a wide variety of areas. China should permit U.S. (and other foreign) sound recording producers to engage in:

* the integrated production, publishing and marketing of sound recordings;
* production, publication and marketing their own recordings in China;
* the signing and management of domestic artistes;

* the distribution of sound recordings via digital platforms and in physical formats;
* the operation of online music delivery services; and
* the importation of finished products of their own sound recordings.

Conclusion – Thoughts on Ways Forward

High copyright piracy levels persist in China, including business software piracy and piracy of recorded music, as well as widespread online piracy of films, television programming and other copyright materials, and piracy of hard goods. The continued overall lack of deterrence against piracy, market closures or barriers for creative content (some of which have been found to violate China's WTO commitments), and the imposition or specter of discriminatory policies toward foreign content, suggest a conscious policy seeking to drive Chinese competitiveness while permitting free access to foreign content through unapproved pirate channels. China's principal reliance on its woefully under-resourced administrative system to deal with IPR infringements rather than through criminal enforcement presents a significant hurdle to effective enforcement.

At the same time, with the ongoing Special Campaign on IP enforcement (which has made progress on some concerns at the margins), and through commitments made in recent bilateral initiatives, the Chinese Government has indicated measures it will take to achieve higher levels of copyright protection. Specifically, the recent meeting of the Joint Commission on Commerce and Trade (JCCT) in December 2010 and the summit between President Obama and President Hu in January 2011 resulted in a number of important commitments by the Chinese to ensure legal use of software in the government and state-owned enterprises (SOEs), seek effective measures to deal with Internet infringements (including intermediary liability), deal with digital library infringements, and ensure that China's "indigenous innovation" policies do not effectively limit market access for U.S. intellectual property owners, compel transfers of intellectual property to access the Chinese procurement market, or create conditions on the use of or licensing of U.S. intellectual property. New Opinions on handling criminal copyright infringement cases contain helpful provisions which could foster an effective criminal remedy against online piracy activities.

However, as has been the case with past commitments to improve copyright protection and market access made by the Chinese Government, it remains to be seen whether the Chinese will implement them in a sustainable and meaningful way, at the central and provincial levels, to ensure that copyright piracy in all its forms is curbed and to provide a fairer and more open market for U.S. creative content. It is particularly critical that the leaders group (led by the State Council) which has been a key driver in the latest Special Enforcement Campaign, be made a permanent part of the enforcement structure, since such high-level involvement has resulted in greater success during this Campaign, and that China take steps in new judicial interpretations to clarify that those who as a business model facilitate infringements online will be held liable.

The bottom line is that China's many notorious online piracy sites and services, its failure to effectively lower enterprise end-user software piracy or legalize government and state-owned enterprise (SOE) use of software or publications, and its market access barriers are effectively shutting U.S. content industries out of one of the world's largest and fastest growing markets. Engagement with China to achieve these goals must be multi-faceted, including through Special 301 as well as discussions in the bilateral Strategic & Economic Dialogue and Joint Commission on Commerce and Trade.

Today's testimony has endeavored to provide the Commission with a snapshot of problems faced by two key copyright industry sectors – business software and recorded music. Through seeking meaningful, results-oriented implementation of the problems identified today, continuing to press for strong enforcement, including where appropriate, criminal enforcement, and addressing barriers and industrial policies that impose discriminatory requirements on foreign right holders and/or deny them the exercise of their IP rights, it is hoped that tangible results – like increasing overall sales and exports to China by the creative industries, as well as fixing market access disparities and violations that put U.S. companies at a competitive disadvantage – can be achieved.

Thank you for the opportunity to share the copyright industries' experiences in China. I would be pleased to answer any questions you may have.

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