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Protecting America's Intellectual Property:

A Legislative History of the Pro IP Act of 2008

Volume 2

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COUNTERFEIT GOODS: EASY CASH FOR CRIMINALS AND TERRORISTS

HEARING

BEFORE THE

COMMITTEE ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS UNITED STATES SENATE

ONE HUNDRED NINTH CONGRESS

FIRST SESSION

MAY 25, 2005

Printed for the use of the
Committee on Homeland Security and Governmental Affairs



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COUNTERFEIT GOODS: EASY CASH FOR CRIMINALS AND TERRORISTS

WEDNESDAY, MAY 25, 2005

U.S. SENATE,
COMMITTEE ON HOMELAND SECURITY
AND GOVERNMENTAL AFFAIRS,
Washington, DC.

The Committee met, pursuant to notice, at 9:35 a.m., in room SD–562, Dirksen Senate Office Building, Hon. Susan M. Collins, Chairman of the Committee, presiding.

Present: Senators Collins, Lieberman, Akaka, and Lautenberg.

OPENING STATEMENT OF CHAIRMAN COLLINS

Chairman COLLINS. The Committee will come to order.

Good morning. During the past 2 years, this Committee has held three hearings to investigate terrorism financing. From the flow of money through certain Islamic charities in this country to terrorist organizations around the world, to the role played by Saudi Arabia, described to this Committee as the epicenter of terrorism financing, we have learned much about this complex and murky subject.

Today, we explore another aspect of the shadowy world of terrorism financing. The theft of intellectual property rights through counterfeiting and pirating of consumer goods is a huge and growing criminal enterprise. It is estimated that counterfeit merchandise accounts for between 5 and 7 percent of all the goods moved in world trade. According to Interpol, this counterfeit merchandise is worth approximately $450 billion annually. According to the U.S. Trade Representative, American businesses lose as much as $250 billion each year to counterfeiters.

The U.S. Bureau of Customs and Border Protection seized about $138 million in fake goods in 2004, compared with $94 million in 2003. Compact disks, computer software, sneakers, golf clubs, perfume, soft drinks, baby food, electronics, auto parts, name the product and someone is selling a bogus or pirated version on a street corner in some American city, and as you can see, we have an array of counterfeit merchandise that has been seized in various raids that is displayed on the table.

For those unfamiliar with the terminology, counterfeit goods are knock-offs or look-alikes of brand-name products, such as this counterfeit Gucci watch. Goods are referred to as pirated when criminals steal and sell the content of a legitimate product, such as the latest Star Wars movie, already out in pirated version, and copy it illegally without the permission of its owner. Both kinds of illegal goods are often referred to as counterfeit.

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Combine counterfeiting's high profits with the uninformed notion that the purchase of a knockoff designer handbag, a fake wristwatch, or a pirated DVD is a victimless crime and it is no surprise that the trade in counterfeit goods is extremely lucrative. This criminal activity has damaging consequences for our economy and for honest businesses and their employees. Moreover, given the evidence that terrorists are engaging in counterfeiting to secure money to support their operations, the potential consequences are far more dire than economic damage.

The unclassified evidence linking terrorism and counterfeiting is compelling and it spans several agencies and years. For example, in a 2002 advisory entitled, "Financing Terror: Profits from Counterfeit Goods Pay for Attacks," the Customs Service warned of an increasingly close connection between transnational crime and terrorism with the profits from counterfeit and pirated goods being the strongest link.

In 2003, the Secretary General of Interpol testified before Congress that intellectual property crime, the pirating of such products as software, CDs, and DVDs, is becoming the preferred method of funding for a number of terrorist organizations. He cited direct and indirect connections between counterfeiting and Hezbollah, the Chechen rebels, extremist groups in Kosovo, and al Qaeda, among others.

Also in 2003, the Terrorist Financing Operations Section of the FBI provided a document to the Committee stating that the sale of counterfeit goods is among the ways in which Hezbollah finances its terrorist activities, and we have a graphic that takes information from this FBI report.

In its 2004 report, "Patterns of Global Terrorism," the State Department wrote that the tri-border region of South America, Argentina, Brazil, and Paraguay, is a regional hub for Hezbollah and Hamas fundraising activities, including the manufacture and movement of pirated goods.

In January of this year, the International Anti-Counterfeiting Coalition stated that there is ample evidence to confirm that terrorist organizations are profiting from the manufacture and sale of counterfeit and pirated goods.

In addition to the high profits, there is another reason that terrorists have turned to this method of financing. The United States and our allies around the world have made some significant progress in shutting off the flow of terrorist money through established mechanisms and institutions. These concerted efforts are making a difference. But we know that terrorists are nothing if not resourceful and determined. When we shut off one avenue of financing, they find another.

This point was made well recently by Treasury's Under Secretary Stuart Levy when he said, "We have indications that terrorist groups like al Qaeda and Hamas are feeling the pressure and are hurting for money. We are also seeing terrorist groups avoiding formal financing channels and instead resorting to riskier and more cumbersome financial conduits, like bulk cash smuggling. One rich source of bulk cash is the sale of counterfeit consumer products."

Finally, I would note that the focus to date by this Committee on its hearings, as well as by our government and our allies, has

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been on high-level terrorist financing, for example, by multi-million-dollar charities and foundations, by entities linked to Saudi Arabia, and by Iran. That certainly is appropriate and it is where the primary focus should be. But we know that terrorism is also funded by street crime. There are many examples of this.

Ahmed Ressam, the Millennium bomber, funded his activities by stealing tourists' suitcases in hotels and by credit card fraud. In testimony before this Committee last June, the former general counsel at the Department of Treasury noted that the Madrid train bombers were financed through criminal activity, including drug dealing.

We also know that it does not take a large sum of money to commit a devastating terrorist attack. After all, the organizing, planning, and training for September 11 cost only an estimated $500,000, a sum easily generated by criminal activity such as counterfeiting.

The purpose of this hearing is to focus much-needed attention on what appears to be a fertile and growing source of financing for terrorists. It is my hope that this attention will lead consumers to reject these low-cost street corner bargains because, in fact, they carry a terrible price. It is my expectation that this attention will lead to increased efforts by our government and our allies to close off this rich avenue of terrorist financing.

Senator Lieberman.

OPENING STATEMENT OF SENATOR LIEBERMAN

Senator LIEBERMAN. Thank you very much, Madam Chairman. Thanks so much for calling this hearing today on a problem that deserves far greater recognition than it has yet received.

Over the years, we have obviously heard much and tried to do much about the counterfeiting of consumer goods and the economic losses suffered by manufacturers whose popular CDs or designer jeans are counterfeited for mass sale around the globe. I want to compliment you, Madam Chairman. I just heard yesterday that "Return of the Sith" was already selling on the streets of Beijing, and here you have already got one, I see. Very impressive. [Laughter.]

But today, obviously, we are going to look at counterfeit goods from a different perspective, from a national security perspective, which adds, of course, a new and critical dimension to the urgency of curtailing this illicit activity, counterfeiting.

The experts estimate that as much as 7 percent of world trade is involved with the sale of counterfeit goods. That amounts to hundreds of billions of dollars a year that eat away at the income of American manufacturers and workers, but counterfeiting is obviously more than just a bunch of people hustling for a few extra bucks, a victimless crime. It has become a major source of income for organized crime and, as we shall hear today, for terrorists because of its low risks and high rewards. In other words, the risk of getting caught and the penalties if you are caught are minimal, while the potential for making money is maximal.

There is a recently published book which was called *Lightning Out of Lebanon,* which details a notorious North Carolina case a few years ago that implicated Hezbollah, the terrorist organization,

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in counterfeiting here in the United States to support their activities in the Middle East. One of our witnesses here today, former FBI analyst Matthew Levitt, worked with the authors of the book and I look forward to hearing about his work in that area.

Madam Chairman, as you well know, 3 years ago, in the context of another investigation by this Committee, the Terrorist Financing Operations Section of the FBI provided an unclassified document to the Committee that listed the sale of counterfeited goods among various criminal activities the terrorist organization Hezbollah uses to raise cash in the United States. This evidence puts the lie to what I think is that commonly held belief that trade of counterfeit goods is a victimless crime. If anybody suffers, it is only a couple of big people at the top of the corporations.

That is not true. Certainly, it has never been true. But as the evidence strongly suggests that we will hear today, profits from counterfeit sales are used to finance terrorist activities, and this is anything but a victimless crime. This is a crime that finances random murder around the world, including, needless to say, the murder of Americans.

We are very fortunate today, in addition to Mr. Levitt, to have two witnesses from Los Angeles who will testify to what they have done and discovered about the counterfeit trade and its connection to terrorism. All three witnesses, I hope, will help us understand the nexus between terrorism and counterfeiting, and also help us to evaluate whether the Federal Government, State, and local governments, and law enforcement generally are receiving the resources and are coordinating their investigatory and prosecutorial activities to meet this challenge.

Local leads regarding counterfeit goods and possible terrorist connections are extremely valuable, particularly since the Federal Government has strong financial tracking capabilities with regard to terrorist financing that have been developed in recent years and were further improved by the intelligence reform legislation signed into law last year by the President, which came out of this Committee. That legislation authorized additional funding for the Treasury Department's Financial Crimes Enforcement Network and its technical tracking capabilities to strengthen the Department's anti-money laundering and anti-terrorist financing efforts.

So we know that Federal agencies track and investigate terrorist financing. What we want to find out today from the witnesses is whether those agencies are doing enough to track and investigate and prosecute those who are using the sale of counterfeit consumer goods to finance terrorist activities. This is a very important hearing today and one in which, Madam Chairman, I think we are playing another appropriate role of oversight, which may lead to legislation—perhaps we will decide that there ought to be stiffer penalties for counterfeiting—but hopefully, we will focus attention on this problem that it hasn't received before, and that attention, in turn, will engender the kind of prosecutorial activity that I believe this problem merits.

Thank you very much.

Chairman COLLINS. Thank you, Senator. Senator Akaka.

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OPENING STATEMENT OF SENATOR AKAKA

Senator AKAKA. Thank you very much, Madam Chairman, for calling this hearing to learn more about a developing and growing problem not only in our country, but in the rest of the world, as well.

Today's hearing provides us, and I join Senator Lieberman in saying that this provides us with two opportunities. One opportunity is to understand the connection that may exist and is developing between organized crime and terrorism. The other opportunity is to, as was mentioned, evaluate the level of cooperation between the Federal level and the local level of law officials.

I want to thank our witnesses for being here to provide us with their testimony. Thank you, Lieutenant Stedman from the Los Angeles County Sheriff's Department, also Kris Buckner and Dr. Matthew Levitt for your expert testimony.

The selling of counterfeit goods pervades every major area of the United States. According to recent estimates, $286 billion in counterfeit goods are sold in the United States every year. The problem is not just large companies protecting their intellectual property and their profits. It is also consumers paying for goods they believe are of a certain quality, only to receive fake goods. It is about people buying dangerous counterfeit pharmaceuticals over the Internet, as we heard at several hearings last year before the Permanent Subcommittee on Investigations.

Interpol recently reported a tragic case of counterfeit baby formula sold in China which resulted in the deaths of 13 babies and serious illness to another 171 babies. Counterfeit goods is not a victimless crime.

Of those organized criminal enterprises that are involved in the profitable business of counterfeit goods, there is a small number who directly threaten our national security by providing financial support to terrorists.

In July 2003, the House Committee on International Relations held a hearing entitled, "Intellectual Property Crimes: Are Proceeds from Counterfeited Goods Funding Terrorism?" At that hearing, the Secretary General of Interpol, Mr. Ronald K. Noble, sounded the alarm that, and I quote him, "Intellectual property crime is becoming the preferred method of funding for a number of terrorist groups."

Department of Homeland Security Under Secretary Hutchinson said, "Terrorist organizations worldwide are looking for a variety of illegal activities to fund their efforts. They have looked at contraband and counterfeiting and piracy, all as means of illegal activity to fund their organizations."

One well-known case involving counterfeit and pirated goods was reported in the joint Departments of Justice and Treasury in 2003 National Money Laundering Strategy, working with Canadian law enforcement. U.S. officials obtained 18 convictions of members of a Charlotte, North Carolina-based Hezbollah cell which had smuggled untaxed cigarettes into North Carolina and Michigan and used the proceeds to provide financial support to terrorists in Beirut.

There is a danger that, over time, terrorist cells and criminal gangs could forge mutually beneficial financial links that will facilitate terrorist infiltration into the United States. It is one short step

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from smuggling narcotics to smuggling terrorists and explosives. Once this link is made, that challenge to our domestic security will have exponentially increased.

Some concern has already been reported about possible connections between al Qaeda and the street gang known as MS–13. While these connections appear now not to have been made, our vigilance must be strict. It illustrates the important need for cooperation between criminal intelligence divisions in the local law enforcement field and terrorist intelligence agencies at the Federal level.

Madam Chairman, I hope today's witnesses will address some of these issues, and I hope, Madam Chairman, that the Committee will continue to look into these issues. I ask to be excused for another important Committee statement that I have to make elsewhere. Thank you very much.

Chairman COLLINS. Thank you, Senator. You are a very dedicated Member of this Committee, and I appreciate your coming by this morning.

Senator AKAKA. Well, it is no secret. I enjoy working with you.

Chairman COLLINS. Thank you. Senator Lautenberg.

OPENING STATEMENT OF SENATOR LAUTENBERG

Senator LAUTENBERG. Thank you, Madam Chairman. It is pretty obvious that we must do whatever we can to interrupt funds that might go to terrorist organizations or countries that support terrorism, and today, we are looking at one way that funds are developed to support these enemies of the United States.

We have all had the experience, as we talk about counterfeit goods, we have all had the experience of walking down streets in cities like Newark, New York, Philadelphia, or any other major city and see people selling items like handbags, clothing, and the miscellaneous replications that we see here on this table and that we are all aware of. At first glance, these items might appear to be a great bargain.

But most of us have learned that when a deal seems too good to be true, it usually is, and that is certainly the case with counterfeit consumer goods. They are a bad deal for consumers because they don't really receive what they think they are buying. And counterfeit goods are certainly a bad deal for the companies whose goods they mimic.

That is one part of the thing. The result is, as we look at today, is not only does it hurt the economy, hurt the companies, and hurt the buyers, but it appears that trade in counterfeit merchandise might even damage our national security by funneling money into the hands of terrorists.

President Bush has said it, that money is the lifeblood of terrorists, and that is certainly true. We have learned that. But there are other larger sources of income to terrorists that are also not being shut down, and one that I have focused on in the past is American companies that do business with terrorist States.

That is why I have introduced a bill that would close the loophole in our current law that allows U.S. companies to do business with nations like Iran, simply by going through offshore subsidiaries.

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Now, we need to close this loophole and cut off the flow of dollars to terrorists, people who want to destroy our lives and our Nation.

I look forward to hearing more about the issue of counterfeit goods from our witnesses. It is my hope that my colleagues will join with me to stop U.S. companies from doing business with terrorists once and for all. We have got to do whatever we can to make sure that no help goes from any American company by any device or ruse to countries like Iran, where funds travel to terrorist organizations, wind up killing or injuring Americans, whether or not they are in or out of uniform, and I commend you, Madam Chairman, for calling this hearing and focusing on this issue of funds to terrorists.

Chairman COLLINS. I would now like to welcome our first panel—our only panel this morning, of witnesses. Each is truly an expert in his field. Lieutenant John Stedman is a 24-year veteran of the Los Angeles County Sheriff's Department and is currently a supervisor in the Criminal Investigative Section of the Department.

Kris Buckner is President of Investigative Consultants, a private investigation firm specializing in intellectual property crime investigations.

And Dr. Matthew Levitt is an expert on the subject of Hezbollah. He is also the Director of the Washington Institute's Terrorism Studies Program.

We are very pleased to have you here with us this morning. We appreciate all of the prior assistance you have given the Committee as we have investigated this issue.

Lieutenant, we are going to start with you. Thank you.

TESTIMONY OF JOHN C. STEDMAN,[1] LIEUTENANT, SHERIFF'S DEPARTMENT, COUNTY OF LOS ANGELES

Lieutenant STEDMAN. Thank you, Chairman Collins and Senator Lieberman, for the opportunity to testify today. My name is John Stedman. I am a lieutenant with the Los Angeles County Sheriff's Department in California. My testimony today will address the enforcement efforts of the Sheriff's Department regarding intellectual property rights crimes and the involvement of organized crime groups operating in Los Angeles county.

My experience with IPR crimes dates to the late 1980s, when my unit was approached by members of the Latin American Music Association. They were experiencing large revenue losses due to proliferation of unauthorized and illegal duplication of music onto cassette tapes. The Music Association was seeking cooperation from local law enforcement to enforce a State of California statute that makes it a crime to illegally duplicate copyrighted or trademarked materials. Over the next 2 years, my unit investigated dozens of these cases, resulting in the seizure of hundreds of thousands of cassette tapes and the incarceration of many suspects.

During the 1990s, the Motion Picture Association of America also requested the services of local law enforcement to enforce the same copyright or trademark statutes of California. Detectives under my supervision completed many of these investigations, seizing thou-

[1] The prepared statement of Lieutenant Stedman appears in the Appendix on page 31.

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sands of illegally duplicated motion pictures. Many of these videos were of films not yet released to the theaters.

In 2003, I was assigned to supervise the Criminal Investigations Section of the Emergency Operations Bureau. It was at this time that I gained a full realization of the pervasiveness of IPR crimes in Los Angeles County. We concentrated our investigative resources on IPR crimes and have uncovered significant organized criminal enterprises operating within Los Angeles County. Victims of the organized criminal groups include the tobacco industry, luxury goods manufacturers, clothing companies, and the music and motion picture industries. Information in open sources indicates that across the globe, anything that has a decent profit margin is being counterfeited.

While there are no local statistics on the magnitude of the problem, I can relate what my small team of one sergeant and six investigators has accomplished in a little more than a year. We have served 60 search warrants, which have yielded 125 arrests and $16 million in seized counterfeit products. An additional $3.5 million in cash has been seized and is currently in forfeiture proceedings. With your permission, Madam Chairman, I would like to show a short video which illustrates one of our warrant operations.

Chairman COLLINS. Please do.

[A videotape was played.]

Lieutenant STEDMAN. Within the Sheriff's Department, there are units designated to combat organized criminal enterprises, such as the one you just saw, and we are represented on nearly every task force created to investigate these groups.

These units have similar experiences with IPR investigations, noting that the profits are enormous with minimal criminal exposure. Russian organized crime, Eurasian organized crime, Asian organized crime, and Lebanese organized crime groups all profit from IPR crimes.

Additionally, we believe that there may be a trend developing for local gang involvement in IPR criminal activity. Recently, we have investigated several individuals with strong gang ties and extensive criminal records. During interviews, these suspects have admitted that IPR crime is attractive because of the high profit and minimal jail sentences. In the parlance of one suspect, it is better than the dope business. No one is going to prison for DVDs.

There are also indicators that some associates of terrorist groups may be involved in IPR crime. During the course of our investigations, we have encountered suspects who have shown great affinity for Hezbollah and its leadership. The following are just two examples.

During the service of a search warrant in which thousands of dollars in counterfeit clothing was seized, I saw small Hezbollah flags displayed in the suspect's bedroom. Next to the flags was a photograph of Hassan Nasrallah, whom I recognized as the leader of Hezbollah. The suspect's wife asked me if I knew the subject of the photograph. I identified Nasrallah and the wife said, "We love him because he protects us from the Jews." Also in the home were dozens of audio tapes of Nasrallah's speeches. During the search, one of my detectives also found a locket which contained a picture of the male suspect on one side and Sheik Nasrallah on the other.

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In 2004, detectives served an IPR search warrant at a clothing store in Los Angeles County. During the course of the search, thousands of dollars in counterfeit clothing was recovered, as were two unregistered firearms. During the booking process, the suspect was found to have a tattoo of the Hezbollah flag on his arm. To my left is a photo of that tattoo.

Again in 2004, detectives served a multi-location IPR-related search warrant involving a large-scale counterfeit blanket operation. During the course of the investigation, detectives located a photo album. Within the photo album were dozens of pictures of attendees at a fundraising event for the Holy Land Foundation. When questioned about the album, the suspect said that the Holy Land Foundation was not a terrorist funding operation. When I informed the suspect that the U.S. Government had shut down the charity because of its alleged support of Hezbollah, the suspect replied that the U.S. Government was stupid and would do anything that the Jews told them.

When confronted with these indicators, we passed the information immediately to the Los Angeles Joint Terrorism Task Force for further review. As a result of this kind of information sharing, we enjoy an outstanding relationship with the JTTF as well as with the other three FBI offices located in Los Angeles County.

As I have stated, the financial rewards of IPR crimes are immense. Many times, the biggest issue for the criminal or his group is how to disperse the money generated from the crimes committed. It is difficult to use traditional banking practices to account for the huge profits generated. In one of our cases involving counterfeit baby blankets, we discovered over $800,000 in cash located throughout the suspect's residence, hidden in trash bags, under beds, stuffed in trash cans, and stashed in the attic. In fact, more than $10,000 was found in a child's piggybank.

On other occasions, we have seen activity consistent with money laundering and structuring occurring between similar businesses.

Another of our cases began with the stop of a suspect at Los Angeles International Airport by U.S. Customs officers. Strapped to the suspect's body was more than $230,000 in cash. The suspect told the Customs officers that she was en route to Lebanon for a vacation. Information was developed that the suspect owned a chain of cigarette shops. Service of search warrants led to the seizure of more than 1,000 cartons of counterfeit cigarettes, an additional $70,000 in cash, as well as wire transfers to banks throughout the world.

The financial cost of IPR-related crimes to the State of California is significant. As an example, my small team has seized about 40,000 cartons of counterfeit, untaxed cigarettes. The California State tax on cigarettes is $8.70 per carton, representing a loss to the State of $348,000.

It should also not be a surprise to anyone that suspects involved in IPR crime do not concern themselves with paying appropriate taxes, whether Federal, State, or local. Our experience has been that suspects claiming $20,000 or $30,000 on their yearly income tax forms routinely keep tens of thousands of dollars in cash at their homes.

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The Los Angeles County Sheriff's Department has, like most local agencies, suffered cutbacks in personnel over the past several years due to severe budget curtailments. There has not been a mechanism to address IPR crimes other than that based on interest from small units or individual investigators. We believe that there is a critical void in personnel to mount an effective campaign against the criminal enterprises that utilize IPR as a revenue stream. It is well-documented that organized criminal enterprises engage in IPR crimes. There are mounting indicators of the involvement of terrorist groups and their supporters.

In Los Angeles County, we believe there should be a task force commitment in order to combat the problem. Members of the Sheriff's Department have begun to explore different sources of revenue to fund such a task force in our region. The private sector has shown interest in contributing to such an effort. In fact, the private sector, comprised of manufacturers and companies such as Investigative Consultants, whose President, Kris Buckner, is speaking today, plays a vital role in our enforcement efforts. Without this cooperative public-private sector relationship, the Sheriff's Department, because of limited personnel resources, would quickly be overwhelmed and would not be able to maintain our current investigative pace.

We also believe that there should be legislation to enact or increase the levy on containers shipped through the ports of Los Angeles and Long Beach. These levies would fund intensified IPR enforcement efforts. It is my hope that by drawing more attention to this crime, we can reinforce the American dream of having an idea, bringing it to market, and profiting from its success without interference from the criminal element.

On behalf of Los Angeles County Sheriff Leroy D. Baca, I wish to thank the Committee for this opportunity to represent our county in discussing this important topic. Thank you, and I look forward to any questions you might have of me.

Chairman COLLINS. Thank you, Lieutenant. Mr. Buckner.

TESTIMONY OF KRIS BUCKNER,[1] PRESIDENT, INVESTIGATIVE CONSULTANTS

Mr. BUCKNER. Thank you. I would like to thank Chairman Collins, Senator Lieberman, and all of the Members of the Committee for the opportunity to appear before you today. Intellectual property crime is an important topic, and I am very pleased that the Committee is holding this hearing to discuss how intellectual property crime affects our country, including the possibility that proceeds from counterfeiting fund terrorism.

For the record, my name is Kris Buckner. I am the President of Investigative Consultants, a licensed private investigative firm based in Southern California. I have been a private investigator for over 10 years and specialize in investigations involving manufacture, distribution, and sale of counterfeit goods.

Investigative Consultants began as a single-person operation in 1994. The company now employs 14 full-time employees and several part-time and contract employees. Ninety-five percent of the

[1]The prepared statement of Mr. Buckner appears in the Appendix on page 35.

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company's time is spent investigating intellectual property matters, and we currently represent over 80 different brand owners.

The job of our company is to work on behalf of brand owners to uncover evidence of counterfeiting activities. When we find concrete evidence that some person or group is substantially engaged in counterfeit goods marketing, we contact the appropriate law enforcement agency and provide them with the evidence and assist them on behalf of the brand owners in the identification, inventory, and storage of the counterfeit items to ensure that the counterfeiters are brought to justice.

How big is the problem of counterfeit goods? Let me answer that in three words. Out of control. In only 10 years, my company has conducted over 9,000 intellectual property investigations that have resulted in the recovery and seizure of over $1 billion worth of counterfeit and pirated merchandise.

Over the past 10 years, our investigations have helped law enforcement arrest over 3,000 people for counterfeiting and piracy. There is no end in sight. My business continues to grow.

I would like to show a short video that illustrates the problem, with your permission.

[A videotape was played.]

Mr. BUCKNER. What you are looking at here is a search warrant getting served at an embroidery factory that contained two sophisticated embroidering machines that were embroidering counterfeit clothing. Each of those machines is worth about $250,000.

What you are looking at now is video footage of an LAPD search warrant of a warehouse that contained counterfeit handbags. The operator, who was subsequently convicted of trademark counterfeiting, advised law enforcement that he was making $30,000 cash per week in this business and had retired from a nine-to-five job at Northrup because this was so lucrative.

What you are looking at now is a DVD lab that is manufacturing counterfeit and pirated movies. Those are finished movies there that you are looking at. This lab has the capability of manufacturing tens of thousands of counterfeit movies per week, and those are the computer tower burners that are used to manufacture the movies themselves.

The counterfeiting problem is not just limited to handbags, watches, and other luxury goods. I have been involved in cases involving DVD movies, music CDs, glue, children's toys, sunglasses, food items, computer equipment, toner products, and numerous other items. I have also seen cases where brake pads, aircraft parts, baby formula, and even cough syrup have been counterfeited. You name it and criminals can and will counterfeit it. As long as counterfeiters are making money, they do not care who they hurt or kill.

Most brand owners go to great lengths to combat the problem. One of the ways in which they do this is hire people like me to serve cease and desist notices on people we know are engaging in the sale of counterfeit merchandise. I have served thousands of these notices.

In my hand is what we call our subject book. This is just one of five such binders, all of which are as big or bigger than this one, that are kept in my office. These binders all contain photographs

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of people that we have served with the cease and desist notices. Ninety percent of these vendors continue to sell counterfeit merchandise, even after we advise them what they were doing was illegal. They continue their operations because of the large amount of money that they make.

And make no mistake about it, counterfeiting is profitable. I have participated in multiple law enforcement operations in which huge sums of cash have been recovered. During one such raid, officers found over $370,000 in cash in a decrepit warehouse. That money was just some of the profits enjoyed by a subject who had merely been selling counterfeit blankets.

Some counterfeit goods are manufactured in the United States. While assisting law enforcement, I have seen California factories involved in the large-scale manufacture of counterfeit merchandise. I have been involved in cases in which owners of factories routinely locked employees inside the manufacturing facilities. Law enforcement had to call the fire department, which used the Jaws of Life to cut open the doors and free the employees. If there had been a fire, the employees would have died. Counterfeiters valued cash more than human life.

The vast majority of counterfeit merchandise is manufactured outside the United States in countries like China, South Korea, Taiwan, and Mexico. The merchandise is often manufactured under unsafe conditions, and there have been cases where counterfeiters used child labor to make products.

Counterfeiters often smuggle goods into the United States. Several times, I have come across brand-name counterfeit handbags sewn inside the linings of generic handbags. Once the generic handbags pass Customs, counterfeiters cut open the generic handbags and remove the counterfeit ones.

Lieutenant Stedman is going to show us a perfect example of one of these bags I just spoke about, where you look at the outside and it looks like a generic, non-descript handbag. But you cut open the lining of the bag and you will see what is inside. And inside, you have the counterfeit. It may seem like a lot of work to smuggle counterfeit handbags, but keep in mind that a counterfeiter can make approximately $500,000 in cash per container.

It is wrong to think that counterfeit merchandise is only sold on the street corners. Counterfeit merchandise regularly ends up in all types of stores, including large chain department stores, hotel gift shops, upscale boutiques, swap meets, flea markets, and other retail locations.

There is a shopping district in Los Angeles called Santee Alley, where counterfeit merchandise is openly sold. On any given day, there are over 75 vendors in Santee Alley selling all kinds of counterfeit merchandise.

I am frequently asked whether I believe organized criminal groups engage in the sale of counterfeit and pirated merchandise, and my answer is yes. Sometimes, an organized counterfeiting operation profits primarily from the sale of counterfeit goods, whereas in other instances, counterfeiting is just another revenue stream for the criminal syndicate.

In Los Angeles, the various criminal groups profiting from the sale of counterfeit goods are extremely well organized. They hire

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lookouts, utilize countersurveillance techniques to track my employees' activities and the activities of law enforcement. The groups use two-way radios and have also developed an elaborate warning system to alert vendors of impending enforcement actions.

During heavy enforcement periods, counterfeiters have placed lookouts near the Los Angeles Police Department's Central Division to monitor the movements of law enforcement. Counterfeiters have surveiled my team of investigators. They have also been spotted surveiling our office location. During counterfeit goods raids, I found lists containing the names of my employees, their physical descriptions, descriptions of our company vehicles, and license plate numbers.

Counterfeiters are making so much money that they will do anything to disrupt our efforts. My investigators have been assaulted by counterfeiters. Counterfeiters have slashed the tires of our vehicles. A counterfeiter injured one of my investigators when he broke out the window of the investigator's vehicle while the investigator was driving it.

There is clear and convincing evidence that street gangs have begun to profit from the sale of counterfeit merchandise on the streets of Los Angeles. Not only do the gangs place their soldiers on the street to sell pirated movies and music, they attack other street vendors who want to sell counterfeit merchandise on their turf. It only stands to reason, then, that the proceeds from the sale of counterfeit goods are used to buy guns and drugs.

More and more organized criminal groups are engaging in the sale of counterfeit merchandise to raise money. The great profits and the limited risk of prosecution make it an extremely attractive enterprise. For these criminals, it is simply a matter of business. They get caught selling drugs, they go to prison. They get caught selling counterfeit goods, they get probation.

I am also frequently asked if terrorist groups profit from the sale of counterfeit goods. I do not know the answer to that question. What I do know is that while working with law enforcement to conduct counterfeit goods raids, I have been in homes and businesses in which photos of Hezbollah Sheik Nasrallah have been prominently displayed. On several occasions during these same raids, I have heard subjects make anti-Israeli and anti-Jewish statements. I have also observed evidence indicating that counterfeiters send large amounts of money to places such as Lebanon and Paraguay.

My company is hired by major corporations, and I know that many people don't have any sympathy for big businesses. However, the public needs to understand that they are forced to pay higher prices for brand-name products because of counterfeiters. It has been estimated that counterfeiting costs brand owners billions of dollars a year in lost revenue. Brand owners must raise their prices to recoup those losses.

In my opinion, the general public has no appreciation for how many mom-and-pop retail establishments are driven out of business every year by counterfeiters. As everyone knows, there is great demand for brand-name products. How can a legitimate small retailer compete when consumers have the option of buying a $20 pair of generic sunglasses in their store or a $20 pair of brand-

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name counterfeit sunglasses in the store next door? Far too many consumers buy the counterfeit brand-name sunglasses.

Time and again, I receive calls from legitimate small business owners begging me to investigate their counterfeit competitors. These people know that they will quickly be driven out of business if the seller of the counterfeit goods is allowed to continue to operate next door to them. There is nothing more rewarding than receiving a congratulatory phone call from these same small business owners after participating in a counterfeit goods raid with law enforcement.

In closing, I would like to say that although I am not an expert on organized crime and terrorism, I do know how the counterfeit goods operations work, and every day in the course of my investigations, I see things that strongly suggest that terrorist groups are raising funds through the sale of counterfeit goods. The opportunity is there and the indicators are there. The sale of counterfeit goods is not a victimless crime.

I again want to thank the Committee for holding this hearing, and I would like to acknowledge the outstanding efforts of the law enforcement agencies in California, especially the Criminal Investigations Section of the Los Angeles County Sheriff's Department and the Los Angeles Police Department. They understand the importance of aggressively pursuing counterfeiters.

Thank you, and I look forward to your questions.

Chairman COLLINS. Thank you. Dr. Levitt.

TESTIMONY OF MATTHEW LEVITT,[1] SENIOR FELLOW AND DIRECTOR OF TERRORISM STUDIES, THE WASHINGTON INSTITUTE FOR NEAR EAST POLICY

Mr. LEVITT. Thank you, Madam Chairman, Senator Lieberman, and Members of the Committee. I am grateful for having the opportunity to testify before you today.

What I would like to do is to put Lieutenant Stedman's and Mr. Buckner's testimony into context in terms of what Hezbollah's modus operandi is. First, let us understand what Hezbollah is all about. Aside from suicide truck bombings targeting U.S. and French soldiers in Beirut in 1983 and 1984, Hezbollah is also behind the Khobar Towers bombing in Saudi Arabia in 1986, two sets of bombings in Argentina in 1992 and 1994, attempted bombings in Thailand in 1994, attempted attacks in the streets of Singapore, and many other attacks internationally targeting American, French, German, British, Kuwaiti, Bahraini, and other interests worldwide.

According to U.S. authorities, concern over the threat posed by Hezbollah is very well placed. FBI officials have testified that Hezbollah continues to have subjects based in the United States and have the capability to attempt terrorist attacks here should this be the desired objective of the group. Hezbollah continues to surveil U.S. interests internationally and in the United States. Former CIA Director George Tenet testified in 2003 that Hezbollah, as an organization with capability and worldwide presence, is al Qaeda's equal, if not a far more capable organization.

[1] The prepared statement of Mr. Levitt appears in the Appendix on page 41.

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Therefore, anything it is doing to fund its activities should be our concern, and I commend the Committee for holding this hearing in the context of its national security implications.

Iran is believed to fund Hezbollah to the tune of at least $100 million a year. But the group is also believed to engage in all kinds of other fundraising techniques through charities, but perhaps most importantly and most successfully through criminal enterprises, and I would like to focus on that criminal enterprise aspect.

Consider just a few examples, because in the open source world, there is only so much detailed information available to us. But in the Charlotte case that Senator Lieberman mentioned earlier, of which I was the government's expert witness, law enforcement authorities were able to trace half-a-million dollars through various accounts tied to the cell members. They believe most of the funds, however, remained in cash. There was approximately $1.5 million to $2.5 million in profit made on $8 million of cigarettes that were smuggled. Of this, tens of thousands of dollars—some investigators still maintain it may be closer to hundreds of thousands of dollars—were never found and are suspected of going to Hezbollah beyond the funds that they can demonstrate went to Hezbollah.

U.S. officials believe a substantial portion of the estimated millions of dollars raised by Middle Eastern terrorist groups in the United States comes from the $20 million to $30 million annually brought in by the illicit scam industry here in the United States. Of the Middle Eastern terrorist groups present in the United States, Hezbollah is far and away the most criminally oriented, and so we need to assume that the vast majority of that activity is being carried out by Hezbollah cells in this country, and there are several.

In South America in the tri-border area, it is especially important to Hezbollah. There are criminal enterprises. The group there raises close to $10 million a year, according to a study by the U.S. Naval War College. According to that report, U.S. Southern Command estimates that the Islamist terrorist groups, including Hezbollah, raised between $300 million and $500 million per year in the Triple Frontier and the duty-free zones of the Iquique, Colon, Maicao, and Margarita Islands.

Hezbollah also raises tremendous amounts of money through foreign expatriate remittances, and this is also tied to criminal activity. For example, in 1988, Lebanese expatriots in Senegal attempted to smuggle approximately $1.7 million to Lebanon. At the time, the local community claimed that the smuggling operation was not intended to fund Hezbollah but merely to evade Senegalese law. It appears that it was intended to both evade Senegalese law and finance Hezbollah. Israeli intelligence, according to one Israeli report, ranks Senegal as the second most important center in Africa for Hezbollah financing after the Ivory Coast.

Similar activity has been documented in South America, where Hezbollah funds are raised through criminal enterprises and then sent back to Lebanon as foreign remittances, or under the cover of foreign remittances.

A senior U.S. law enforcement official noted that, "there is a significant amount of money moved out of the United States attributed to fraud that goes to terrorism." The most outstanding case

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that we know about is the case in Charlotte, North Carolina, where two brothers, Mohammed and Chawki Hamoud, led a cell in Charlotte, North Carolina, with a parallel part of the network in Canada. Investigators reviewed over 500 bank, credit card, and other financial accounts.

Some members used multiple identities. For example, they would simply buy-out the identity of Middle Eastern students who had been studying at the University of North Carolina-Charlotte and use those legal identities under the names like Ali Abu Sala or Hassan Shavski. They had several legitimate driver's licenses, INS work authorization cards, Social Security numbers. Each of these individuals had multiple identities. Said Harub, one of the cell members who turned evidence against his fellow cell members, had three legitimate driver's licenses, over a dozen other I.D.'s with which he established credit and busted out that credit at the $150,000 limit and then did it over and over again.

The bottom line is that every member of this cell, this network, entered the country illegally, stayed here illegally, committed crimes while they were here, and sent the proceeds back to Hezbollah.

In Canada, where the network procured dual-use technologies, like night-vision goggles, for Hezbollah, some of the material was bought with funds that were sent from Lebanon. Some of the material, however, was bought through credit card scams. And to make matters worse, Hezbollah would still pay the cell members 50 cents on the dollar so that they made profit on the material that they were procuring for Hezbollah. It is a typical modus operandi for Hezbollah, where individual cell members are often out for the money, which is one of the reasons they are so interested in criminal activity.

In a particularly disturbing case, the Canadian part of the network talked about—there is no evidence that it actually did—taking out life insurance policies for suicide bombers in Southern Lebanon—this was just before the Israeli withdrawal in 2000—taking out life insurance policies for suicide bombers who would then attack Israelis and then cashing in those life insurance policies in Canada.

Hezbollah and other terrorist groups also traffic narcotics in North America. A DEA investigation into a pseudoephedrine smuggling scam in the American Midwest led investigators as far as Jordan, Yemen, Lebanon, and other Middle Eastern countries, including bank accounts tied to Hezbollah and Hamas. Then-DEA Chief Asa Hutchinson confirmed that a significant portion of some of the sales are sent to the Middle East and used to benefit terrorist organizations.

In South America, Hezbollah operatives engage in a wide range of criminal enterprises to raise, transfer, and launder funds in support of their terrorist activities. In one case, Paraguayan officials arrested Ali Khalil Mehri, a Hezbollah operative, for selling millions of dollars in pirated software and funding Hezbollah with some of the profits.

Assad Barakat, one of the most important Hezbollah operatives in South America, not only served as a treasurer for Hezbollah, but was also involved, according to their investigation, in a counter-

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feiting ring that distributed fake U.S. dollars and generates cash to fund Hezbollah operations. He personally cleared contributions to Lebanon for Hezbollah.

Hezbollah operatives also run otherwise legitimate business enterprises that function as shell companies or fronts for raising, laundering, and transferring large sums of money. For example, the Charlotte cell members used some of the money they raised to buy a BP gas station, funded in part with a loan from the Small Business Administration. Mohammed Hamoud, the cell leader, wondered to his wife at the time what kind of background investigation would be required, and when she asked why he was so concerned, he said, "There are some things about me you are better off not knowing."

According to Israeli officials, Hezbollah operatives run several Western Union offices in Lebanon and use the co-opted services of others worldwide. In some cases, they actually run the offices and skim some of the 7 percent service fee charge, which they split between themselves as profit and for Hezbollah.

In at least one case in the United States involving Western Union, in January 2002, a case in Burbank, Illinois, three Middle Eastern men sent hundreds of thousands of dollars to Turkey, Germany, and the United Arab Emirates. There is no known terrorist link to that investigation, though it was never fully investigated and it remains an open question.

According to a former senior law enforcement official, and I quote, "Hezbollah is very criminally oriented for its fundraising in the United States, including legitimate and illegitimate business activities." Despite all the money the group receives from Iran, Hezbollah activists in the United States are believed to be self-funding, mostly through criminal enterprises, including counterfeit goods.

The extent of Hezbollah counterfeit activity in South America, of which we know a great deal, combined with the group's known presence in this country and its predilection for engaging in fraud and other criminal activity in this country, point to the group's likely deep involvement in counterfeit activity in the United States.

I thank you for having me here to testify and I look forward to answering any questions you may have.

Chairman COLLINS. Thank you for an excellent statement.

I want to thank all of you for adding to our knowledge of this important subject. When most consumers look at counterfeit goods, such as those displayed on the table, I think they believe, oh, it doesn't matter if it is fake. It is kind of fun to have one and I am going to buy it. I hope through this hearing today that we can help increase public awareness of just what the consequences are of buying counterfeited goods, that it isn't some kind of lark, but rather that the proceeds not only harm legitimate businesses and their workers, but even more troubling, are being used for criminal and terrorist activities. So one of the reasons I wanted to hold this hearing is to try to get consumers to think twice before purchasing counterfeited or pirated goods.

Dr. Levitt's statement talked about Hezbollah targeting Americans around the world, and indeed, the 9/11 Commission found that prior to the attacks on our country by al Qaeda on September

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11, that Hezbollah was responsible for killing more Americans than any other terrorist group.

Lieutenant Stedman, you noted in your opening statement that one of the individuals you arrested for the sale of counterfeit goods had a Hezbollah logo tattooed on his arm, and you pointed to the picture, which we have blown up. Could you walk us through what is on the tattoo, since many of us are not familiar with the symbols and the Arabic script?

Lieutenant STEDMAN. I had the Arabic examiner for the Sheriff's Department take a good look at it and this is what he interpreted to me. The bottom script, underneath the green, in the Arabic writing would be translated as "The Islamic Revolution of Lebanon," and you have the upraised arm, fist, holding the assault weapon. The script above that was translated as saying "Hezbollah are the Winners," and then the dome you see at the top is a temple mount or—the disputed dome in Jerusalem. Pretty much, that is the same picture, Hezbollah logo that you see on the flags and all the other paraphernalia that we run across.

Chairman COLLINS. And you have also found, I understand, audio tapes that contain the speeches of Hezbollah's leader. Is this an isolated occurrence, or have you seen this evidence and audiotapes during other raids on counterfeit operations?

Lieutenant STEDMAN. We have seen those on numerous occasions, both in the residences that we go to and the businesses. I have seen thousands of those tapes all over.

Chairman COLLINS. You have seen thousands of those tapes?

Lieutenant STEDMAN. Yes, ma'am.

Chairman COLLINS. Dr. Levitt, you mentioned that Hezbollah is operating in the United States in cells. What do you think are Hezbollah's objectives in the United States?

Mr. LEVITT. Hezbollah, like Hamas and most other groups in this country, with extended continued presence in this country, take advantage of the freedoms in this country and use the United States primarily as a cash cow to engage in fundraising through charities and, of course, as we have discussed today, through criminal activities.

I should note that in the Charlotte case, it was the same exact thing, tremendous amounts of Hezbollah material were found all over the place.

The FBI has testified before Congress in the past, however, that Hezbollah operatives are also known to surveil potential targets in this country. The FBI has assessed that those activities are primarily used to vet new recruits, but the fact is that they then have that surveillance report available for off-the-shelf use, and the FBI has also testified, as I mentioned earlier, that Hezbollah has the capability to conduct attacks, should it be their desire to do so. So it is a tremendous concern to us.

We know that Richard Reid, for example, the infamous shoe bomber, was sent on a similar vetting mission, including going to Israel and other places, and that his report was found in Afghanistan. That report was available to al Qaeda later should they want to use it for attacks, as Hezbollah would be able to use vetting reports, reports from vetting operations where new recruits are asked to surveil targets here.

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Chairman COLLINS. Mr. Buckner, you have mentioned that you have an excellent partnership with law enforcement, and that is obviously critical. Have you learned during the course of your investigations whether individuals that you are looking at for intellectual property crimes are also the subject of investigations by other law enforcement groups, particularly the FBI?

Mr. BUCKNER. Yes, ma'am. On numerous occasions when we have conducted even civil enforcement actions at a location, I have received several calls from the FBI asking me about our activities and what we were doing at locations, and this has happened to us numerous different times.

Chairman COLLINS. Have you seen any evidence of wire transfers to Lebanon?

Mr. BUCKNER. Yes. During my 10 years of doing this, I have seen tremendous amounts of wire transfers going to both Lebanon and Paraguay, it seems like is one of the countries of choice.

Chairman COLLINS. Lieutenant Stedman, what about you? Have you seen evidence of wire transfers and other ways to get funds from the United States from these counterfeit goods to Lebanon and the three-state area in South America?

Lieutenant STEDMAN. My experience has been that—I don't have a lot of experience in the three-state area, but we do see wire transfers, both Western Union and bank transfers, from the States to—I have seen them to Jordan, Lebanon, Syria. They are very common. As Kris said, we see them almost everywhere we go.

Chairman COLLINS. And one final question for the three of you before I yield to my colleague. In addition to educating consumers that by their purchases of counterfeited or pirated goods, they may well be supporting terrorist activities, what more do you think we should be doing to assist law enforcement in cracking down in this area, or beyond law enforcement? What steps would you recommend that this Committee encourage? I will start with Dr. Levitt.

Mr. LEVITT. Perhaps one of the most useful discussions could be about potential punishment for this type of activity. As my colleagues have discussed, there basically is none. In other areas, I know, and there may be in this already, I am not an expert on the legal side, but terrorism enhancements, and if there are not terrorism enhancements for this type of activity, that is something we should definitely consider. It should be.

Senator LIEBERMAN. You mean enhanced penalties?

Mr. LEVITT. Yes, sir. It should be considered a worse crime if you are doing something that is not only illegal but is also supporting terrorism, even if we can't meet the threshold of the material support statute, which has very technical thresholds that need to be met.

The other thing I think we are already well along in doing, and both my colleagues have highlighted this, and in Los Angeles, it certainly sounds like it is working very well, and that is the local law enforcement and FBI JTTF cooperation. Again in the Charlotte case, this started with an off-duty sheriff who came across a case. In that case, however, there was not direct communication with the FBI at that time. It is only when they went to the U.S. Attorney's Office with their case. Then the FBI came to the U.S. Attorney's

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Office and said, do you see this slide? They said, yes, that is our cigarette smuggling ring. And then they showed them another slide of identical people and said, well, this is our Charlotte Hezbollah cell, and they decided at the U.S. Attorney's Office level to make this much more than just a smuggling fraud case.

If we can get the cooperation at a much lower level, like Lieutenant Stedman said is common in his jurisdiction, I think we can do a lot more to prevent this activity.

Chairman COLLINS. Thank you. Those are very helpful suggestions.

Mr. Buckner.

Mr. BUCKNER. I think public education is the most important key, as you stated previously. We have to kill the demand for the counterfeit goods, and we really do have to educate the public on where the proceeds go and that it is not a victimless crime. Though I represent the brand owners and that is how I make my living, there are a lot of mom-and-pop retail folks out there that are trying to make a living that get killed by the counterfeiters out there.

Chairman COLLINS. Thank you. Lieutenant Stedman.

Lieutenant STEDMAN. I agree with what both of my colleagues have said. I would only add that we have had some contact with the Department of State, and this is way out of my realm of expertise, but some pressure put on the countries that are manufacturing all these goods, specifically in my experience China, would be helpful, to stem the flow at the other end.

Chairman COLLINS. That is another good suggestion. Thank you very much. Senator Lieberman.

Senator LIEBERMAN. Thanks, Madam Chairman. Thanks to the witnesses. Your testimony has been excellent, I think.

Let me ask you a few factual questions just to make sure I am clear of how this is happening, and to go really to the beginning of the counterfeiting operations themselves. This is not the kind of stuff that you can do in your living room or your basement. I mean, I suppose if you had enough sophisticated equipment, you could, but what I am saying is it is real manufacturing. You have got to have the semblance of a business.

So my question is, who is doing it at that level? Are these just entrepreneurs here in the United States or Asia or other parts of the world, or is there organized criminal involvement at the level of the counterfeiting itself? I will start with anybody. Mr. Buckner.

Mr. BUCKNER. In regards to certain different types of counterfeit goods, whereas DVDs and CDs can be mass produced in a small apartment—in fact, in my experience in Los Angeles, most of the labs that we come across are based out of small apartments.

Senator LIEBERMAN. Right. Though as you said, or somebody did, you still have to have a pretty expensive set of equipment to do it.

Mr. BUCKNER. Yes, sir. You are probably looking at about $10,000 worth of computer towers, printers, things of that nature, and you can really set up a nice operation that can——

Senator LIEBERMAN. Actually, that is relatively inexpensive compared to the profit. I guess I was thinking about the quarter-of-a-million dollars that was the other video.

Mr. BUCKNER. Yes, the different goods will dictate how your operation needs to be set up. An embroidery factory, as we saw in the

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videotape, you do need a warehouse-type facility to house those machines and it takes a large-scale operation.

Senator LIEBERMAN. So my question really is, who are those people here and other places around the world? Are they just unethical business people, or does organized crime get in at that level, at the manufacturing level?

Lieutenant STEDMAN. Our experience has been that the people that are involved in importing these goods, which is most of my business, the importation, they have been doing this for a lot of years. The community in Los Angeles has been around for probably 20 or 30 years in the garment district. My grandmother and my mother used to shop down there. These people have been importing textiles for years and years, and from the same companies that are dealing the counterfeits and the same countries.

Senator LIEBERMAN. So it is not clear whether there is organized crime involved in the manufacturing.

Lieutenant STEDMAN. That is outside my realm of expertise. I know there is once it gets here.

Senator LIEBERMAN. Dr. Levitt, do you have any information on that?

Mr. LEVITT. I don't have any information on the extent of it in this country. My sense is that it is likely, coming from production in China or elsewhere, and if there are then, as you saw in the videos, selling it here. What we do know, there is a lot more information on what goes on in South America and the likely trends may be parallel. In South America, Hezbollah operatives are deeply involved in import-export companies.

Senator LIEBERMAN. Right.

Mr. LEVITT. They are deeply imbedded in the free trade zones in Iquique and Maicao——

Senator LIEBERMAN. Where there is manufacturing going on, or is that more the export-import?

Mr. LEVITT. I don't know if there is manufacturing going on there, but they are then at that level involved in the import-export themselves as opposed to someone else importing it and them just taking and running with it here.

Senator LIEBERMAN. Got it.

Mr. LEVITT. But the software side of it is extremely inexpensive.

Senator LIEBERMAN. Inexpensive?

Mr. LEVITT. Inexpensive.

Senator LIEBERMAN. Right.

Mr. LEVITT. In our think tank, after we have an event, we put it on CD. We send it out to our trustees. We have a tower. It doesn't cost a lot of money. We do it in a couple hours. We produce a whole bunch of these CDs to send out to people who couldn't make the event.

Senator LIEBERMAN. Right. I mean, another question I raise, and I want to pursue it on my time, I want to get on to the subject, is whether legitimate businesses who happen to manufacture pocketbooks or hats are doing this as a sideline.

Mr. BUCKNER. I have had cases where there have been legitimate businesses that have also turned after hours into counterfeiting operations, double-dipping, is what we will say.

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Senator LIEBERMAN. Let me ask you about the distribution chain. You said that these counterfeit goods are not only sold on street corners, etc., but often in stores. Is it your presumption that the merchants who are selling counterfeit goods know that they are counterfeit, or are they being duped?

Mr. BUCKNER. Well, I think your street corner vendors do, but your fixed retail locations, I could name names of some very big chain stores today, which I don't want to do, that have been involved in counterfeiting unknowingly.

Senator LIEBERMAN. Unknowingly?

Mr. BUCKNER. Yes, sir.

Senator LIEBERMAN. So let us now go to the subject of terrorist links. Let me ask the question simplistically. If you are in Hezbollah's cell in Los Angeles or Charlotte and you are looking to make some money to send back to finance terrorist activities, where do you go to begin to connect to the counterfeit ring? How do you do that? How would they do that?

Lieutenant STEDMAN. It is very simple. Like I said, this group down in the Santee Alley—like Kris was talking about—they have been there for years and years. The counterfeiting has been going on for years and years. You could go down there, start as just a part-time employee, and before you know it, you have people driving up to your door with vans loaded full of counterfeit stuff. You don't even have to go search it out. They are going to bring it right to you and you can start business that day.

Senator LIEBERMAN. Well, that is very interesting. So if you are Hezbollah and you are trying to raise money illegally, that is not very complicated to get into the distribution network to get the stuff.

Lieutenant STEDMAN. It is an easy business, not like the drug business, where you would have to be introduced and vetted out and be trusted before you would be able to operate. It is just so rampant that you can set up today and get started.

Senator LIEBERMAN. Let me ask this question. Is there any evidence of direct connections between organized criminal families, let us say, operations, and terrorism? In other words, I don't mean the organized criminal families are involved in terrorism, but is there any evidence of joint activities between, let us say, Hezbollah and organized criminal gangs or organized crime operations?

Mr. BUCKNER. One thing that I can say, I don't know the exact answer to that question, but groups down in Los Angeles who normally may be enemies in the real world will cooperate with the——

Senator LIEBERMAN. Such as?

Mr. BUCKNER. Let us say Israelis, Jewish folks, along with these other groups of people that we are talking about. They will cooperate to make money. They will buy from each other, trade their goods. It is all about the money.

Senator LIEBERMAN. No scruples of any kind. What I was thinking of, you know, there is some significant evidence, suggestion, that there may be cooperation between Latin American drug gangs and terrorists in limited areas, for instance, in helping to smuggle, bring terrorists into the United States. You don't have any evidence of an organized connection between those two.

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We have focused on Hezbollah here. Is there any evidence of any of the other terrorist groups, Middle Eastern or otherwise, benefiting from the sale of counterfeit goods here in the United States?

Mr. LEVITT. Certainly involving criminal enterprises. I don't know the specifics about whether they are involved in counterfeit goods, but we do have evidence not only of cigarette smuggling, but of baby formula and credit card fraud——

Senator LIEBERMAN. By other terrorist groups?

Mr. LEVITT. Yes, groups like Hamas and——

Senator LAUTENBERG. I wonder, Madam Chairman, are we going to have a second round, because then I could jump in here and be out.

Senator LIEBERMAN. I am going to yield to you. I am sorry. I didn't see the clock going.

Chairman COLLINS. We will have a second round if you need additional time.

Senator LAUTENBERG. Yes, and I can get my first one and go.

Senator LIEBERMAN. OK. Very significant answers to the questions and a significant problem. I want to come back on my second round and talk a little bit more about what more we might do to focus attention and action on this problem.

Thanks, Madam Chairman.

Chairman COLLINS. Dr. Levitt, I want to give you a chance, however, to answer Senator Lieberman's question. You started to and mentioned Hamas, I believe.

Mr. LEVITT. Yes, just that we do know, and law enforcement officials tend not to speak open source in great specifics, but they have mentioned Hezbollah, Hamas, and others, is usually the way they put the package together, involved in this type of fraud activity, credit card fraud and all these other things we have discussed. I think it would be naive to assume that they are not involved in the kind of other criminal activity that we are looking at here at the table.

Chairman COLLINS. Thank you. Senator Lautenberg.

Senator LAUTENBERG. Thank you, Madam Chairman.

The thing that occurs to me is that we permit a lot of this to go on by issuing licenses to street vendors who invariably, I think, do tend to carry counterfeit or knocked-off goods, as they call it. I don't understand why the licenses are issued in the streets of New York or Boston or Newark in my State. If they don't issue the licenses to these people, which are competitive with the regular merchants, and the regular manufacturers and merchants are much more able to determine whether or not they are getting counterfeit goods. And then they just do street sweeps. I mean, to me, it is kind of cozying up to the idea and permitting discounted merchandise to be sold in front of very valuable leasehold properties that companies invest in. Do you have any idea on why these permits are issued?

Lieutenant STEDMAN. Our experience is that once the permits are issued, if there is an enforcement action, whether it is a search warrant or maybe a civil action by someone like Kris, the permit may be revoked by the city, but then the next family owner will go get a new permit with a new name and continue business on. So there is——

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Senator LAUTENBERG. There ought to be a look at that.

Mr. Levitt, I want to ask you, how much damage do you think Iran does by its interference in our activities in Iraq? Are they a significant factor, do you know, in providing resources to Iraq, equipment, etc.?

Mr. LEVITT. Officials do believe that Iran is engaged in disruptive activity in Iraq for certain, not only supporting some of the militias that are causing a great deal of damage and loss of life there, but also with reportedly a great number of intelligence operatives of their own. Hezbollah's al Manar satellite television not only includes vitriolic messages of hate against Israel, but also very explicitly against the United States, and that doesn't help, either.

Senator LAUTENBERG. So we must do whatever we can to cut off resources for Iran.

Mr. LEVITT. Yes. Easier said than done, in large part because the oil industry is such that while I certainly think there is an important moral statement to be made by our not participating in funding Iran, someone else is going to step in by the nature of the fundible oil industry and I don't believe that is necessarily going to cause a loss of income to Iran unless it is extremely multi-lateral. And given the nature of international oil business and the price of oil today, there is, unfortunately, always going to be someone out there willing to buy that barrel.

Senator LAUTENBERG. I don't want to ask you to moralize here, but should American companies be particularly outside the circle—I mean, competition for the business, that as an excuse can create all kinds of things. Why don't we grow more opium here? Why don't we get into the business if someone else is going to do it? I don't buy that at all. To me, if help comes for an American company, I think it is treasonous if it goes to Iran and then helps to kill our troops. Every day, you hear the reports about two more, four more being killed, and the number of Iraqis being killed. To me, I think that we have to be—this is a very interesting hearing that we are having, Madam Chairman, and I think it is important.

I think it is important from two standpoints. One is the fleecing of the customers, the penalty for business. But when those funds flow to enemies of our country, and you mentioned, I think, Dr. Levitt, that Hezbollah has surveillance routines existing in our country——

Mr. LEVITT. That is what the FBI says, yes.

Senator LAUTENBERG. Now, are they surveying potential targets for violence against those individuals? Is that part of their scheme?

Mr. LEVITT. The FBI has described it as basically training missions for new recruits, but we need to assume, because this is traditional terrorist modus operandi, that they don't then throw out those reports. Those reports are available to be used as off-the-shelf operational menus should they decide to use them. I don't know what types of targets specifically they are surveiling, but yes, we need to be concerned that there is that possibility.

Senator LAUTENBERG. Well, everyone is very concerned with I.D. thefts. I mean, that then permits lots of funny things to go on. People hide their real identity and adopt those that would get them into places that we don't want them to be.

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I thank you for your testimony, all three of you, but I really think that we have to kind of look inside and make sure that by accident or design, that no American companies are helping Iran, and I will be damned if the reason that we shouldn't do it is because a competitor could come in there. We are either out to protect democracy and lives or we are not. And if we say, well, hey, listen, business comes first, then it is a kind of society I don't think that is good for my family or my friends or my community. Thank you.

Chairman COLLINS. Mr. Buckner, you have concentrated, as has Lieutenant Stedman, on the Los Angeles area and what is going on there with regard to counterfeit goods, but is this a problem throughout the United States? Does it affect smaller cities? Could you give us some idea of the scope of counterfeiting operations in this country?

Mr. BUCKNER. Yes. The counterfeiting problem is widespread throughout the United States. Obviously, in your bigger metropolitan areas, it is more in your face, on the streets of New York, the streets of Los Angeles. But I have worked cases in probably 30 different States, and there are investigators just like me all over the country that do exactly what I do. It is amazing, the scope and the magnitude of the problem.

Chairman COLLINS. Each of you has mentioned that the high profits involved and the ease of getting into counterfeiting makes this activity very attractive to criminals, including terrorists. Is another factor that it is unlikely to be prosecuted? Is there a low risk of these cases actually making their way to the courts? Lieutenant Stedman.

Lieutenant STEDMAN. All of our cases are filed. The priority in Los Angeles is violent crime. There is a lot of violent crime going on, the robberies, rapes, and murders and all that kind of stuff. This, obviously, would take secondary interest to the District Attorneys' Offices because of that. But we have actually had pretty good cooperation from the District Attorneys' Offices. They see the problem. I think because there are units like mine out there starting to do more and more of it, they are realizing the scope of it and we are actually getting pretty good cooperation from the District Attorney's Office.

Chairman COLLINS. I think one of you may have mentioned that if you are a criminal who is dealing drugs, you have a far greater chance of going to prison than if you are selling counterfeit goods, and yet when you look at the implications of these sales for terrorist activities, you may, in fact, be doing more damage even than someone who is peddling drugs.

Mr. Buckner, could you comment based on your experience, is there a low risk of going to prison, a low risk, in fact, of being prosecuted?

Mr. BUCKNER. I have to compliment the L.A. County DA's Office. They really proactively are looking at doing more and more of these cases, but unfortunately, for example, there is a subject that we arrested five different times. On his sixth arrest, he finally is going to State prison. The sixth time, he is now going to State prison.

Unfortunately, what usually happens is guys get probation, and the problem is the profit margin is so huge on this, I don't think

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anybody really realizes that it is worth the risk. If they get arrested one time, get probation, pay a fine, they look at it as a cost of doing business, and that is the unfortunate part.

At the same time, the DA's Office in L.A. County is taking these cases more seriously and filing more cases than they ever have. I think the problem is just really overwhelming.

Chairman COLLINS. Dr. Levitt, do you have any comment on that based on your work? I realize it is a little bit outside of your area.

Mr. LEVITT. Just I completely agree with what they said. We have a problem with being short-staffed, as Lieutenant Stedman said. We do need more resources. Law enforcement is doing a wonderful job, but the problems are immense and there are so many things on their plate.

As Mr. Buckner said, not only terrorists, but criminals realize how profitable this is and many of them, certainly in the case of Hezbollah, they see how successfully they have been able to engage in these activities in other places, particularly in South America, where the laws are even more lax, and they take that assumption here, too. Frankly, they find it to be very similar, probation and a fine. The way Mr. Buckner put it, the cost of doing business, I couldn't have put it better myself. That is exactly how they see it, and frankly, that is all it is.

Chairman COLLINS. That is why I think that your suggestion that we take a look at the penalties and whether there should be an enhanced penalty is a very interesting suggestion and one that I am very interested in exploring further.

Mr. LEVITT. Thank you, and I think that part of the problem is that we all agree that if there were a way to decrease demand, that would be wonderful. But, I don't know, maybe it is the realist in me. There are people with low incomes, there are people who—everybody is looking—this is the United States of America. Everybody wants to get a deal. And so it is going to be very hard, even with great public education, to significantly decrease the demand. I think that is just the reality—which doesn't mean we shouldn't try, and it doesn't mean there aren't things we can do that would make a serious dent.

But I think if we are really serious about this, we have to focus on the supply. Like Lieutenant Stedman said, we have to have the State Department and others focus on countries like China, where this is being done rampantly and being shipped here. We need to focus on vendors who may be doing this, and we need to focus on ways to decrease the supply.

Chairman COLLINS. Thank you. Just one final question for Lieutenant Stedman. You have referred to a particular part of the Los Angeles that is known for this activity. Why not just shut it down? Am I missing something here?

Lieutenant STEDMAN. There are many legitimate businesses down there, people trying to make a decent living, playing by the rules, obeying the laws. I don't know what the percentage would be, but it wouldn't be 20 or 30 percent of the area that is doing this. It is a huge draw for the city. It is huge tax revenue, legitimate tax revenue, but there is a significant counterfeit problem down there. We are doing the best we can, but I think it is—I just

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don't want to shut down the whole area to get rid of a few bad apples.

Chairman COLLINS. Thank you. Senator Lieberman.

Senator LIEBERMAN. Thanks again, Madam Chairman.

You know, it strikes me, as we talk about public education, I know we hear a lot about brand name—from brand name companies involved in a lot of this stuff about cutting back on intellectual property violations around the world, particularly in Asia, but around the world. Maybe I missed it, but—and American companies lose hundreds of—well, I may be overstating it, but a lot of billions of dollars, hundreds of billions, in this operation.

I wonder if it would be worth it for them to launch an advertising campaign which basically says to people, when you buy something—when you buy a counterfeit good on the street, you may be saving a few bucks, but the dollars you are spending may well be going to terrorist groups that are going to use it to kill Americans. That is a strong message, but from all you have told us today, there is some truth to it. I don't know, it is not within your—maybe the Chairman and I can think about how to call on some of the large companies that are really concerned about this problem and suffer from it to try the demand reduction part of it.

Mostly up until now, as I understand it, they have tried the supply reduction, particularly in trade negotiations and diplomatic relations with some of the producer countries, and it obviously hasn't worked very well.

Mr. BUCKNER. One thing I can say about several of the brand owners, they have partnered up with several different magazines and they have put into print and sponsored articles regarding counterfeiting and where the proceeds go and the other implications. And more and more, since I started this business, more and more, I am seeing these companies do press releases and actually interact with the press, where they were scared to interact with the press before, to try to get the message out. But I definitely agree that more needs to be done on behalf of the private sector.

Mr. LEVITT. If I could add——

Senator LIEBERMAN. Yes.

Mr. LEVITT [continuing]. One concern, and that is, again, I think targeting demand is important, but you may recall that there were commercials years ago, post-September 11, about drugs and how purchasing drugs is not only an issue of drugs, it also can finance terrorism.

Senator LIEBERMAN. Yes.

Mr. LEVITT. They were so poorly received by the public and it became a joke, which is the last thing we would want to do. So I am not a marketing expert, but my concern would be that it has to be done, it has to be done properly. I am not sure what the right exact message is——

Senator LIEBERMAN. Because the public thought it was farfetched?

Mr. LEVITT. Yes.

Senator LIEBERMAN. OK. That is something that the marketing and advertising experts at the brand name companies can answer better than I can.

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Lieutenant Stedman, Senator Collins asked a question which raised an interesting point about this problem obviously doesn't only exist in Los Angeles. It exists, I presume, anywhere there is a significant market for counterfeit goods, and that is a lot of places in the United States of America. What is your sense—a quick response, but what is your sense of to what extent others, particularly large urban police departments, or sheriff's offices, have focused efforts on stopping counterfeit sales?

Lieutenant STEDMAN. I know New York had a huge problem. I know they are trying to put a dent in it like we are.

Senator LIEBERMAN. NYPD is on it.

Lieutenant STEDMAN. That is correct. I was in New York over last summer and it was pretty rampant. I mean, my daughter tried to buy a purse and I dissuaded her, but——

Senator LIEBERMAN. Good work. [Laughter.]

Lieutenant STEDMAN. Yes. It was worse than even Los Angeles. It was everywhere, everywhere I walked down the street. But I know in New York, we talk to them often——

Senator LIEBERMAN. That is what I was just going to ask. Do you all communicate on this problem?

Lieutenant STEDMAN. We do. We have connections in most of the major metropolitan areas and we talk about people of interest, and we run across a lot of business records where different businesses are talking to each other, shipping back and forth. There is actually an overland trucking of this material from New York to California in some instances, or by train. So it doesn't just come through the ports of Los Angeles and Long Beach. It comes overland, probably stops along the way. But between New York and Los Angeles, there is a huge transit.

Senator LIEBERMAN. This is obviously a national problem. It is an international problem. So let me ask you now, to what extent in the work that you are doing in Los Angeles you have received cooperation from Federal agencies.

Lieutenant STEDMAN. We receive actually outstanding cooperation from the Customs Service and from——

Senator LIEBERMAN. And this obviously has to do with——

Lieutenant STEDMAN. The ports.

Senator LIEBERMAN [continuing]. The counterfeit goods coming in.

Lieutenant STEDMAN. Yes. They do a great job down there, but I am sure you have been to the port. You know how many containers come in every day. It is really shoveling sand against the tide. We do get great cooperation when we try and backtrack some of the shipments that come in from Customs. We have a great relationship with ICE agents. A lot of these people's immigration status is iffy.

Senator LIEBERMAN. Right.

Lieutenant STEDMAN. And we invite them along with us when we think that might be the case.

Senator LIEBERMAN. So Customs and Immigration, good cooperation. How about Federal law enforcement, like FBI?

Lieutenant STEDMAN. We speak to the FBI often. We deconflict every case that we do, because we never know where we are going or who we are going to be seeing that day. So we have five——

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Senator LIEBERMAN. What does deconflict mean in this case, for the record?

Lieutenant STEDMAN. Deconfliction means that we are not stepping on somebody else's toes.

Senator LIEBERMAN. Another agency that is investigating, you mean?

Lieutenant STEDMAN. That is correct. We have five members of the Sheriff's Department on the JTTF. We clear every investigation through them to make sure we are not stepping in the middle of an investigation that is already going on at the Federal level.

Senator LIEBERMAN. So that, in other words, you may be pursuing a counterfeit goods ring, but somebody else will be pursuing those same people for a terrorist investigation?

Lieutenant STEDMAN. Exactly right. I don't get that information, but I make that attempt to make sure we don't bungle somebody else's investigation by either hitting the suspect too quick or not at all, so we do that on every case that we do.

Senator LIEBERMAN. Dr. Levitt, with your experience at the FBI, can you comment on whether you think the efforts to enforce anti-counterfeiting laws are getting enough attention and are sufficiently coordinated at the Federal level, particularly whether there is a clear sense of coordination between the FBI, Treasury, for instance?

Mr. LEVITT. Well, unfortunately, I really can't, only because I wasn't involved in any of that at the FBI. I was on the counterterrorism and on the intelligence side——

Senator LIEBERMAN. Right.

Mr. LEVITT [continuing]. And that would have primarily been run through the Criminal Division. But I do know from my interaction with FBI officials and Treasury officials now that there is a tremendous amount of attention being given not only to this issue substantively, but to the nature of the cooperation. I think there is still some ways to go, but I am actually very pleased at the kind of attention that people at very senior levels are giving to making sure that the interconnectivity and the cooperation is improving.

Senator LIEBERMAN. That is encouraging.

One last question. I am curious, a couple of times Paraguay has been mentioned. What is going on in Paraguay?

Mr. LEVITT. Paraguay, Brazil, and Argentina, where those three countries meet is the triple border, or the tri-border area. Asuncion is a very big problem, and you can cross that border with great ease. It is beautiful. A very famous waterfall is there.

Senator LIEBERMAN. Right.

Mr. LEVITT. A great tourist attraction. And if there is ever any counterfeit good that you could ever imagine, it is there, and——

Senator LIEBERMAN. Manufacturing is going on there, or——

Mr. LEVITT. I don't know that there is manufacturing going on there.

Senator LIEBERMAN [continuing]. Or sales?

Mr. LEVITT. My sense is that it is all sales and that it is—basically, imagine this neighborhood in Los Angeles times I don't know how many——

Senator LIEBERMAN. So what you are saying is that there is reason to believe that there is at least a Hezbollah presence there——

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Mr. LEVITT. We know there is a Hezbollah presence there. There is a Hamas presence there. It is a very serious problem. It is getting a lot of attention.

Senator LIEBERMAN. Thank you. Thank you, all three of you. You have really been excellent, and I hope we can take it from here.

Thanks, Madam Chairman.

Chairman COLLINS. Thank you, Senator.

I want to thank our witnesses today for their fascinating and well-informed testimony. It was very helpful.

We have had success in this country in shutting down some of the formal mechanisms, the financial mechanisms that terrorist groups have been using as well as closing down certain Islamic charities that have been used as conduits for terrorists to finance their operations. But as today's hearing shows, each time one avenue is closed down, another one is exploited by ever-resourceful terrorist groups, and counterfeiting, because it is extremely lucrative and easy to get into, is the mechanism that terrorist groups have discovered and are exploiting.

I want to thank you for increasing our knowledge of this, and I hope this hearing will help promote better public awareness, as well, which I agree with Mr. Buckner is a key part of the solution in addition to looking at enhanced penalties, international efforts, and other means of cracking down on this problem.

I want to thank the staff for their hard work on this hearing, and I particularly want to recognize the efforts of Bill Priestap, who is sitting quietly in the corner. He has worked for the Committee for the past 16 months as a detailee from the FBI. He was the one who suggested that we look into this area. He has worked very hard on a whole host of issues, but particularly the terrorism financing issues, and his work has been outstanding.

I am very sad to have him go back to the FBI, but I do appreciate the Director allowing us to have him for more than a year's time and we very much appreciate the new role that he is going to be taking on at the Bureau in the new Intelligence Office. I would note, he starts his new job next week, so he is not even taking any time off between assignments.

So, Bill, thank you for all your hard work, and we wish you well and will miss working with you.

The hearing record will remain open for 15 days.

I do want to announce that the Committee will be having a very brief business meeting after the first vote to act on some pending nominations, including that of Phil Perry, who has been nominated to be the General Counsel of the Department of Homeland Security.

This hearing is now adjourned.

[Whereupon, at 11:14 a.m., the Committee was adjourned.]

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APPENDIX

United States Senate
Committee on Homeland Security and Governmental Affairs

Testimony of John C. Stedman , Lieutenant
County of Los Angeles Sheriff's Department
Leroy D. Baca, Sheriff
May 25, 2005

"Counterfeit Goods: Easy Cash for Criminals and Terrorists"

My testimony today will address the enforcement efforts of the Los Angeles County Sheriff's Department regarding Intellectual Property Right (IPR) crimes and the involvement of organized crime groups operating in Los Angeles County.

My experience with IPR crimes dates to the late 1980's when my unit was approached by members of the Latin American Music Association. They were experiencing large revenue losses due to the proliferation of unauthorized and illegal duplication of music onto cassette tapes. The Music Association was seeking cooperation from local law enforcement to enforce a State of California statute that makes it a crime to illegally duplicate copyrighted or trademarked materials. Over the next two years, my unit investigated dozens of these cases resulting in the seizure of hundreds of thousands of cassette tapes and incarceration of many suspects.

With the advent of the video-cassette rental business during the same time period, we began to see the illegal duplication of motion pictures as a high-return, low risk, criminal enterprise. During the 1990's, The Motion Picture Association of America (MPAA) also requested the services of local law enforcement to enforce the same copyright or trademark statutes of California. Detectives under my supervision completed many of these investigations seizing thousands of illegally duplicated motion pictures. Many of these videos were of films not yet released to the theaters.

In 2003, I was assigned to supervise the Criminal Investigation Section of the Emergency Operations Bureau. It was at this time that I gained a full realization of the pervasiveness of IPR crimes in Los Angeles County. We concentrated our investigative resources on IPR crimes and have uncovered significant organized criminal enterprises operating within Los Angeles County. Victims of these organized criminal groups include the tobacco industry, luxury goods manufacturers, clothing companies, and the music and motion picture industries. Information in open sources indicates that across the globe anything that has a decent profit margin is being counterfeited. Items such as motorcycles, auto parts, memory chips, software, consumer electronics, and of most concern, pharmaceuticals, are being manufactured.

While there are no local statistics on the magnitude of the problem, I can relate what my small team of one sergeant and six investigators has accomplished in little more than one year. We have served 60 search warrants which have yielded 125 arrests and 16 million dollars in seized counterfeit products. An additional 3.5 million dollars in cash has been seized and is currently in forfeiture proceedings.

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Within the Sheriff's Department there are units designated to combat organized criminal enterprises and we are represented on nearly every task force created to investigate these groups. These units have similar experiences with IPR investigations, noting that the profits are enormous with minimal criminal exposure. Russian Organized Crime, Eurasian Organized Crime, Asian Organized Crime and Lebanese Organized Crime groups all profit from IPR crimes. Additionally, we believe that there may be a trend developing for local gang involvement in IPR criminal activity. Recently, we have investigated several individuals who have strong gang ties and extensive criminal records. During interviews, these suspects have admitted that IPR crime is attractive because of the high profit and minimal jail sentences. In the parlance of one suspect, "It's better than the dope business, no ones going to prison for DVDs."

There are also indicators that some associates of terrorist groups may be involved in IPR crime. During the course of our investigations, we have encountered suspects who have shown great affinity for Hezbollah and its leadership. The following are just two examples: during the search of a residence pursuant to an IPR related search warrant, I saw small Hezbollah flags displayed in the suspect's bedroom. Next to the flags was a photograph of Hassan Nasrallah whom I recognized as the leader of Hezbollah. The suspect's wife asked me if I knew the subject of the photograph. I identified Nasrallah and the wife said, "We love him because he protects us from the Jews". Also in the home were dozens of audio tapes of Nasrallah's speeches. During the search, one of my detectives also found a locket which contained a picture of the male suspect on one side and Sheik Nasrallah on the other.

In 2004, detectives served an IPR search warrant at a clothing store in Los Angeles County. During the course of the search, thousands of dollars in counterfeit clothing was recovered as were two unregistered firearms. During the booking process, the suspect was found to have a tattoo of the Hezbollah flag on his arm.

Also in 2004, detectives served a multi-location IPR related search warrant. During the course of the investigation, detectives located a photo album. Within the photo album were dozens of pictures of attendees at a fund raising event for the Holy Land Foundation. When questioned about the album, the suspect said that the Holy Land Foundation was not a terrorist funding operation. When I informed the suspect that the United States government had shut down the charity because of its alleged support of Hamas, the suspect replied that the United States government was stupid and would do anything the Jews told them.

When confronted with these indicators, we pass the information immediately to the Los Angeles Joint Terrorism Task Force (JTTF) for further review. As a result of this kind of information sharing, we enjoy an outstanding relationship with the JTTF as well as with the other three FBI offices located in Los Angeles County.

As I have stated, the financial rewards of IPR crimes are immense. Many times the biggest issue for the criminal or his group is how to disperse the money generated from the crimes committed. It is difficult to use traditional banking practices to account for the huge profits generated. In one of our cases, we discovered over $800,000 in cash located throughout the

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suspect's residence, hidden in trash bags under beds, stuffed in trash cans, and stashed in the attic. In fact, more than $10,000 was found in a child's piggy bank. On other occasions, we have seen activity consistent with money laundering and structuring occurring between similar businesses.

Another of our cases began with the stop of a suspect at LAX by U.S. Customs Officers. Strapped to the suspect's body was more than $230,000 in cash. The suspect told the Customs Officers that she was enroute to Lebanon for "vacation." Information was developed that the suspect owned a chain of cigarette shops. Service of search warrants led to the seizure of more than 1,000 cartons of counterfeit cigarettes, an additional $70,000 in cash as well as wire transfers to banks throughout the world.

The financial cost of IPR related crimes to the State of California is significant. As an example my small team has seized about 40,000 cartons of counterfeit, untaxed, cigarettes. The California State Tax on cigarettes is eight dollars and seventy cents per carton, representing a loss to the State of $348,000. It should not be a surprise to anyone that suspects involved in IPR crime do not concern themselves with paying appropriate taxes whether federal, state or local. Our experience has been that suspects claiming twenty or thirty thousand dollars on their income tax forms routinely keep tens of thousands of dollars in cash at their homes.

The World Customs Organization estimates counterfeiting accounts for lost sales to legitimate companies worldwide at over 500 billion dollars. The United States accounts for nearly $300 billion of this total. Official estimates are that between five and seven percent of products produced worldwide are counterfeit. Despite these numbers, large, multi-national corporations, big tobacco, and the pharmaceutical industry are not generally seen as sympathetic victims; retail purchasers seek out these goods with little appreciation for the ramifications of such a purchase. There must be the understanding that this crime affects all citizens through fraud, the diversion of tax revenue, and the empowerment of the criminal element.

The Los Angeles County Sheriff's Department has, like most local agencies, suffered cutbacks in personnel over the past several years due to severe budget curtailments. There has not been a mechanism to address IPR crimes other than that based on interest from small units or individual investigators. We believe there is a critical void in personnel to mount an effective campaign against the criminal enterprises that utilize IPR as a revenue stream. It is well documented that organized criminal enterprises engage in IPR crimes. There are mounting indicators of the involvement of terrorist groups and their supporters.

In Los Angeles County we believe there should be task force commitment in order to combat this problem. Members of the Sheriff's Department have begun to explore different sources of revenue to fund such a task force in our region. The private sector has shown interest in contributing to such an effort. In fact, the private sector, comprised of manufacturers and companies such as Investigative Consultants, whose president, Kris Buckner, is speaking today, plays a vital role in our enforcement efforts. Without this cooperative public/private sector relationship, the Sheriff's Department, because of limited personnel resources, would quickly be overwhelmed and would not be able to maintain our investigative pace.

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We also believe there should be legislation to enact or increase the levy on containers shipped through the Ports of Los Angeles and Long Beach. These levies would fund intensified IPR enforcement efforts. It is my hope that by drawing more attention to this crime, we can reinforce the American dream of having an idea, bringing it to market, and profiting from its success without interference from the criminal element.

On behalf of Los Angeles County Sheriff Leroy D. Baca, I wish to thank the Committee for this opportunity to represent our County in discussing this important topic.

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Statement of Kris Buckner
President, Investigative Consultants
Before the U.S. Senate
Homeland Security and Governmental Affairs Committee
25 MAY 2005

"Counterfeit Goods: Easy Cash for Criminals and Terrorists"

I would like to thank Chairman Collins, Senator Lieberman, and all other Members of the committee for the opportunity to appear before you today. Intellectual property crime is an important topic, and I am very pleased that the committee is holding this hearing to discuss how intellectual property crime affects our country, including the possibility that proceeds from counterfeiting fund terrorism.

For the record, my name is Kris Buckner. I am the President of Investigative Consultants, a licensed private investigation firm based in Southern California. I have been a private investigator for over ten years, and specialize in investigations involving the manufacture, distribution, and sale of counterfeit goods.

Investigative Consultants began as a single person operation in 1994. The company now employs fourteen full-time employees and several part-time and contract employees. Ninety-five percent of the company's time is spent investigating intellectual property matters, and we currently represent over eighty different brand owners.

The company plays a vital role in the fight against counterfeiting and piracy on behalf of the world famous brand owners we represent. We are the front line for identifying and investigating the counterfeiters and pirates who victimize brand owners. Our efforts include investigating all types of criminal counterfeiters, from small time street vendors to large, highly organized manufacturers, importers, smugglers, and sellers of counterfeit and pirated merchandise.

The job of our company is to work on behalf of brand owners to uncover evidence of counterfeiting activities. When we find concrete evidence that some person or group is substantially engaged in the counterfeit goods market, we contact the appropriate law enforcement agency and provide them with the evidence. If, in the course of their investigation, law enforcement seizes the counterfeit goods, our company assists them, on behalf of the brand owner, in the identification, inventory, and storage of the counterfeit items. In sum, we represent victim companies and assist law enforcement to ensure that counterfeiters are brought to justice.

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The Scope of the Problem

How big is the problem of counterfeit goods? Let me answer that question in three words - "out of control." In only ten years, my company has conducted over 9,000 intellectual property investigations that have resulted in the recovery and seizure of over one billion dollars worth of counterfeit and pirated merchandise. Over the past ten years, our investigations helped law enforcement arrest over 3,000 people for counterfeiting and piracy. Last year, in California alone, our investigations helped law enforcement arrest over 600 people for movie piracy. There is no end in sight - my business continues to grow.

The counterfeiting problem is not just limited to handbags, watches, and other luxury goods. I have been involved in cases involving DVD movies, music CDs, glue, children's toys, sunglasses, food items, computer equipment, toner products, and numerous other items. I have also seen cases where brake pads, aircraft parts, baby formula, and even cough syrup have been counterfeited. You name it, and criminals can and will counterfeit it. As long as counterfeiters are making money, they do not care who they hurt or kill.

Most brand owners go to great lengths to combat the problem. One of the ways in which they do this is to hire people like me to serve cease-and-desist notices on people we know to be engaging in the sale of counterfeit merchandise. In my hand is what I call our "subject book." This is just one of five such binders, all of which are as big or bigger than this, that are kept in my office. These binders contain photographs of vendors that my company has served with cease-and-desist notices. As you can see, the binder contains a massive amount of photographs. Ninety percent of these vendors continued to sell counterfeit merchandise - even after we advised them that what they were doing was illegal. They continue their operations because of the large amount of money they make. And make no mistake about it, counterfeiting is profitable. I have participated in multiple law enforcement operations in which huge sums of cash have been recovered. During one such raid, officers found over $370,000 in a decrepit warehouse. That money was just some of the profits enjoyed by a subject who had merely been selling counterfeit blankets.

Counterfeiting is out of control, and I believe the problem will continue to grow until the public realizes that counterfeiting is not a victimless crime, and until the laws which penalize counterfeiters are strengthened. Keep in mind that counterfeiting is just as, if not more, lucrative than selling drugs. A counterfeiter can sell counterfeit handbags and make as much money as someone selling cocaine. However, today, there is little chance that a counterfeiter will ever see the inside of a prison. We need to do a better job protecting the intellectual ingenuity that has made our country so great. We can no longer allow criminals to so easily profit from the sale of counterfeits.

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How a Counterfeit Goods Operation Works

Some counterfeit goods are manufactured in the U.S. While assisting law enforcement, I have seen California factories involved in the large-scale manufacture of counterfeit merchandise. I have been involved in cases in which the owners of factories routinely locked employees inside the manufacturing facilities. Law enforcement had to call the fire department, which used the "jaws-of-life" to cut open the doors and free the employees. If there had been a fire, the employees would have died. Counterfeiters value cash more than human life.

The vast majority of counterfeit merchandise is manufactured outside of the United States, in countries like China, South Korea, Taiwan and Mexico. The merchandise is often manufactured under unsafe conditions, and there have been cases where the counterfeiters used child labor to make the products.

After counterfeit goods are manufactured overseas, the merchandise is loaded into containers and exported to the United States. Counterfeiters will often pack the counterfeit merchandise in the rear of the container and pack authentic merchandise at the front of the container. Thus, customs inspectors would have to unload the entire container to find the counterfeit merchandise. Once the counterfeit merchandise passes customs, it is taken to warehouses for distribution. The distributors then sell the merchandise to various sized wholesalers and retailers, who, in-turn, sell it to consumers.

Counterfeiters often smuggle goods into the U.S. Several times, I have come across brand-name counterfeit handbags sewn inside the linings of generic handbags. Once the generic handbags pass customs, counterfeiters cut open the generic handbags and remove the counterfeit ones. It may seem like a lot of work just to smuggle counterfeit handbags, but keep in mind that a counterfeiter can make approximately $500,000, in cash, per container.

It is wrong to think that counterfeit merchandise is only sold on street corners. Counterfeit merchandise regularly ends up in all types of stores, including large chain department stores, hotel gift shops, upscale boutiques, swap meets, flea markets, and other retail locations. There is a shopping district in Los Angeles called Santee Alley where counterfeit merchandise is openly sold. On any given day there are over 75 vendors in Santee Alley selling all kinds of counterfeit merchandise.

Do Organized Criminal Groups Engage in the Sale of Counterfeit Goods?

I am frequently asked whether I believe organized criminal groups engage in the sale of counterfeit and pirated merchandise, and my answer is, "yes." Sometimes an organized counterfeiting operation profits primarily from the sale

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of counterfeit goods, whereas in other instances, counterfeiting is just another revenue stream for the crime syndicate.

Sophisticated counterfeiting operations often mirror other sophisticated criminal and terrorist operations. Counterfeiting operations are divided into operating cells, often according to their manufacturing, distributing, or selling functions. By operating in cells, counterfeiters lessen the possibility that their entire operation can be taken-down by law enforcement.

In Los Angeles, the various criminal groups profiting from the sale of counterfeit goods are extremely well organized. They hire look-outs and utilize counter-surveillance techniques to track my employees' activities and the activities of law enforcement. The groups use two-way radios, and have also developed elaborate warning systems to alert vendors to impending enforcement actions. During heavy enforcement periods, counterfeiters have placed look-outs near the Los Angeles Police Department's Central Division to monitor the movements of law enforcement. Counterfeiters have surveilled my team of investigators. They have also been spotted surveilling our office location. During counterfeit good raids, I have found lists containing the names of my employees, their physical descriptions, and descriptions of company vehicles, including license plate numbers.

Because we often act as expert witnesses for the prosecution in counterfeit good cases, counterfeiters have hired private investigators to try to discredit me and my team of investigators. Counterfeiters are making so much money that they will do anything to disrupt our efforts. My investigators have been assaulted by counterfeiters. Counterfeiters have slashed the tires of our vehicles. A counterfeiter injured one of my investigators when he broke out the window of the investigator's vehicle - while the investigator was driving it.

Many groups engaging in the sale of counterfeit goods also sell drugs. We have worked on cases in which counterfeiters were selling powder cocaine, crack cocaine, and marijuana. One individual, who was awaiting trial on a counterfeit goods charge, was arrested by Immigration and Customs Enforcement agents for smuggling drugs from the Middle-East into the U.S. We have also come across counterfeiters in possession of loaded firearms.

There is clear and convincing evidence that street gangs have begun to profit from the sale of counterfeit merchandise on the streets of Los Angeles. Not only do the gangs place their "soldiers" on the street to sell pirated movies and music, they "tax" other street vendors who want to sell counterfeit merchandise on their turf. It only stands to reason then that proceeds from the sale of counterfeit goods are used to buy drugs and guns.

More and more organized criminal groups are engaging in the sale of counterfeit merchandise to raise money. The great profits and the limited risk of prosecution

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make it an extremely attractive enterprise. For these criminals, it is simply a matter of business: if they get caught selling drugs, they go to prison, whereas if they get caught selling counterfeit goods, they get probation.

Do Terrorists Engage in the Sale of Counterfeit Goods?

I am also frequently asked if terrorist groups profit from the sale of counterfeit goods. I do not know the answer to that question. What I do know is that while working with law enforcement to conduct counterfeit good raids, I have been in homes and businesses in which photos of Hezbollah leader Sheik Nasrallah have been prominently displayed. On several occasions during these same raids, I have heard subjects make anti-Israeli and anti-Jewish statements. I have also observed evidence indicating that counterfeiters send large amounts of money to places such as Lebanon and Paraguay.

Is the Sale of Counterfeit Goods a Victimless Crime?

My company is hired by major corporations, and I know that many people don't have any sympathy for "big businesses." However, the public needs to understand that they are forced to pay higher prices for brand name products because of counterfeiters. It has been estimated that counterfeiting costs brand owners billions of dollars a year in lost revenue. Brand owners must raise their prices to recoup these losses.

In my opinion, the general public has no appreciation for how many "Mom and Pop" retail establishments are driven out of business every year by counterfeiters. As everyone knows, there is great demand for brand name products. How can a legitimate small retailer compete when consumers have the option of buying a $20.00 pair of generic sunglasses in their store or a $20.00 pair of brand name counterfeit sunglasses in the store next door. Far too many consumers buy the counterfeit brand name sunglasses.

Time and again I receive calls from legitimate small business owners begging me to investigate their "counterfeit competitors." These people know that they will be quickly driven out of business, if the seller of counterfeit goods is allowed to continue to operate next door to them. There is nothing more rewarding than receiving a congratulatory phone call from these same small business owners, after participating in a counterfeit goods raid with law enforcement.

The public also needs to understand that millions of dollars in tax revenue is lost every year to counterfeiters. Counterfeit good sales are primarily conducted in cash, and sellers of counterfeit goods don't pay governments the sales taxes that are supposed to be generated from the sales of products. With budgets tight, especially in California, the economic cost of the lost tax revenue is staggering.

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In closing, I would just like to say that I am not an expert on organized crime and I am not an expert on terrorism. But, I do know how counterfeit good operations work - I live and breath counterfeit goods. And every day, in the course of my investigations, I see many things that concern me. It only takes common sense to believe that proceeds from counterfeiting benefit terrorist groups. The opportunity is there and the indicators are there. The sale of counterfeit goods is not a victimless crime.

I again want to thank the committee for holding this hearing, and I would like to acknowledge the outstanding efforts of the law enforcement agencies in California, especially the Criminal Investigative Section of the Los Angeles County Sheriff's Department and the Los Angeles Police Department. They understand the importance of aggressively pursuing counterfeiters.

Thank you.

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Hezbollah: Financing Terror Through Criminal Enterprise[1]

Testimony of
Dr. Matthew Levitt[2]
Senior Fellow and Director of Terrorism Studies
The Washington Institute for Near East Policy
May 25, 2005

Committee on Homeland Security and Governmental Affairs
United States Senate

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I. INTRODUCTION: CONSTRICTING THE OPERATING ENVIRONMENT

It is a painful reality that no counterterrorism technique or effort, however extensive, international, or comprehensive, will put an end to terror attacks or uproot terrorism. There will always be people and groups with entrenched causes, an overwhelming sense of frustration, a self-justifying worldview, and a healthy dose of evil, who will resort to violence as a means of expression.

The goal of counterterrorism, therefore, should be to constrict the environment in which terrorists operate so that it is increasingly difficult for terrorists to carry out their plots of destruction and death at every level, such as conducting operations, procuring and transferring false documents, ferrying fugitives from one place to another, and financing, laundering, and transferring funds. This includes cracking down not only on operational cells, but on their logistical and financial support networks as well.

The September 11 attacks drove home the central role logistical and financial support networks play in international terrorist operations. Clearly, individuals who provide such support must be recognized as terrorists of the same caliber as those who use that support to execute attacks.

Since September 2001, America—together with many of its allies—has spearheaded a groundbreaking and comprehensive disruption operation to stem the flow of funds to and among terrorist groups. Combined with the unprecedented law enforcement and intelligence efforts to apprehend terrorist operatives worldwide and thereby constrict the space in which terrorists can operate, cracking down on terrorist financing denies them the means to travel, communicate, procure equipment, and conduct attacks. Though the amount of money frozen internationally remains negligible, the impact of freezing terrorists' assets can be significant if the right accounts, companies, or front organizations are shut down. Denying terrorists access to their preferred means of raising, laundering, and transferring funds complicates their efforts to conduct their activities.

II. BEYOND AL-QAEDA: THE THREAT FROM HEZBOLLAH

However, al-Qaeda is not the only international terrorist network that poses a serious threat. Deputy Secretary of State Richard Armitage identified Hezbollah as "the A team of terrorism," and warned "their time will come, there's no question about it."[3] Semantics aside, such statements are more than just tough talk. Highlights of Hezbollah's record of terror attacks include suicide truck bombings targeting U.S. and French forces in Beirut (in 1983 and 1984) and U.S. forces again in Saudi Arabia (in 1996), its record of suicide bombing attacks targeting Jewish and Israeli interests such as those in Argentina (1992 and 1994) and in Thailand (attempted in 1994), and a host of other plots targeting American, French, German, British, Kuwaiti, Bahraini and other interests in plots from Europe to Southeast Asia to the Middle East.[4]

According to U.S. authorities, concern over the threat posed by Hezbollah is well placed. FBI officials testified in February 2002 that "FBI investigations to date continue to indicate that many Hezbollah subjects based in the United States have the capability to attempt terrorist attacks here should this be a desired objective of the group."[5] Similarly, CIA Director George Tenet testified

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in February 2003 that "Hezbollah, as an organization with capability and worldwide presence, is [al-Qaeda's] equal, if not a far more capable organization."[6]

Still, some maintain that Hezbollah is merely a "resistance" organization responding to Israeli occupation of disputed land. The distinction is, appropriately, lost on most Western experts, given that the "resistance" groups in question employ acts of terrorism such as suicide bombings to achieve their goals and that many of the operatives go back and forth between serving in guerilla units fighting in South Lebanon and international terror cells plotting bombings abroad.[7] In any event, no goal, however legitimate, legitimizes the use of terrorist tactics and the killing of innocent civilians.

U.S. intelligence officials have also expressed concern over possible links between Hezbollah and Abu Musab al-Zarqawi, highlighting the ad hoc tactical relationship brewing between Iran's Shia proxy and the loosely affiliated al-Qaeda network. In September 2003, when U.S. authorities designated Zarqawi and several of his associates as 'Specially Designated Global Terrorist' entities, the Treasury said that Zarqawi not only had "ties" to Hezbollah, but that plans were in place for his deputies to meet with both Hezbollah and Asbat al-Ansar (a Lebanese Sunni terrorist group), "and any other group that would enable them to smuggle mujaheddin [sic] into Palestine."[8] The Treasury claimed that Zarqawi received "more than $35,000" in mid 2001 "for work in Palestine," which included "finding a mechanism that would enable more suicide martyrs to enter Israel" as well as "to provide training on explosives, poisons, and remote controlled devices."[9]

Similarly, while the 9/11 Commission found no evidence that Iran or Hezbollah had advance knowledge of the September 11 plot, the commission's report does note that Iran and Hezbollah provided assistance to al-Qaeda on several occasions. For example, al-Qaeda operatives were allowed to travel through Iran with great ease. Entry stamps were not put in Saudi operatives' passports at the border, though at least eight of the September 11 hijackers transited the country between October 2000 and February 2001. The report also noted a "persistence of contacts between Iranian security officials and senior al-Qaeda figures" and drew attention to an informal agreement by which Iran would support al-Qaeda training with the understanding that such training would be used "for actions carried out primarily against Israel and the United States." Indeed, al-Qaeda operatives were trained in explosives, security, and intelligence on at least two occasions, with one group trained in Iran around 1992, and a second trained by Hezbollah in Lebanon's Beka'a Valley in the fall of 1993.[10]

In the final analysis, whether suspected ties between Hezbollah and global jihadist elements such as Zarqawi and the 9/11 plotters are proved or not, Hezbollah warrants being designated a terrorist group of global reach on the merits of its own activities. The means by which the group finances its vast and varied activities is therefore of paramount concern to U.S. intelligence officials and policymakers.

HEZBOLLAH FINANCES: A SNAPSHOT

Few details are publicly available about Hezbollah's finances. Iran, however, is believed to fund Hezbollah to the tune of at least $100 million per year. Recently, Western diplomats and

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analysts in Lebanon estimated Hezbollah may now receive closer to $200 million a year from Iran.[11]

A few snippets of information are publicly available, providing some measure of insight into the organization's funding activities. Consider the following examples:

- ✓ In the wake of the death of Palestinian leader Yasser Arafat, Hezbollah reportedly received an additional $22 million from Iranian intelligence to support Palestinian terrorist groups and foment instability in Israel, the West Bank and Gaza.[12]

- ✓ Iran was also reported to have financed and established terrorist training camps in the Syrian-controlled Beka'a Valley to train Hezbollah, Hamas, PIJ and PFLP-GC terrorists to use rockets such as the short range Fajr-5 missile and the SA-7 anti-aircraft rocket.[13] According to a report by a "Western intelligence agency," the Iranian training program cost $50 million and included training Lebanese and Palestinian terrorists to carry out "underwater suicide operations."[14]

- ✓ At the time of the founding of Hezbollah's al-Manar satellite television in 1991, the station reportedly received seed money from Iran and had a running budget of $1 million. By 2002 its annual budget had grown to approximately $15 million.[15] Middle East analysts and journalists maintain that most of this funding comes from Iran.[16]

- ✓ According to Arab media reports, in December 2003 Hezbollah lost US$2 million when an aircraft crashed in Africa carrying contributions from wealthy Lebanese expatriates living in Africa.[17]

- ✓ In 2001, Paraguayan police searched the home of Hezbollah operative Sobhi Mahmoud Fayad in Ciudad Del Este, a town along the tri-border area where the borders of Brazil, Argentina, and Paraguay meet. Searching Fayad's home, police found receipts from the Martyr's Organization for donations Fayad sent totaling more than $3.5 million dollars.[18] Authorities believe Fayad sent over $50 million to Hezbollah since 1995.

- ✓ In some cases, the foreign remittances discussed above are funneled to Hezbollah though the group's charities. Members of the Hezbollah cell in Charlotte, North Carolina, received receipts from Hezbollah for their donations, including receipts from the office of then-Hezbollah spiritual leader Sheikh Mohammad Fadlallah.[19]

- ✓ Law enforcement authorities were able to trace half a million dollars through various accounts tied to members of the Charlotte cell, but they believe most of the funds – estimated overall at about $2 million stayed in cash. Of this, tens of thousands of dollars – some officials estimate it may be closer to a few hundred thousand of dollars – were never found.

- ✓ One receipt, signed by Ali Abu Al Shaer, the financial manager of "the office of his Excellency Ayat Allah Mr. Mohammed Hussein Fadlallah," thanked "brother

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Mohammed Hammoud," the subsequently convicted leader of the Charlotte cell, for a $1,300 donation.[20]

- ✓ Hezbollah runs the al-Janoub hospital in the southern Lebanese city of Nabatiyah—one out of a network of some fifty hospitals the group runs throughout the country. The hospital receives $100,000 a month from Hezbollah and is run by Ahmad Saad, the hospital director who is also a member of Hezbollah's "national health committee."[21]

- ✓ Paraguayan officials arrested Ali Khalil Mehri for selling millions of dollars in pirated software and funding Hezbollah with some of the profits.[22]

- ✓ The tri-border area is especially important to Hezbollah, where the group raises close to $10,000,000 a year, according to a study produced by the U.S. Naval War College. According to the report, "U.S. Southern Command estimates that Islamist terrorist groups raise between three hundred million and five hundred million dollars per year in the Triple Frontier and the duty-free zones of Iquique, Colon, Maicao, and Margarita Island."[23]

- ✓ Hezbollah uses money wiring companies like Western Union not only to launder and transfer funds, but to raise money as well. For example, Hezbollah funding to Palestinian terrorist groups in the West Bank is almost entirely transferred via Western Union – including some $3 million over a one year period in 2003-2004 alone. In some cases, Hezbollah activists run Western Union offices and share the profits with Hezbollah.[24]

What is clear is that above and beyond the significant funding the group receives from Iran, Hezbollah raises still more funds – especially through foreign expatriate remittances, charities and front organizations, and criminal enterprises.

FOREIGN EXPATRIATE REMITTANCES

Hezbollah receives significant financial support from the contributions of Hezbollah supporters living abroad, particularly from Lebanese nationals living in Africa, South America and other places with large Lebanese Shia expatriate communities. Hezbollah's main income, according to Hezbollah Parliamentarian Mohammad Raad, comes from the groups own investment portfolios and wealthy Shias.[25]

Take the example of the case of the Union Transport Africaines (UTA) Flight 141, bound for Beirut, which crashed on take-off from Cotonou in Benin, West Africa on 25 December 2003. According to accounts in the Arab press, a "foreign relations official of the African branch of the Lebanese Hezbollah party and two of his aides" were among those killed.[26] Arab press reports also claim the Hezbollah officials were carrying US$2 million in contributions, raised from wealthy Lebanese nationals living in Africa, to the organization's headquarters in Beirut.

Arab media reports regarding the US$2 million that Hezbollah lost in the aircraft crash noted that "this amount represented the regular contributions the party receives from wealthy Lebanese nationals in Guinea, Sierra Leone, Liberia, Benin, and other African states."[27] The fact that

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Hezbollah immediately sent an envoy to Benin "to console the sons of the Lebanese community" indicates the value that the group places on these expatriate communities.[28]

As is the case among all terrorist groups that raise funds under the cover of charitable giving, some donors are defrauded unwittingly into funding terrorism while others are willing participants in Hezbollah's financing schemes. As the Israeli estimate suggests, the transfer of US$2 million at once and by human courier—is remarkable in its audacity. The last known transfer of this size occurred in 1998, when Lebanese expatriates in Senegal attempted to smuggle approximately US$1.7 million to Lebanon.[29] At the time, the local community claimed the smuggling operation was merely an attempt to evade Senegalese law, not to finance Hezbollah. Israeli intelligence, however, ranks Senegal as the "secondary centre for Hezbollah's fundraising activity in Africa" after the Ivory Coast.[30] An Israeli intelligence report focusing on Hezbollah fundraising operations in the Ivory Coast, Senegal, the Democratic Republic of Congo (formerly Zaire) and South Africa estimated that the organization raises "hundreds of thousands of U.S. dollars yearly" on the continent.[31] The sum would be higher had more attempts to smuggle such remittances to Hezbollah succeeded.

Hezbollah supporters living in the U.S. also sent remittances back to Lebanon to fund Hezbollah activities. For example, in Charlotte, NC Hezbollah support networks organized regular parlor meetings held in members' homes where a collection basket was passed around after watching Hezbollah propaganda videos, usually produced by al-Manar.[32]

Similar activity has been documented in South America, where authorities investigating the activities of Hezbollah operative Assad Barakat noted his involvement in "a network of economic financing, that would have as its center of operations Ciudad del Este, Paraguay, which would be sending funds to Lebanon disguised as benefiting the families of victims of the conflict with Israel. It is fitting to mention that the remittances have as their destination relatives fallen in terrorist acts and the economic strengthening of Hezbollah."[33] Argentinean officials express similar concern about Hezbollah activity in Ciudad del Este. Mario Baizan, a former Argentine presidential advisor, described the city as "one of the world's biggest centers for financing of the pro-Iranian militant group Hezbollah."[34]

CHARITIES AND FRONT ORGANIZATIONS

Hezbollah uses charities and front organizations to conceal its fundraising activities, although it is less reliant on charities that groups like Hamas due to its annual subsidies from Iran and significant involvement in criminal enterprises. Take, for example, the al-Aqsa International Foundation, a terrorist front organization banned by the United States, Germany and Great Britain (though not the European Union). While al-Aqsa primarily served as a Hamas front organization, Sheikh Moayad, the head of the al-Aqsa office in Yemen, was arrested in Germany and extradited to the United States for providing financial support to al-Qaeda. Moayad proudly told an undercover FBI informant that he not only funded Hamas but also raised millions of dollars, recruited operatives, and provided weapons to al-Qaeda. According to one report, one of the foundation's offices in Europe also raised funds for Hezbollah.[35]

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The "Martyr's Organization" (Bonyad-e Shahid), headed by Mohammad Hasan Rahimiyan, admittedly supplies charitable funds for the family of suicide bombers. In 2001, Paraguayan police searched the home of Hezbollah operative Sobhi Mahmoud Fayad in Ciudad Del Este, a town along the tri-border area where the borders of Brazil, Argentina, and Paraguay meet. Searching Fayad's home, police found receipts from the Martyr's Organization for donations Fayad sent totaling more than $3.5 million dollars.[36] Authorities believe Fayad sent over $50 million to Hezbollah since 1995. According to press reports, Iran has traditionally funded Palestinian dissident groups in the Lebanese refugee camps, including al Maqdah, through the Institute of the Palestinian Martyrs.[37]

According to a declassified research report based on Israeli intelligence Hezbollah also receives funds from charities that are not directly tied to Hezbollah but are radical Islamist organizations and donate to Hezbollah out of ideological affinity. "Besides operating a worldwide network of fundraisers, funds are also raised through so-called 'charity funds.' Some of these are extremist Islamic institutions that, while not directly connected to Hezbollah, support it, albeit marginally, in view of their radical Islamic orientation."[38] The report cites many such charities worldwide, including four in the Detroit area alone: The Islamic Resistance Support Association, the al-Shahid Fund, the Educational Development Association (EDA) and the Goodwill Charitable Organization (GCO). Also cited are the the al-Shahid Organization in Canada, the Karballah Foundation for Liberation in South Africa, the Lebanese Islamic Association and al-Shahid Social Relief Institution in Germany, and the Lebanese Welfare Committee, The Help Foundation and The Jam'iyat al-Abrar (Association of the Righteous) in Britain.

While some of these funds undoubtedly paid for Hezbollah's military and terrorist operations, other funds enable the group to provide its members with day jobs, to drape itself in a veil of legitimacy, and to build grassroots support among not only Shia but Sunni and Christian Lebanese as well. For example, Hezbollah runs the al-Janoub hospital in the southern Lebanese city of Nabatiyah—one out of a network of some fifty hospitals the group runs throughout the country. The hospital receives $100,000 a month from Hezbollah and is run by Ahmad Saad, the hospital director who is also a member of Hezbollah's "national health committee."[39]

In light of its support from Iran, Hezbollah needs not rely on charities to raise funds as much as other groups like al Qaeda or Hamas. Nonetheless, as Assistant Secretary of State E. Anthony Wayne testified before Congress in September 2003, donating money to charities affiliated with terrorist groups like Hamas or Hezbollah frees up existing monies to support the group's terrorist activities. "If you are funding the organization, even if there are many charitable activities going on, there is some fungibility between funds. You are strengthening the organization."[40] Moreover, such funds are objectionable in their own right when they build grassroots support for terrorist organizations and subsidize the families of suicide bombers.

According to U.S. intelligence officials, "Hizbullah maintains several front companies in sub-Saharan Africa".[41] Little information is available on these purported fronts, though they are widely assumed to include import-export companies (an established terrorist modus operandi). These officials say that many Hezbollah activists in the tri-border region relocated to Africa and other locations as a result of the increased attention drawn to Hezbollah activity after the group's role in the 1992 and 1994 truck bombings in Argentina. In an effort "not to have all their eggs in

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one basket", one analyst adds, some Hezbollah operatives have "moved on" from locations in South America and Europe and set up shop in Africa, Asia and less conspicuous parts of South America.[42]

CRIMINAL ENTERPRISES

Hezbollah depends on a wide variety of criminal enterprises, ranging from smuggling to fraud to drug trade to diamond trade in regions across the world, including North America, South America, and the Middle East, to raise money to support Hezbollah activities. Published reports even suggest that Al-Qaida and Hezbollah have formed additional tactical, ad-hoc alliances with a variety of terrorist organizations to cooperate on money laundering and other unlawful activities.[43]

In the United States, law enforcement officials are investigating a variety of criminal enterprises suspected of funding Middle Eastern terrorist groups, including the stealing and reselling of baby formula, food stamp fraud, and scams involving grocery coupons, welfare claims, credit cards, and even unlicensed t-shirts sales. U.S. officials believe "a substantial portion" of the estimated millions of dollars raised by Middle Eastern terrorist groups comes from the $20 million to $30 million annually brought in by the illicit scam industry in America.[44] Prominent examples include an Arab-American in Detroit caught smuggling $12 million in fraudulent cashiers checks into the United States, and a fitness trainer in Boston accused of providing customers' social security and credit card numbers to Abd al-Ghani Meskini, an associate of Ahmad Ressam, the Algerian convicted of plotting to blow up Los Angeles international airport in 2000.[45] A senior U.S. law enforcement official concluded, "There is a significant amount of money moved out of the United States attributed to fraud that goes to terrorism."[46]

The most outstanding case in North America is the Charlotte, North Carolina, cell run by two brothers, Mohammed and Chawki Hamoud. In June 2002, the Hamoud brothers were convicted of a variety of charges including funding the activities of Hezbollah from the proceeds of an interstate cigarette smuggling ring. Seven other defendants pled guilty to a variety of charges stemming from this case, including conspiracy to provide material support to terrorists, cigarette smuggling, money laundering and immigration violations.[47] Mohammed Hassan Dbouk and his brother-in-law, Ali Adham Amhaz, ran the Canadian portion of this network under the command of Haj Hasan Hilu Laqis (Hezbollah's chief military procurement officer). Their activities were funded in part with money that Laqis sent from Lebanon, in addition to their own criminal activities in Canada (e.g., credit card and banking scams).[48] Among the items that they purchased in Canada and the U.S. and smuggled into Lebanon were night-vision goggles, global positioning systems, stun guns, naval equipment, nitrogen cutters and laser range finders. The Canadian Hezbollah network also sought to take out life insurance policies for Hezbollah operatives committing acts of terrorism in the Middle East.[49] According to a wiretapped conversation with another member of his cell that was summarized by Canadian intelligence, "Dbouk referred to a person down there [in Southern Lebanon] ... who might in a short period of time go for a 'walk' ... and never come back, and wondering if Said [the other cell member] could fix some papers and details ... for him (person) and put himself (Said) as the reference."[50]

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Members of the Charlotte cell entered the U.S. from South America using false documents and through sham marriages carried out in Cyprus. They conducted their activities under multiple identities. Cell members paid indigent Americans to travel to Cyprus at Hezbollah's expense and engage in sham marriages so additional operatives could get visas to come to America.[51]

In South America, Hezbollah operatives engage in a wide range of criminal enterprises to raise, transfer, and launder funds in support of their terrorist activities. These enterprises include, among others, mafia-style shakedowns of local Arab communities, sophisticated import-export scams involving traders from India and Hong Kong, and small-scale businesses that engage in a few thousand dollars worth of business but transfer tens of thousands of dollars around the globe.[52] In one case, Paraguayan officials arrested Ali Khalil Mehri for selling millions of dollars in pirated software and funding Hezbollah with some of the profits.[53] The tri-border area is especially important to Hezbollah, where the group raises close to $10,000,000 a year, according to a study produced by the U.S. Naval War College.[54]

According to the U.S. Treasury Department, Assad Barakat "threatened TBA [tri-border area] shopkeepers who are sympathetic to Hezbollah's cause with having family members in Lebanon placed on a 'Hezbollah blacklist' if the shopkeepers did not pay their quota to Hezbollah via Barakat."[55] The Treasury Department noted that Barakat is reported to be "the deputy to a Hezbollah financial director, Ali Kazan, and the primary liaison in the TBA for Hezbollah's Spiritual Leader Hussein Fadlallah."[56] Barakat not only served as a treasurer for Hezbollah, he was also "involved in a counterfeiting ring that distributes fake U.S. dollars and generates cash to fund Hezbollah operations" and personally couriered contributions to Lebanon for Hezbollah.[57] Barakat's personal secretary, Sobhi Mahmoud Fayad, served as Hezbollah's military leader in the tri-border region. Fayad was arrested at least three times since 1999, including once for surveilling the U.S. embassy in Asuncion.[58]

Hezbollah activities in Latin America, however, are by no means limited to the tri-border area. Chilean officials have identified several import-export companies, primarily located in free trade zones such as the Iquique Free Trade Zone (ZOFRI) in northern Chile, that are suspected as serving as either front organizations or shell companies for Hezbollah. These include Kalmiar Ltd, Bahamas Ltd., Las Vegas Nevada Ltd., San Francisco Ltd., Saleh Trading Ltd., Frankfourt Ltd., Guarany Ltd., Teen Chile Ltd., and Lucky Crown Ltd.[59]

According to Chilean law enforcement officials, "starting in 1980 Lebanese members of Hezbollah have been expanding its presence in South America and continue developing its network of contacts in the Triple Border area."[60] In 1994 and 1995, these officials note, Hezbollah operatives began visiting Chile "to establish a new operational center for the development of their activities since the authorities of the Triple Border countries initiated greater and more rigorous control with respect to the activities of these foreigners, especially the Lebanese, who according to information provided by international security services are associated with terrorist members of Hezbollah."[61] According to a U.S. Naval War College report, "U.S. Southern Command estimates that Islamist terrorist groups raise between three hundred million and five hundred million dollars per year in the Triple Frontier and the duty-free zones of Iquique, Colon, Maicao, and Margarita Island."[62]

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Hezbollah members in Venezuela—centered within the large Lebanese expatriate community on Margarita Island—helped several members of the Hezbollah cell in Charlotte, North Carolina infiltrate into the United States through Venezuela in 1992.[63] In the free trade area of Maicao, Columbia, Hezbollah is believed to participate in cigarette smuggling and may have operated a clandestine radio station broadcasting the group's propaganda.[64]

Hezbollah also raises money from drugs and conflict diamonds to support its operations. Hezbollah benefits both financially and operationally from the Beka'a Valley's poppy crop, which the group trades to Israeli-Arabs for intelligence on Israeli infrastructure and placement of Israeli soldiers. Israeli authorities have broken up a series of Israeli-Arab cells working for Hezbollah in return for money and, frequently, drugs. Some of these cells, like one operating out of the Galilee village of Abu Snan, were planning to kidnap Israeli soldiers. In September 2002, an Israeli military court indicted a Lieutenant Colonel in the Israeli army, part of a ten member gang, for spying for Hezbollah. The officer, who reportedly lost an eye fighting Hezbollah guerillas, passed classified information to Hezbollah operatives in return for money, hashish and heroin.[65] Hezbollah benefits from the drug business in Lebanon (which in turn is linked to the group's activities in other drug producing areas like South America and Southeast Asia).[66]

Hezbollah and other terrorist groups also traffic narcotics in North America to fund their activities back in the Middle East. A Drug Enforcement Administration (DEA) investigation into a pseudoephedrine smuggling scam in the American Midwest led investigators as far as Jordan, Yemen, Lebanon, and other Middle Eastern countries, including bank accounts tied to Hezbollah and Hamas. DEA chief Asa Hutchinson confirmed, "a significant portion of some of the sales are sent to the Middle East to benefit terrorist organizations."[67]

Long before al Qaeda was suspected of converting cash into easily transportable commodities like diamonds, Hezbollah learned to raise significant funds by dealing in so-called 'conflict diamonds' in Sierra Leone, Liberia , and Congo.[68]

In his U.S. Senate testimony on the links between conflict diamonds and terrorism the former U.S. ambassador to Sierra Leone, Joseph Melrose Jr., and the former Sierra Leonean ambassador to the US, John Leigh, confirmed that diamonds mined in Sierra Leone finance the activities of terrorist groups such as Hezbollah and al-Qaeda.[69]

According to David Crane, prosecutor for the Special Court in Sierra Leone: "Diamonds fuel the war on terrorism. Charles Taylor is harbouring terrorists from the Middle East, including al-Qaeda and Hizbullah, and has been for years."[70] Moreover, a July 2000 Belgian intelligence report stated that "there are indications that certain persons, the 'Lebanese connection' mentioned in the diamond smuggling file, also put in an appearance in files on money laundering, the drugs trade and the financing of Lebanese terrorist organisations such as Amal and Hizbullah."[71] Belgian intelligence reports also tie the Congolese diamond trade to the financing of various terrorist groups including Hezbollah.[72]

Speaking in the context of the diamond trade and its links to Middle Eastern terrorist groups, one official recently noted the "influx of hard-core Islamist extremists" in the Congo, over the past three years. He added, "We know Hezbollah is here, we know other groups are here, but they can

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probably operate a long time before we know enough to stop them."[73] The movement of Hezbollah operatives to Congo in the late 1990s and early 2000s is significant, given the rebellions that divided the country after the end of Mobutu Sese Seko's dictatorship in 1997.

Hezbollah operatives also run otherwise legitimate business enterprises that function as shell companies or fronts for raising, laundering and transferring large sums of money. The most egregious example appears to be the use of Western Union offices by local Hezbollah operatives. Though Western Union officials were not complicit in this activity, the company failed to make any real efforts to vet local operators even as their international operations grew exponentially over a few short years, especially in areas of conflict.[74] According to Israeli officials, Hezbollah operatives run several Western Union offices in Lebanon and use the co-opted services of others worldwide, especially in Southeast Asia. In some cases, where the local Western Union agent is a Hezbollah member or supporter, experts believe Hezbollah gets a cut of the 7% service fee charge split between Western Union and the local agent. In other cases, Hezbollah simply uses the money wiring company to launder and transfer funds. For example, Hezbollah funding to Palestinian terrorist groups in the West Bank is almost entirely transferred via Western Union – including some $3 million over a one year period in 2003-2004 alone.[75]

CONCLUSION

According to a former senior law enforcement official, "Hezbollah is very criminally-oriented for its fundraising in the United States, including legitimate and illegitimate business activities."[76] The members of the Charlotte cell, for example, raised significant sums of money for Hezbollah but used some of their earnings to buy nice houses and lead what appeared to be normal, middle-class American lives. Despite all the money the group receives from Iran, Hezbollah activists in the United States are believed to be self-funding, mostly through criminal enterprises.

Interestingly, while engaging in criminal activity often increases a group's vulnerability by further exposing them to the scrutiny of law enforcement authorities, Hezbollah's reliance on fellow sympathizers and members of local expatriate communities minimizes that potential exposure. Still, as the case of Hezbollah criminal activity in the tri-border region of South America makes clear, the group does engage in criminal activities that gave rise to the unwanted attention of local and international authorities, including mafia-style shakedowns of local store-owners, illegal pirating of multimedia, and the international drug trade. Moreover, as the Charlotte case highlighted, there are cases in which even sympathizers and members of close-knit communities can be convinced to break with their fellow Hezbollah supporters and cooperate with law enforcement authorities.

Cracking down on Hezbollah's proactive involvement in criminal enterprises in the United States has been and should continue to be a focus of U.S. law enforcement authorities' strategy for combating the group's presence in this country and its effectiveness abroad.

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COUNTERFEIT GOODS: EASY CASH FOR CRIMINALS AND TERRORISTS

Written Testimony of

Timothy P. Trainer
President
Global Intellectual Property Strategy Center, P.C.

Before the
United States Senate
Committee on Homeland Security and Governmental Affairs

May 25, 2005

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Mr. Chairman and members of the Committee, this hearing to examine trademark counterfeiting and its relationship to organized crime and terrorism is extremely important in view of the global onslaught to steal these valuable assets.

I take this opportunity to submit these comments due to the ongoing global assault on trademark assets owned by U.S. companies, large and small, and companies elsewhere that are victimized by counterfeit goods. These comments are not submitted on behalf of any entity, but are offered due to my continuing work in the area of intellectual property enforcement. My work in this area has included both public (U.S. Customs Service and the U.S. Patent and Trademark Office) and private (Arter & Hadden law firm and the International Anti-Counterfeiting Coalition, Inc.) experience.

In part, I restate the testimony presented on March 23, 2004, before the Senate Judiciary Committee as well as the testimony I presented before the U.S. China Commission in February this year.

RECOMMENDATIONS

At the outset, these recommendations are put forward for further consideration by this Committee, the Administration and industry to combat the scourge of counterfeiting and piracy that exist and will be elaborated upon further in the following pages:

- Take immediate steps to introduce a Senate companion to H.R. 32 "Stop Counterfeiting in Manufactured Goods Act";
- Protect IP rights as part of C-TPAT and CSI programs;
- Impose aggressive IP enforcement provisions, including enforcement in free trade zones, on trading partners entering into bilateral trade agreements with the U.S. ;
- Increase efforts to have trading partners improve enforcement at the border;
- Request less burdensome enforcement data from industry;
- Seek immediate increase in criminal enforcement in China; and
- Consider whether notions of territoriality prevent small and medium enterprises from obtaining effective enforcement in foreign markets.

1. GENERAL BACKGROUND

Trademark counterfeiting is as complex and difficult to combat as copyright piracy. While copyright owners confront pirates who use technology to steal content before products are available to consumers,[1] trademark owners are also combating sales of counterfeit goods on the internet[2] and the manufacture, distribution and sale of physical

[1] *See*, Joshua Chaffin and Scott Morrison "Online Pirates Beat Star Wars Rush for Premiere," Financial Times (May 19, 2005). "Online pirates beat the rush to the theatre and were already downloading the film from file-sharing websites on Wednesday".

[2] "Golfers Get Clubbed by Cheap Chinese Knock-offs," The Globe and Mail (May 18, 2005). Internet auction sites offer counterfeit golf clubs, motivating Callaway, Nike and others to combat counterfeiters together.

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goods around the world. In view of the counterfeiters' expansion into more product areas, the paramount issue related to trademark counterfeiting, i.e., product counterfeiting, is public health and safety as all types of products are now being counterfeited:

- Pfizer's Vice Chairman states that between 10% and 15% of all drugs sold in the world are fakes;[3]
- Fourteen died from fake alcohol in China;[4]
- CBS's Chicago affiliate uncovers counterfeit extension cords in discount stores;[5]
- Police arrest individuals involved in dealing in counterfeit cosmetics;[6]
- Approximately $10 million dollars worth of fake auto parts seized (filters, pistons, brake pads, and more) in the United Arab Emirates, including tens of thousands of counterfeit GM products;[7]
- South African authorities uncover tons of staple foods bearing fake marks;[8]
- "Disney Acts on Fake Asian Toys";[9]
- Hair dryers and extension cords found bearing counterfeit UL marks seized in Canada;[10]
- Counterfeit shampoos and hair oils concern Indian industries;[11]
- "Unsafe condoms sold under Durex name";[12]
- Counterfeit Kiwi shoe polish, power drills, motor oil, and teas are subject to counterfeiting;[13] and
- Authorities seize counterfeit shampoos, creams, toothpaste, soaps and hair oil found in warehouses in Sharjah, UAE.[14]

From a public policy perspective, these examples provide ample reason for increased government enforcement efforts as counterfeiters continue to invade a broad array of product areas and put consumers in harm's way.

In addition to the public health and safety risks related to counterfeiting, there is the continuing reference to organized crime involvement. The U.S. Attorney's office in New York charged 51 individuals, arresting 29, from rival Chinese gangs for their involvement in international smuggling activities and gambling. The charges involved smuggling immigrants and importing counterfeit goods from China, as well as additional charges for

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[3] Agence France Presse (May 18, 2005).
[4] Xinhua News Agency (May 18, 2005).
[5] CBS News, Chicago CBS Channel 2 (May 9, 2005).
[6] The Monitor (Uganda) (May 5, 2005).
[7] Gulf News (April 19, 2005).
[8] Sunday Independent (Johannesburg) (April 17, 2005).
[9] Dominion Post New Zealand (April 13, 2005) (Disney acts because of small parts that pose a choking hazard and paints with high levels of metal such as lead.).
[10] Ottawa Citizen (April 2, 2005).
[11] Financial Times (March 17, 2005).
[12] Irish Times (March 15, 2005).
[13] Business Week (February 7, 2005).
[14] Khaleej Times (August 17, 2004).

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attempted murder, extortion and money laundering.[15] The recognition of the organized crime element is not limited to the United States and Western Europe. Recently, authorities in the Philippines have expressed their belief that Chinese-Filipino syndicates are flooding Philippine markets with counterfeit goods, ranging from clothes and shoes to medicines from China.[16]

Adding to the organized crime and dangerous products concerns arising from counterfeits is yet another issue that raises social issues: child labor. Reports have begun to surface that underage children are employed by those engaged in the production and distribution of counterfeit and pirate product. Industry[17] and a human rights organization[18] have raised this issue as it relates to China. However, it is not limited to China as other reports have been provided by industry to trade associations regarding the use of underage children to be runners and look-outs in South America.[19]

As trade in counterfeiting and piracy continue to expand and envelope ever more criminal activities, the cases of authorities detecting more shipments attempted to be transported across borders increase. During the first three-quarters of 2004, the European Union's national border enforcement authorities conducted over 16,300 enforcement actions resulting in the seizure of over 74 million counterfeit and pirated items.[20] Japan's Ministry of Finance reported record seizures of counterfeit and pirated products at its borders for 2004, reporting a 23% increase over 2003 with seizures of goods from China doubling.[21] The Bureau of Customs and Border Protection, U.S. Department of Homeland Security, reported that for fiscal year 2004, Customs seized over 7,200 shipments containing counterfeit and pirate goods, valued at over $138 million dollars.

While understandable that the American, European and Japanese markets would be targets of counterfeiters, even Malta is now finding significant quantities of counterfeits. In a five month period, Malta's authorities have detected the equivalent of 14 full containers of counterfeit goods.[22] The goods are usually from the Far East and destined for other markets.

Rich and poor countries alike are combating the massive movement of counterfeit and pirate products. This brief snapshot of some of the counterfeiting and piracy activity provides a glimpse into a bad situation that appears to be getting worse, not better. The ongoing counterfeiting enterprises continue because of the continuing large scale profits that can be realized in the face of weak enforcement efforts and non-deterrent penalties.

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[15] Julia Preston, "U.S. Charges 51 with Chinatown Smuggling," New York Times (November 13, 2004).
[16] Manila Standard (April 28, 2005).
[17] Evening Standard (London) (February 11, 2005).
[18] Daily Mail (UK) (March 14, 2005).
[19] In February 2005, the International AntiCounterfeiting Coalition, Inc., asked its member companies to provide any information they might have regarding the involvement of child labor in counterfeiting and piracy. Responses were limited.
[20] http://europa.eu.int/comm/taxation_customs/counterfeit_piracy
[21] Daily Yomiuri (Tokyo) (April 4, 2005).
[22] Paul Cachia, Di-ve News (May 17, 2005)

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There is no doubt that industry and government must redouble their efforts in various areas in order to make "progress", which in some countries is simply slowing the growth rate of counterfeiting. Unfortunately, the list of substandard and dangerous products made and distributed around the world makes anyone anywhere a potential victim of counterfeit products.

2. LEGISLATION

In the United States, legislation needs to be strengthened at all levels, local, state and federal. A recent traffic stop along Interstate 80 resulted in police charging two individuals who were found with $680,000 dollars worth of counterfeit luxury goods in their vehicle.[23] In November 2004, New York City's Comptroller estimated that the City loses over a billion dollars in tax revenues due to sales of counterfeit and pirate goods.[24] Both suggest that the statistics issued by the Bureau of Customs and Border Protection reflect a tiny fraction of the counterfeiting activity within the United States.

Strategies here and abroad suggest potential ways forward in combating counterfeiting and piracy. On April 19, 2005, trademark owner Louis Vuitton (LV) won a preliminary injunction against a landlord who owns seven storefronts on Canal Street in New York City. The landlord agreed to take action to prevent the sales counterfeit LV goods on his properties.[25] In Scotland, city council licensing officials have taken the unprecedented step of banning sales of DVDs, CDs, videos and computer games at a flea market in a crackdown on pirated goods, demonstrating the need for more aggressive enforcement actions.[26]

Government and industry must consider a combination of new and old approaches to combat counterfeiting and piracy, whether civil or criminal penalties. There is no doubt that in many cases of product counterfeiting, the individuals involved have no regard for either the consumer or the trademark owner. In recent years, there has been only one piece of federal legislation aimed at strengthening the criminal law against trafficking in trademark counterfeit goods. Both last year and this year, Representative Joe Knollenberg's "Stop Counterfeiting in Manufactured Goods Act" has been introduced.[27] It would strengthen the criminal provision, Title 18, U.S.C., Section 2320. The legislation, which was passed by the House of Representatives just days ago, does take steps forward to eliminate loopholes that currently exist. Therefore, companion legislation in the Senate is needed for this section of the federal criminal law to be strengthened.

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[23] Pittsburgh Post-Gazette (May 22, 2005). He Dejin and XiaoLaning charged with having counterfeit purses, watches and other items bearing Chanel, Coach, Prada, Burberry and Gucci marks.
[24] Eric Dash, "The Handbag? Total Knockoff. The Price Tag? All Too Real," New York Times (November 23, 2004).
[25] Julia Boorstin, "Louis Vuitton Tests a New Way to Fight the Faux," Fortune Magazine(May 3, 2005).
[26] Evening News (Edinburgh) (May 21, 2005).
[27] H.R. 32 was introduced in January 2005.

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3. CBP INITIATIVES

Recognizing that both the Container Security Initiative and the Customs-Trade Partnership Against Terrorism are intended to safeguard the United States from terrorist acts and weapons of mass destruction, these programs can also contribute greatly to our economic security with an emphasis on IP protection. In view of the huge quantities of counterfeit goods entering the U.S. market, these programs should not provide foreign exporters and domestic importers with "guarantees" of getting goods into the U.S. market once they become participants of these programs.

Despite the increased CBP IP seizure statistics for FY 2004, it is requested that Congress monitor these programs and require that these programs include a strong and aggressive IP enforcement component in order to combat counterfeiting and piracy. As noted in this submission, combating IP theft targets organized crime groups operating abroad that engage in other types of illegal activity. By looking at IP theft too narrowly, we fail to appreciate how criminals here and abroad use IP theft to fund other illegal conduct.

4. BILATERAL AGREEMENTS

The strong enforcement provisions of the Free Trade Agreements (FTAs) that have been concluded are positive steps toward combating counterfeiting. Future FTAs should clearly indicate that, in addition to *ex officio* authority for goods intended for export and moving in-transit, goods in free trade zones are also subject to the same enforcement requirements.

Despite ongoing and aggressive efforts to address counterfeiting in the countries of manufacture, the concentration of Asian-made counterfeit goods being sent to every region of the world should be sufficient grounds to redouble the Administration's efforts to require improved enforcement in the countries of importation. Thus, all forms of bilateral trade agreements should be enhanced to heighten enforcement efforts at the border by all trading partners. Moreover, the obligation for *ex officio* criminal enforcement by our trading partners should be closely monitored to ensure that criminal IP theft is vigorously pursued.

5. GOVERNMENT REQUEST FOR DATA

In September 2004, the Office of the U.S. Trade Representative (USTR) requested industry data regarding specific cases pursued in China. With the exception of a few, companies did not respond in sufficient numbers to provide USTR with a reliable picture of what happens to cases pursued in China. To some extent, detailed information on each case pursued by a company was deemed to be too burdensome for IP owners to respond. In the future, there may be alternative data elements that could be requested and still provide the type of "picture" of IP theft that is occurring and causing harm to companies or industry sectors. As an alternative, USTR could seek more general information from companies, for example:

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1) Total number of raids in (name of country) (identify time period);
2) How many times a particular facility was raided/results;
3) Total of items seized/destroyed (identify type of product) (identify time period);
4) Total number of arrests;
5) How many cases were pursued with criminal investigations/prosecutions;
6) Disposition of defendants in administrative/criminal cases (e.g., level of fines imposed/paid, prison sentences imposed and served);
7) Information regarding the disposition of the equipment used to produce goods;
8) Information about facility (shut down or not);
9) Seizures of country X origin goods in 3d markets; and
10) Identify the type of IP (copyright, trademark, etc.) and, if a trademark, the marks used by the counterfeiters.

These data elements are suggested and would allow the submitting company (or companies in an industry sector) to submit aggregated data. Because these are not case specific, it might result in more industry representatives submitting data. It is not likely that any entity will be able to provide data as to all the elements above, but these or other data elements may be easier to obtain and to provide than the specific case information previously requested. Ultimately, industry should be able to develop its own data elements that it can provide either individually or as a group of affected companies.

6. CHINA CHALLENGE

For most trademark owners, China continues to present the greatest challenge to efforts to protect and enforce their rights. Having said this, some trademark owners find other countries to be worse than China in their efforts to protect their rights.[28] Despite the chorus of complaints regarding deficiencies in China's domestic market and border enforcement systems, trademark owners have reported 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.[29]

Still, 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, the enforcement system continues to be fraught with weaknesses and inefficiencies that facilitate massive counterfeiting and piracy.

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[28] *See*, International AntiCounterfeiting Coalition, Inc.'s (IACC) 2005 Special 301 submission and the Canada report at p. 8 (February 11, 2005). At the time of this submission, I was president of the IACC.
[29] China's official Xinhua News Agency reported on April 21, 2005, that over 50,000 trademark infringement and counterfeiting cases were investigated and dealt with in 2004.

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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 and, as noted above, pose health and safety concerns. China sourced counterfeits range from counterfeit medicines and auto parts to home electrical products to apparel and footwear.[30] 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.[31] Based on these statistics, China accounted for 63% of the total monetary value of intellectual property seizures in FY 2004. The export of counterfeit and pirate products impose 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.

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. 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.

Turning to the judicial interpretations concerning criminal enforcement, these were recently issued by the judicial authorities. 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

[30] *See*, "Fakes!", Business Week at p. 54 (February 7, 2005).
[31] Both of these statistical measures were increases over FY 2003 when CBP seized 2,056 shipments with a domestic value of over $62 million.

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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 the 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.

The new judicial interpretations continue to have obstacles to effective enforcement, including:

- Minimum thresholds for criminal liability;
- Significantly higher thresholds for corporate counterfeiters;
- Weak valuation of counterfeit goods—using the value of the illegal merchandise; and
- Reliance on an extensive administrative enforcement system.

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." While the Article 225 provisions may be intended for products specially regulated by the government (such as cigarettes, telecommunications and publishing), it should apply to all underground and illegal operations.

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.

The U.S. will have to continue its ongoing engagement with Chinese authorities, constantly identifying the obstacles to enforcement and how these obstacles can be reduced and eliminated. 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 through more aggressive use of the criminal enforcement system.

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7. *IMPACT ON SMEs*

The China export machine has caused companies of all sizes to experience the counterfeiting problem. 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 national 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.

Along these lines, the U.S. Government is increasing its efforts to raise awareness among small and medium enterprises (SMEs). 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.

The challenges posed by the massive quantities of counterfeit and pirated products made in China and elsewhere and exported throughout the world have exposed the IP system to a collision. 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 that are the victims are also failing to make progress in this battle because of the territorial nature of some IP rules,[32] 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 are likely to receive protection of their rights only 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.

For SMEs that do not have trademark registrations in dozens of countries, but whose success leads to criminal IP theft, there needs to be criminal enforcement against those who engage in global counterfeiting. Civil remedies will not deter today's criminal counterfeiter.

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[32] 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.

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S. HRG. 109-989

PIRACY OF INTELLECTUAL PROPERTY

HEARING

BEFORE THE

SUBCOMMITTEE ON INTELLECTUAL PROPERTY

OF THE

COMMITTEE ON THE JUDICIARY
UNITED STATES SENATE

ONE HUNDRED NINTH CONGRESS

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PIRACY OF INTELLECTUAL PROPERTY

WEDNESDAY, MAY 25, 2005

UNITED STATES SENATE,
SUBCOMMITTEE ON INTELLECTUAL PROPERTY,
COMMITTEE ON THE JUDICIARY,
Washington, D.C.

The Subcommittee met, pursuant to notice, at 2:34 p.m., in room SD–226, Dirksen Senate Office Building, Hon. Orrin G. Hatch, Chairman of the Subcommittee, presiding.

Present: Senators Hatch and Leahy.

OPENING STATEMENT OF HON. ORRIN G. HATCH, A U.S. SENATOR FROM THE STATE OF UTAH

Chairman HATCH. All right, we have had enough frivolity here. We have got to go to work, so welcome to today's hearing before the Intellectual Property Subcommittee.

Today, we will be examining a variety of problems and challenges involving international piracy, and that is international piracy of U.S.-owned intellectual property. This hearing will focus on copyright piracy, but I hope the Subcommittee will be mindful of the serious issues in the trademark counterfeiting and patent infringement realms as well.

Piracy and counterfeiting inflict significant and widespread harms on the American economy. Theft of intellectual property abroad is disastrous and very much disadvantages this country's entrepreneurs, innovators and, of course, the creative community. Ultimately, it also harms consumers, shareholders and American workers and their families.

The timing of this hearing was intended to coincide roughly with a number of recent developments and events relevant to our consideration of piracy issues. On April 29, 2005, the Office of the United States Trade Representative issued its decision resulting from the out-of-cycle review of China's enforcement practices, and completed the special 301 process. Much of the focus in that process and in USTR's conclusions remains on the inadequate enforcement of intellectual property rights in Russia and China.

Russia remains on the Priority Watch List this year due to continuing problems with its legal regime, which is described as having weak intellectual property enforcement and a lack of data protection. It appears that Russia's current intellectual property regime is inconsistent with its bilateral trade obligations and likely does not conform to the obligations which Russia needs to fulfill in order to join the WTO.

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Other recent events that have prompted some additional interest and scrutiny on both sides of the Hill include a number of studies and reports on piracy and counterfeiting which indicate that we are not making much headway in many areas. And I might add that some of these suggest some very disturbing trends in other areas as well. For example, various analyses indicate that piracy level in many sectors are close to or exceed 90 percent in China. In Russia, the overall losses to copyright-related industries have continued to increase and are, at least in my opinion, at unacceptable levels.

Today, we will hear a description of the big-picture issues in the fight to protect U.S. interests and to ensure that American export products reliant on intellectual property rights receive appropriate attention and protection. We will also hear specific experiences and instances that illustrate how rapidly and widely pirated works reach countries around the globe. For example, it was recently reported that unauthorized disks of the new "Star Wars" movie were on sale on the streets of Beijing just days after the film's premiere. My understanding is that Mr. Hackford, who directed the movie "Ray," has had a very similar experience with his film.

We also will discuss the importance to the U.S. economy of the industries that rely most heavily on intellectual property rights. For example, according to the International Intellectual Property Alliance and other sources, the core U.S. copyright industries account for about 6 percent of our total United States gross domestic product. Employment in these industries has recently been estimated at 5.5 million workers, or 4 percent of total U.S. employment. Between 1996 and 2002, the information technology sector grew by 26 percent. This is a growth sector for the United States economy and in my own home State of Utah and one of the few areas in which we really have a positive balance of trade.

I also want to point out that piracy of entertainment products is not the sole concern in the copyright realm. Although movies and music receive a lot of attention today, we are going to hear this day from Mr. Holleyman of the Business Software Alliance about a recently released report indicating that software piracy just in the Asia-Pacific region alone cost manufacturers in this country an estimated $8 billion in 2004. Losses due to software piracy worldwide are estimated at more than $32 billion, with predicted piracy rates of 90 percent in some countries.

In preparing for this hearing, we asked witnesses to provide both a general description of the global state of affairs on intellectual property rights, as well as a discussion of specific areas of concern to them respectively. From the testimony, it appears that most of the witnesses have serious concerns about Russia and China. This is consistent with the feedback that I have received from a wide variety of sources.

I note, however, that recent reports have also highlighted long-standing and serious problems particularly in the area of optical media piracy in places such as Pakistan, Malaysia and the Philippines. And although there has been progress in some areas, it does not appear at least to me that consistent headway is being made in many countries.

Finally, I note that today's hearing is particularly timely because the Chinese delegation to the Intellectual Property Working Group

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of the Joint Commission on Commerce and Trade is scheduled to meet here in Washington to discuss some of these issues with Government officials. Now, I am hopeful that some progress will be made, and I stand ready to provide whatever assistance is necessary to move forward on these very important issues.

Let me close by observing that during the Cold War it was said that the Soviet Union's style of negotiation could be summed up as follows: what is mine is mine and what is yours is negotiable. If Russia, China or any other government attempts to adopt this view with respect to their responsibilities to protect intellectual property under international trade law and agreements, I can assure you that public support for U.S. trade agreements will be undermined and there will be a strong resistance from, and appropriate action taken by, members of Congress.

To put a fine point on it, before the Congress votes in favor of Russia joining the WTO, many of us will have to be convinced that the Russian government is serious about cracking down on theft of U.S. intellectual property. As the ranking Republican on the Finance Committee and the Chairman of this Subcommittee, I have a particular interest in the intellectual property problems that will be outlined today, and I intend to work with members of both sides of the aisle and in both committees to ensure that these issues receive the attention and resolution they merit.

I know that Senator Leahy and many others, such as Senators and Cornyn and Feinstein, are concerned about these problems as well. So I look forward to hearing from the witnesses and I want to thank all of you for coming and for testifying here today and I believe this hearing should be a very good hearing.

[The prepared statement of Senator Hatch appears as a submission for the record.]

We will begin the hearing by turning to our stalwart, Marybeth Peters, who is Register of Copyrights and Associate Librarian for Copyright Services of the United States Copyright Office right here in Washington, D.C. After Marybeth, we will turn to Stephen M. Pinkos, the Deputy Under Secretary of Commerce for Intellectual Property and Deputy Director of the United States Patent and Trademark Office, in Alexandria, Virginia. Then we will turn to James E. Mendenhall, the Acting General Counsel of the Office of the United States Trade Representative.

We welcome all three of you here today and we look forward to taking your testimony at this time.

STATEMENT OF MARYBETH PETERS, REGISTER OF COPYRIGHTS AND ASSOCIATE LIBRARIAN FOR COPYRIGHT SERVICES, U.S. COPYRIGHT OFFICE, WASHINGTON, D.C.

Ms. PETERS. Thank you, Mr. Chairman. Thank you very much for the opportunity to speak to you today about one of the most pressing issues in copyright—international piracy. It is always a pleasure to appear before you, and I am pleased to see the reestablishment of the Subcommittee and I congratulate you on your chairmanship.

Mr. Chairman, in my nearly 40 years in the Copyright Office, piracy, and especially global piracy, has been an enduring problem. We can and should strive to reduce piracy to the lowest levels pos-

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sible, levels that will not deny authors and copyright owners of the incentives to create and distribute the works that have made America's creative industries the envy of the world.

The Copyright Office has had a long history in working toward this goal both on its own initiative and in cooperation with other agencies of the Federal Government. In the ten years since the adoption of the TRIPs Agreement, there have been tremendous improvements worldwide in countries' legal frameworks for copyright protection. By incorporating the substantive copyright obligations of the Berne Convention and supplementing them the civil, criminal and border enforcement obligations, TRIPs established a minimum standard against which all countries' copyright regimes could be judged.

The Office's contribution to this success includes participation in the negotiation of the TRIPs agreement and other copyright treaties and agreements, as well as training of foreign officials. Our main program for training foreign copyright officials is our International Copyright Institute. This program exposes foreign officials from developing and countries in transition to a wealth of copyright knowledge and information presented by the U.S. Government and foreign and domestic industry experts.

The Copyright Office works hand in hand with USTR on bilateral and regional trade agreements, including negotiations implementing the free trade agreements. We also support USTR free trade agreements by providing technical assistance to our negotiating partners.

The Office is a major contributor to the strengthening of copyright protection through international organizations, notably the World Intellectual Property Organization. It played a key role in the negotiation of the WIPO Internet treaties which are substantially improving the legal framework for the protection of copyright in numerous countries around the world, including our own copyright law.

I believe United States copyright law does the best job of providing appropriate protections to authors and copyright owners, while still allowing for fair and reasonable use of copyrighted material. But our law is not perfect and when we go to other countries seeking improved copyright protection, they are quick to point out the deficiencies and gaps in our law.

For example, the United States has not amended its law to delete a provision of Section 110(5) added to our law in 1998 which significantly broadened the exemption for performance of musical works in public places like bars and restaurants. A WTO dispute resolution panel has determined that this expansion is inconsistent with our TRIPs obligations. Also, because our law has extremely narrow performance rights for sound recordings, many countries limit protection for U.S. rights-holders to only the protection that we provide, despite the popularity and widespread of U.S. recordings overseas.

No matter how good a country's law is on the books, enforcement of that law is essential to effective copyright protection, which is why the TRIPs Agreement contains specific provisions requiring adequate and effective enforcement measures.

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Our FTAs have built upon the TRIPs enforcement text by adding specificity to what is found in TRIPs and other obligations not found in TRIPs. The FTAs also provide us with the flexibility to address enforcement problems that are particularly problematic in a given region or country.

The fact remains, however, that copyright enforcement in too many countries around the world is extremely lax. China is a good example of why enforcement is absolutely essential to the protection of copyright. As China joined the WTO in 2001, the Office worked with the USTR-led interagency team to provide technical advice and to urge the Chinese government to amend its law to be TRIPs-compliant. While its revision feel short in several important respects, the law is more than sufficient to provide some meaningful protection if it is enforced. Unfortunately, it is not.

Last year, China made a number of commitments to improve various aspects of its intellectual property regime, most notably with regard to enforcement. Shortly before meetings in which those commitments were made, the Office hosted a delegation of Chinese officials, led by the National Copyright Administration. We have enjoyed a 25-year relationship with them which has helped promoted greater understanding between our governments. But NCAC does not have the final say on copyright policy and enforcement in China and China's implementation of last year's commitments has been incomplete.

Russia has been on the Priority Watch List since 1997. According to IIPA, piracy rates in China in 2004 for most sectors are about 80 percent and losses are beyond $1.7 billion. Obviously, there is a serious problem in Russia. The Copyright Office is committed to be a member of interagency efforts to combat intellectual property violations in Russia. Certainly, statements by President Putin and other high-ranking government officials indicate a comprehension of the serious nature of the problem, but piracy remains and we haven't gotten the desired results.

There are two causes of inadequate enforcement: one, lack of competent police, prosecutors and/or judges, and, two, lack of political will to enforce copyright. We and others do our best through training programs to address the first problem. The second, lack of political will, is much more difficult.

Let me say something about the nature of piracy that we see in other countries. Much of it is done by for-profit criminal syndicates. Factories through China, Southeast Asia, Russia and elsewhere are churning out millions of copies of copyrighted works, sometimes before their authorized release. These operations most certainly involve other criminal activities, and although the information is sketchy at best, there have been a series of rumored ties between pirating operations and terrorist organizations.

What is problematic is that some American commentators who are prone to hyperbole are providing arguments and rationalizations that foreign governments are using to defend their failure to address this type of organized crime. The confusion wrought by the imprecision and lack of clarity in these commentators' statements is not helpful to achieving the goal for which there is no credible opposition—dramatic reduction in organized piracy of U.S.-copyrighted works abroad.

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International piracy poses a tremendous threat to the prosperity of our creative industries and it deserves our utmost attention. This attention must be consistent and long-term if it is to be successful, but we must be realistic in our goals, lest we become discouraged. While it is not realistic to expect to eliminate all piracy, we can assist in improving the global situation to the benefit of authors and rights-holders here in the United States and throughout the world.

Thank you.

[The prepared statement of Ms. Peters appears as a submission for the record.]

Chairman HATCH. Thank you, Ms. Peters. We really appreciate that.

Mr. Pinkos, we will turn to you.

STATEMENT OF STEPHEN M. PINKOS, DEPUTY UNDER SECRETARY OF COMMERCE FOR INTELLECTUAL PROPERTY AND DEPUTY DIRECTOR, UNITED STATES PATENT AND TRADEMARK OFFICE, ALEXANDRIA, VIRGINIA

Mr. PINKOS. Thank you, Mr. Chairman, and I appreciate the opportunity to join with you today in a discussion about international piracy issues. I have a deep respect for the role that the Judiciary Committee plays, or the leading role that it plays in crafting our Nation's intellectual property laws and oversight of the agencies that implement them, and I think much of them is spawned from the fact that I spent six years as a staff member of the Judiciary Committee over on the other side of the Capitol.

In fact, I think my last memory of this room is being in here a couple of years ago as we negotiated the PROTECT Act while we tried to catch glimpses of the NCAA Championship game in the other room right there. Luckily, the result of the legislative effort was strong and the game depended on whether you were—I think it was Kansas or Syracuse that year.

I wanted to emphasize that the Bush administration is keenly aware and fully understands that intellectual property protection is critical to the competitiveness of our economy, and that U.S. businesses face enormous challenges in protecting their IP overseas.

Secretary of Commerce Gutierrez, who has just been on the job for five months or so, is also very aware of the significance of intellectual property for America and he has made combatting piracy one of his top priorities. The U.S. Patent and Trademark Office is dedicated to carrying out his vision of marshaling all U.S. Government efforts and agencies to reduce IP theft.

As you noted, Mr. Chairman, increasingly both the United States and our trading partners rely on IP to drive economic growth. The statistics you cited show that IP-based businesses such as software and entertainment now represent the largest single sector of our U.S. economy.

Unfortunately, the economic benefits of intellectual property have also captured the attention of thieves and organized crime and, as Marybeth mentioned, even terrorists. Because of that, the threats to U.S. economic safety and security, the administration is working hard to curb IP crime and to strengthen enforcement around the world.

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I am certain that many of you and your colleagues have heard about the STOP initiative, which is the Strategy Targeting Organized Piracy. It is a White House-coordinated effort of all U.S. Government agencies that are involved in protecting IP and it is the most comprehensive U.S. Government-wide initiative yet. It is designed to simply eliminate trade in pirated and counterfeited goods worldwide, and the greatest benefit thus far has been bringing a lot of agencies together to discuss the different efforts that they have underway to stop trade in counterfeit and pirated goods.

We are seeing some results: a report on behalf of some of my other colleagues in the administration that the Department of Homeland Security is increasing seizures. They are applying new technologies and accounting methods to try to stop bogus goods coming over our borders. DOJ, as you are well aware in your oversight of that agency, is stepping up their prosecutions and increasing the amount of special units they have for IP crimes.

Over at the Department of Commerce, we are trying to inform U.S. businesses how to best protect their rights with a new hotline and a website and some training programs around the world. And specifically in the United States, Mr. Chairman, we started this week a series of seminars for small and medium-size enterprises. This applies more for the patent and trademark world, but we were out in Utah Monday and Tuesday of this week and we had over 200 businesses represented in our seminar out there. Jon Dudas represented the agency there and from all accounts, it was quite a success. We are expanding that around the country and we are having a couple that are China-specific as well. We did one in Baltimore and we are going to Detroit soon.

As I mentioned, USPTO is engaged in enforcement and training efforts around the globe and here. We have offered training and technical assistance to 55 different countries and we have trained hundreds, if not thousands, of officials—judges, prosecutors, legislators—in how to have a strong IP system and then how to enforce, as well.

We have had particular focus on China and one of the things we are trying to do in China is, as has been stated, they have some good laws on the books, but they need to implement them and they need to enforce them. They have one of the fastest growing patent and trademark offices in the world and we are trying to give them the technical assistance so that when U.S. businesses go to protect their property there, the offices actually function as they should.

As was mentioned by you, the Joint Commission on Commerce and Trade is meeting this week here in Washington, and the Working Group on IP, which is chaired by Mr. Mendenhall's colleague, Deputy Ambassador Josette Shiner, along with Jon Dudas, are meeting with the Chinese and we are pressing them to implement an IPR action plan that will address some specific IPR problems.

The PTO remains active at WIPO, which is always a unique institution to deal with. It is represented by developed and developing countries, but we work with them to set these international standards for IP protection and enforcement, and work to harmonize IP laws to the greatest extent possible. And we are trying to break some ground with a broadcasters treaty there, after the success of the Internet treaties.

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USPTO is also working closely with the USTR to provide the support they need with free trade agreements, and we have been fortunate, I think, with some of the recent trade agreements with Singapore and Chile and Morocco to have state-of-the-art IP protections in those agreements—what we like to call TRIPs-plus, going above and beyond what TRIPs requires.

Mr. Chairman, just to say in closing counterfeiting and piracy do appear to be on the rise, but the administration, I think, is making progress in attacking the problem. There is a lot of work that needs to be done, but I am personally increasingly hopeful that with the continued coordination among agencies and the administration, work with this Subcommittee and other committees in Congress, and with private industry as well—they are a big partner in this—we can continue to do more to help American businesses protect their important intellectual property.

Thank you.

[The prepared statement of Mr. Pinkos appears as a submission for the record.]

Chairman HATCH. Well, thank you so much.

Mr. Mendenhall, we will take your testimony at this time.

STATEMENT OF JAMES MENDENHALL, ACTING GENERAL COUNSEL, OFFICE OF THE U.S. TRADE REPRESENTATIVE, WASHINGTON, D.C.

Mr. MENDENHALL. Thank you, Mr. Chairman, and thank you for inviting me here today and giving your attention to this critical issue to our economy.

The protection of intellectual property and access for U.S. goods dependent upon IP protection is at the top of USTR's enforcement agenda. In the area of trade, IPR protection is one of the most important and certainly one of the most complex issues that we face today. Yet, we are pursuing this issue with single-minded resolve. We are making some progress. Clearly, a lot of work needs to be done.

But to preserve our economic strength, we have to cultivate an atmosphere of creativity and innovation both in the United States and abroad. And if that atmosphere doesn't exist, we have to create it, and that means in part strengthening IP rules around the world. We had a good start with that with the TRIPs Agreement, the global rules on intellectual property. But without enforcement of those rules, those rules are meaningless.

Now, two points about enforcement. Ensuring enforcement is actually often harder than negotiating the rules themselves. Enforcement requires political will from legislators, prosecutors, judges, police and administrators at all levels of government, and that is hard to litigate. If we go to dispute settlement, it is hard to craft a rule which compels political will, but political will is essential if we are going to be successful in this mission.

Furthermore, ensuring enforcement is not solely about bringing dispute settlement cases against our trading partners. Dispute settlement is a valuable tool, but neither dispute settlement nor, in fact, any particular legal mechanism is the silver bullet here. When we talk about enforcement, we are talking about getting results. We need to think outside the box and it is not a one-size-fits-all so-

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lution. The solutions involve pushing multiple levers in the right sequence and with the right amount of pressure.

Now, let me give you a couple of examples of what we have done over the past year where we have had some success. Every year, as you know, the U.S. Trade Representative's office issues a special 301 report cataloguing IPR problems around the world and putting countries in a hierarchy of wrongdoing, from Watch List, to Priority Watch List, to Priority Foreign Country. This year, we have done 50, 60 countries, perhaps more than that, in our special 301 report.

One of them, for example, is Pakistan, which you mentioned in your opening statement. Pakistan is on the Priority Watch List this year, as they have been for a while, in large part because they have within their borders a series of well-known plants churning out pirated copies of optical disks, millions of them over the past several years. We have taken every opportunity to raise the issue with Pakistan. We have put on the Priority Watch List again this year. Five days later, Pakistan shut down six of those plants.

We also use the carrot-and-stick approach that we have through using our preference programs, like the GAP program. Over the past six months or so, we have worked closely with Brazil, for example, where we have indicated to them that they would face the possibility of revocation of GAP benefits if they don't put their enforcement house in order. Recently, as a result of our efforts, Brazil has undertaken a very comprehensive action plan, including many elements, in fact, suggested by U.S. industry.

Now, with both Pakistan and Brazil, we have a lot of work to do, so I don't mean to say our work is done there. But there are many levers that we can use and that we need to bring to bear on this project. Dispute settlement, of course, is a key tool that we need to use, and we have used it and we will use it again if that is the most effective way to achieve our objectives. We recently won a case, for example, against the E on the protection of geographical indications. We are willing to do that again if, as I said, that is the most effective tool available to us, which brings us to China.

Now, it comes as no surprise to you or anyone in this room, I am sure, that China is perhaps our number one enforcement challenge when it comes to IPR. On China, when we have a problem, many folks have a knee-jerk reaction that we should go immediately to dispute settlement. We have gone to dispute settlement before with respect to China in other areas. In fact, the United States is the only country in the world that has ever challenged China in dispute settlement, which we did last year. We got a successful resolution of a case involving a tax matter.

We have utilized WTO procedures even earlier this week, when we requested consultations with China on a direct sales regulation that they are proposing. It is not formal dispute settlement, but they are WTO procedures that we are making use of, and we will continue to do that.

Now, WTO rules are clearly going to be helpful to us in IPR, which I will get to in a minute about how those two relate. But I want to give you a quick overview of what we have done on our China strategy over the past year.

First, we have held China to its existing obligations. We have negotiated new commitments, when appropriate, to fill any gaps that

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may exist. Second, we have monitored progress on the ground in close coordination with our industry to ensure that those commitments are being implemented. And if not, we have ratcheted up pressure on China and will continue to do so to ensure that those commitments are fulfilled.

Now, over the past year we have moved through all these phases with China. Last year at the JCCT meeting, we negotiated a set of new commitments on IPR, with the overall objective of significantly reducing piracy and counterfeiting. A month later, we dedicated a section of our special 301 report indicating that we take those obligations seriously, that we would monitor their implementation and we would seek to ensure that they are implemented, and that we would review the matter in an out-of-cycle review that, in fact, we started in December of last year.

In the summer of last year, we took an unprecedented step of issuing an open letter to industry soliciting information on enforcement problems in China. We reiterated that request when we started the out-of-cycle review and again when we sent the questionnaire to every member of Congress asking that they work with us to inform their constituents of problems in China and help us build a database.

At the end of that process, the out-of-cycle review results in April, we put China on the Priority Watch List. We have ratcheted up the pressure on them. China wasn't happy with it, but we thought the report card that we gave them was appropriate, given the lack of progress that we have seen.

This week, as has been discussed, we are working with China through the IPR Working Group under the JCCT. In the coming weeks, we are going to be issuing a request through WTO rules seeking additional information from China on the status of enforcement in the country. And then we are going to be working with industry over the coming months to refine our arguments, collect additional information to fill any holes that we may have.

We have seen some progress in China. We saw China issue new judicial interpretations in December of last year making it easier to bring criminal cases. We have seen other steps they have taken, including a nationwide campaign, but we haven't seen enough progress and we need to consider carefully what our next steps will be.

Now, if we are going to go forward and we are going to utilize WTO procedures, we have to have our facts in order. We have to have a full and complete docier of information to prove our case. Everybody knows it is a problem. Everybody around the world knows it is a problem. The Chinese know it is a problem, but we have to have a full evidentiary basis to prove our case with them if we expect them to make serious progress. Now, we have worked with industry over the past couple of months to do that. We hope you and members of Congress will work with us to work with industry to gather that information as appropriate.

Just a word on Russia. Here again, we have got a serious enforcement problem well-known to you and others, of course. We have taken a series of steps to try to increase pressure on Russia to improve their IPR regime. We have raised the issue at the presidential level. We have put them on the Priority Watch List again

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this year. We are having an out-of-cycle review on China later this year.

We continue to review the petition the copyright industry has filed to withdraw GAP benefits, and we are continuing to raise the issue as a critical issue to be addressed in the WTO accession negotiations. Ultimately, again, any progress in this area is going to depend on the political will of Russia's leadership. We will continue to press Russia to undertake that commitment to crack down and deal with this problem straight on.

Finally, just two closing remarks. As I indicated in the beginning of my statement, we have a good foundation with the TRIPs rules on enforcement. They need to be elaborated upon, they need to be fleshed out further. We have started that process with our FTAs, as my colleagues on the panel indicated. We have dedicated about half of our IP chapters and our FTAs to enforcement and we are working through the strategy targeting organized piracy to build a global consensus on the need for IP enforcement and build the machinery to ensure that we have the tools available to us, working with our trading partners, to cleanse international trading lanes of pirating counterfeit goods.

Thank you.

[The prepared statement of Mr. Mendenhall appears as a submission for the record.]

Chairman HATCH. Well, thanks to all three of you. Let me just ask a couple of questions.

The collective picture the administration witnesses paint of the problem of China is stark and unattractive to me. It is obviously disastrous for our software manufacturers that 90 percent of software installed on computers in China was as a result of pirating of intellectual property.

I understand that the American film industry used to be able to say that they had a positive balance of trade in every country in which they do business, but I also understand that this is no longer the case with one country, and that is China. This is not because they are an international film-making powerhouse, and while I am sure the Chinese are making some good films, I am also told that the Chinese will not let the American film industry compete fairly in China. I also understand that whenever a new American film opens, illicit copies are available on the streets in Beijing almost the same day as they are shown, or within days after they are shown. And all of this is taking place when we have big trade deficits with China.

You have all touched on this to a degree, but I would like you to just be more specific. What are you doing to fix the IP theft problem in China and what can Congress do to help you? What can we do, if anything, to help you in this area?

Mr. MENDENHALL. Clearly, the copyright problem—the movies, music, and so on—in China is an extremely serious issue that we take extremely seriously. We have worked very closely with our industries to get a sense for the real problems they face on the ground and figure out what the best steps forward would be.

When we talk about movies, in particular, which is what your question focused on, we have got a couple of problems. One is that China puts a cap on the number of movies that come into the coun-

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try every year to be shown in theaters and such. As a result of that cap, China effectively creates a market for pirate movies to come in; that is to say for the 20 or so movies that are allowed in, there may be 30 additional movies that our industries would like to show and that people would like to see. As a result, there is a black market that grows up with respect to those particular movies. So we have a market access problem that contributes to the creation of a black market.

We also have the problems that we face in a lot of other sectors, including the fact that there just simply is a lack of enforcement in China. There are plants turning out millions of optical disks that aren't being shut down. If they are shut down, they may open the next day; the vendors, the same thing. They may be shut down and they open the next day.

Now, the steps that we have to take are complicated, as I indicated in my remarks. We have tried to work with the Chinese cooperatively. We have set for them overall objectives of significantly reducing piracy and counterfeiting, as well as specific objectives. The work plan that Mr. Pinkos referred to that we are talking to the Chinese about this year is quite detailed, asking them to take specific steps to build up their enforcement machinery at all levels, and we have worked very closely with the Chinese on that.

Now, the Chinese may balk at that. As I said, they think they are doing a lot. We haven't seen the results yet, so I can't tell you what the results of those discussions are going to be. If we don't see results, though, we do need to think about next steps we need to take in this area, and that may include working perhaps within the WTO procedures, as we indicated in our out-of-cycle review results. So we're working the diplomatic angle and the negotiation angle as much as we can. If there is nothing more to be gained about that, we do need to think about next steps and that may be for the utilization of WTO procedures.

Chairman HATCH. Is there anything we can do that we are not doing that would better help you there?

Mr. MENDENHALL. Well, as I indicated, I think what would be most helpful is if we all worked together cooperatively; the administration, Congress and the industry work together to, one, give a united and consistent message to the Chinese that this is a serious problem that has to be grappled with. Two, we need to impress upon—well, we need to work together to ensure that both the private sector and the Government bring the proper amount of resources to bear upon this issue, which includes not only resources for data collection purposes, but also legal resources appropriate for us to build and refine our arguments, build our database so that we can go to the Chinese and present a very solid case, backed up by evidence, that something needs to be done here.

Chairman HATCH. I guess I am asking you are there aspects of U.S. law that, in your opinion, need to be changed to assist you in your efforts to combat international piracy.

Mr. PINKOS. I don't know if there are laws that will help us deal specifically with China. I think the administration is working on a legislative package to submit to the Congress that will help rightsholders enforce their rights here in the United States a little more aggressively. The Department of Justice is working on that, and

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the Patent and Trademark Office and Customs. So we would like to work with you on that as we bring some items forward.

Mr. Chairman, if I could suggest something that I think is helpful that I think many of you know intuitively, but when you all travel abroad to take a strong message, but not just to China, but really, as Mr. Mendenhall alluded to, this is going to require an effort in China specifically, among multiple nations.

Chairman HATCH. Well, I have the same basic question with regard to Russia. It is a big problem, too, and the question is what can we do now to stop the widespread and growing piracy of U.S.-owned and U.S.-developed intellectual property in Russia. It is a big, big problem over there, as well.

Mr. PINKOS. That is exactly right, and we are raising it at the highest levels, as Mr. Mendenhall said, with the President, and likewise analyzing their progress in terms of their WTO ascension, as you mentioned in your statement as well.

Chairman HATCH. Well, to be honest with you, I am not going to ask you what Congress can do to help with the situation in Russia because I hear a growing number of my colleagues are complaining and very upset and grumbling about their concern that if we go along with ascension to the WTO, Russia is going to become the new China, and they will do it blatantly when it comes to attempting to gain the benefits of free trade for its citizens at the same time it acts to hurt the interests of U.S. copyright-holders and U.S. workers and investors and their families by avoiding the responsibilities under the international trade agreements and in areas where both Russia and China almost blatantly flaunt their theft of U.S.-owned intellectual property materials.

Before I ask you to specifically comment on the situation in Russia, particularly on the role of organized crime in intellectual property theft over there, I want to make a few comments on the state of affairs between the Senate and the administration on trade issues.

Everyone knows that the situation with CAFTA is fraught with difficulties and that the administration is going to need every supporter that it can both on the Hill and in the public as well. Everyone on the Judiciary Committee members only too well the misadventures we had when USTR negotiators included immigration language in several trade agreements last Congress that caused enough furor on the Judiciary Committee to actually unite us on a bipartisan basis, and that was not easy to do on this Committee, I have to admit.

One of the messages we conveyed, and the House Judiciary Committee as well conveyed to the administration is that we want to be consulted and taken seriously on these types of issues. Many of us in the Senate have felt from time to time that either those in the administration who have been working directly are not taking back our concerns, or if they are, these concerns are not being effectively conveyed or listened to or considered.

I have been a strong supporter of free trade and everybody knows that, and I hate to see the increasing erosion of support among the public and within Congress for trade agreements especially with people like me. But one way to help reverse this growing tide against trade agreements is to be able to assure the public

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and the Congress that the U.S. Government is standing up for our rights in areas where we lead the world, such as the intellectual property-dependent sectors of software, entertainment, information technology and biotechnology. There is a growing weariness that while we may have all the right words on the paper, at the end of the day there is no teeth in the words. And when it comes down to enforcing the laws against the outright, flagrant theft of U.S. intellectual property, there is no strength behind that.

So with that, I would just ask all of you to comment on the situation in Russia and whether the Russian government is effectively combatting IP theft by organized crime in Russia, and if you could comment very quickly because we will turn to Senator Leahy as soon as you are through.

Ms. PETERS. Clearly, the answer is no, they are really not doing enough. They actually do have an Internet piracy problem. Many of us realize that in the United States we also have a problem that you and Senator Leahy tried to address last year and time ran out, and we are waiting to see what happens in the Grokster case. But if it comes out, quote, "the wrong way"—

Chairman HATCH. We are all waiting for that, aren't we?

Ms. PETERS. If it comes out the wrong way, you may have to take the effort back up again because people will look to the kind of law that we have and how we protect our works in an Internet environment before we go there and tell them that they have their Internet problem and they are not solving it.

Chairman HATCH. Mr. Mendenhall, go ahead, or Mr. Pinkos. We will go right across.

Mr. MENDENHALL. Just a couple of points in response to what you said. Your question, I know, was directed at Russia, but you also mentioned in the course of your comment our free trade agreements, CAFTA and others, and I want to pick up on that because one of the problems that we have when we talk about the enforcement obligations in the WTO and elsewhere is that the rules that we have in TRIPs, for example, are fairly blunt instruments.

So what we have tried to do in CAFTA, as with our other trade agreements, is refine the enforcement rules. We have roughly 25 pages of our IP chapters dedicated solely to enforcement, much of it dedicated specifically at copyright enforcement to update the rules applicable in these countries, whether it be on the Internet, dealing with the specific issues related to the Internet, or even broader than that on other matters. So when it comes to our free trade agreements, we are refining and honing the rules and we have seen significant progress.

Now, in Russia specifically, I certainly share the frustration that you expressed with Russia's failure to adequately enforce IP rights. I think we all recognize that. That is why we put them on the Priority Watch List this year. That is why we are going to continue to monitor it closely through the out-of-cycle review toward the end of the year. And I can assure you that it is an issue that has taken a very high profile, very prominent, in our discussions in the accession process and our IPR bilateral dialogue with them. We will continue to do what we can to impress upon them to make progress, but it is a serious problem. We recognize that.

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Chairman HATCH. Let me just ask one other question before turning to Senator Leahy. It is my understanding that the TRIPs provisions are a floor, not a ceiling, and I hope you agree with that statement.

Does anybody disagree with that?

[No response.]

Chairman HATCH. Okay. Can you comment on whether it is the policy of our Government to attempt to negotiate in a TRIPs-plus fashion, when appropriate, such as in the fast-changing IP areas? I will just mention one, e-commerce. These areas were not fully developed when the TRIPs provisions were adopted in the mid-1990s.

Do you care to comment about that?

Mr. MENDENHALL. Sure. I can start, but my colleagues may want to jump in. Yes, TRIPs is a floor. Yes, it is ten years out of date, in a sense. Since then, there have been new rules that have emerged, internationally but not universally accepted in WIPO, for example, to deal with the Internet issue. Our FTAs, as I said, have a very intense focus on enforcement, including on e-commerce and the Internet. They do need to be updated—not the FTAs; the global rules do need to be updated in some sense.

We are pressing in all of our bilateral dialogues, including with China, for example, the adoption of rules to bring their enforcement regimes up to snuff. Mr. Pinkos, I think, indicated that we are urging China to fully implement and adopt the WIPO Internet treaties. They have indicated to us that they would seek to do that this year, that the draft regulations in train, and we hold them to do that commitment. It is something that we have discussed at the JCCT, and we will continue to do that.

But we are pressing our trading partners through our FTAs and outside of our FTAs and in any other context we can raise it, including through the special 301 process, adoption of rules that modernize the enforcement regimes and go above TRIPs standards.

Chairman HATCH. Thank you.

Mr. PINKOS.

Mr. PINKOS. I think we have seen success with our FTAs in implementing TRIPs-plus, but it is increasing tough sledding in these multi-national settings like WIPO or at the WTO because there is really a very active anti-IP developing world sentiment. In these bodies that require consensus or near consensus to agree on things, it makes it particularly difficult to get further protections.

As we saw with the GI case, the geographical indications case, we even have some differences with our European trading partners on the height or strength of IP protection. So it is tough sledding, but I think we are working really hard in these international organizations to try to push through some things.

Chairman HATCH. Thank you.

Senator Leahy.

STATEMENT OF HON. PATRICK J. LEAHY, A U.S. SENATOR FROM THE STATE OF VERMONT

Senator LEAHY. Thank you, Mr. Chairman, and I am sorry that I was late. I want to commend you for having this hearing. I also wanted to submit for the record a statement by Senator Biden, who is on the floor, as you know, with a nomination.

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Chairman HATCH. Without objection.

Senator LEAHY. We Americans think globally as we enjoy the fruits of a lot of creativity of other Americans. I was just getting some messages here on a Blackberry, but that is just one example. Unfortunately, a lot of other people think globally and enjoy the fruits of people's creativity and innovation and they do it because they steal it. I pay for those things I get, as does the Chairman, but a lot of the advances of the digital age have eliminated a lot of the barriers between buyers and sellers.

Software, music, photographs—any of those things can be sent around the globe. We saw the opening of the latest "Star Wars" movie. It had the biggest opening, I guess, of any movie in history, and within the first day they were downloading pirated copies and selling pirated copies overseas and some here in the United States. So it is a global problem.

Because we are the world leader in intellectual property, we at least should be acutely aware of the impact on U.S. industry and our own citizens' creativity. Intellectual property is vital to our health. According to the International Intellectual Property Alliance, in 2002 the various copyright industries accounted for 12 percent of the U.S. gross domestic product. That is $1.25 trillion, and 11.5 million people employed, but they still lose hundreds of billions of dollars to piracy every year.

The Business Software Alliance estimates its loss at $30 billion in software sales annually. The MPAA estimates it loses $3 billion a year to piracy. The International Intellectual Property Alliance reports that the U.S. lost more than $13 billion in trade due to copyright piracy in 2003. The FBI says that we lose $200 to $250 billion annually to counterfeiting alone.

You have people who work very hard to develop, to create something. This is their livelihood, this is what they are proud of, and it is just stolen. We all understand if you break into somebody's house or warehouse and steal what is there, but these people are broken into maybe from 10,000 miles away.

We focus today on China and Russia, and for good reason. The Chairman asked the pertinent question is Russia doing enough. Well, we all know the answer to that. China, in the year 2000, entered the World Trade Organization and I expressed concern about China's record on human rights and labor rights, a record which is terrible. When ultimately I voted in favor of establishing permanent and normal trade relations, I did note that isolationist policies do not work.

For several years now, we have been engaging China in attempts to improve its record on piracy. Instead of progress, the United States Trade Representative's 2005 special 301 report placed China on its Priority Watch List. The report notes that while China has expended efforts, we have not seen any meaningful reduction in infringement that China promised to attain. I sometimes wonder when you see raids for television, whether you raid the front end of the pirate business in China while work goes on at the back end. It has resulted in an estimated loss of $2.5 billion to $3.8 billion annually in pirated copyrighted works.

Russia, as the Chairman has mentioned, is on USTR's Priority Watch List. We know that while Russia has passed numerous laws

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designed to improve intellectual property protection, enhanced enforcement has not followed. It is sort of like you pass a law and say we will have a law against burglary, but you can't put locks on your doors and the police won't ever bother to come around and check the place at night. Well, the law looks good on the books and nothing happens.

The piracy rate for the recording industry is 66 percent; for the movie industry, 80 percent. Among the many problems in Russia is that the pirated goods that are confiscated by law enforcement—think about this—the goods they do confiscate so they can show us how hard they are working, 70 percent of it is returned to the market. It is sort of like, hey, everybody, look at this, we are getting tough here in Russia, we are grabbing this stuff. Okay, the camera is gone, give 70 percent back. You have got to have more than a revolving door. The copyright industry's estimated loss in Russia is $1.7 billion.

Last week, Senator Cornyn and I introduced S. 1095, the Protecting American Goods and Services Act of 2005, to criminalize possession of counterfeit goods with intent to traffic, to close off the loopholes. In 1996, Senator Hatch and I worked together to pass the Anti-Counterfeiting Consumer Protection Act, which amended several sections of our criminal and tariff codes.

We know it is more than a problem for just a few of us. We have to ask if the United States Trade Representative has adequate tools to address this issue. Do we need to strengthen our domestic laws through legislation like the legislation Senator Cornyn and I recently introduced? Do we have to engage more vigorously with China, Russia and other countries that don't enforce IP enforcement? I think the answer to all those questions is yes.

I am probably preaching to a lot of the converted in this room, but, Mr. Chairman, we are hurting on this. The other thing is now we know it is not just some of these countries that are allowing this. We have organized crime syndicates turning to piracy. It is a lot easier than going out to rob banks. When they asked Willie Sutton why he robbed banks, he said, well, that is where the money is. Organized crime has always looked where the money is, whether it was selling liquor during Prohibition times, or drugs, or whatever. Piracy is a very easy way to go.

I read Eric Smith's written testimony and it was very much like Marybeth Peters', who is a person who has enormous credibility before this Committee on both sides of the aisle. They mention the very disturbing possibility that this piracy may be funding terrorist groups. That is something that worries me. If terrorist groups are looking for money, why not go to piracy?

Ms. Peters, did you want to add to that at all?

Ms. PETERS. Not really. I agree with you a hundred percent that the organized crime element that we see in the international arena should be of tremendous concern to everybody and not just the United States, but other countries.

Senator LEAHY. Well, you know, we put China as a member of the WTO on the idea that maybe this will help us get them to stop all the counterfeiting, but they keep right on doing it. Is there any reason to think that Russia will do any better if we put them in WTO, Ms. Peters, based on our experience so far?

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Ms. PETERS. Well, I think that the possibility to bring about any kind of changes is during the entrance process, our ability to negotiate with them and what they need to do in order to become a WTO member, and make sure that they live up to those agreements. We hope that if the United States Government believes that that is where they should go that we will have managed to elicit more than promises, but effective actions.

Senator LEAHY. But have we seen much in what they have been doing so far to make us think that they are going to?

Ms. PETERS. No.

Senator LEAHY. Mr. Pinkos?

Mr. PINKOS. From what I understand—and Mr. Mendenhall may want to take a shot at this—it has been pretty tough sledding, pretty tough negotiations, but we have been pretty strongly insistent that they make the IP commitments before we are going to acquiesce to their ascension to the WTO.

Senator LEAHY. Mr. Mendenhall?

Mr. MENDENHALL. It is a difficult issue, obviously. It is a complex issue. We have been in negotiations with Russia for a long time. Through that time, we have seen incremental progress, for example, in having Russia get its laws in shape. As with China and as with a lot of these other countries, the laws on the books don't matter a whole lot if they aren't enforcing them.

But we have seen some progress in getting the laws in shape. We have emphasized to them that that is not enough, that they actually need to enforce those laws. They need to go forward and reduce the piracy and counterfeiting levels. We have made that a critical part of the accession package, the accession negotiations, as I indicated earlier. We have raised it at the highest levels and we will continue to do so to impress upon them the need to make progress on this issue as we go forward in the process.

Senator LEAHY. But what is going to make them do it? I mean, we can raise it to the highest level, but in the past nothing seemed to worry them. I bet you anything that if you go to downtown Beijing within hours of the time just about any movie comes out that is going to be kind of a blockbuster, or downtown Moscow, you can buy pirated copies. I have seen them there.

What is enough of either a carrot or a stick to make them change, especially when it seems to be governmental policy to allow this?

Mr. MENDENHALL. Well, of course, that is the $64,000 question. I mean, what is going to do it? As I indicated in my opening remarks, we have a series of tools that we have used—you mentioned China, in particular—to gradually escalate the issue—actually, not so gradually. We have escalated the issue over the past year with China, starting with diplomatic initiative through the JCCT, working through an out-of-cycle review, stepping up from there to make a finding of Priority Watch List which, as I indicated, China has taken seriously.

I can tell you that because they are here this week talking to us about it. They have expressed their concern about that listing as a Priority Watch List country. We are working with them further on developing an IPR action plan over the next couple of weeks and we are going to be resorting to WTO procedures, as I said, on the

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transparency side in the coming weeks. And if we still haven't seen progress, we need to think seriously about next steps that we need to take in the WTO or otherwise.

So what we are doing is what I think we need to do with China, as we need to do with Russia. We need to speak with a unified and strong voice. We need to impress upon them the importance with which we take it, and I think it is almost important, frankly, to get them to change the mindset so they see it in their own interest. And we have started to do that through various training programs that the various agencies represented here have undertaken, as well as others have.

We will get there, but it is going to be a slow process because as I said in my remarks, this is not your typical trade case. This is not a case where you need to change a number in a tariff schedule. You need to change the mindset. You need to get political will at all levels of the government to take it seriously. And if you want to change the mindset, that takes time. It is not a matter of simply changing a number in a tariff schedule, but we are using all the procedures and all the levers we have at our disposal to do it.

Senator LEAHY. Thank you. Thank you, Mr. Chairman. I have a number of other questions, but I will submit them for record.

Chairman HATCH. Thank you so much, Senator Leahy.

We appreciate all three of you coming. You have been helpful to us here today and we are going to have to work on this together. I think the next panel will have a number of suggestions on what might be done and I hope you will pay strict attention to what they have to say, as well. Maybe there are some ideas there that might augment some of the ideas you already have.

We have got to put a stop to it. We have got to go after these people and we have got to go after these countries and get them to start being responsible to protect intellectual property. But we appreciate the work all of you do. Thanks for being here.

Mr. MENDENHALL. Thank you, Mr. Chairman.

Chairman HATCH. Thanks.

Our next three witnesses will be Eric Smith, President of the International Intellectual Property Alliance here in Washington, D.C., then Taylor Hackford, board member of the Directors Guild of America, from Los Angeles, California, and Robert W. Holleyman, President and Chief Executive Officer of the Business Software Alliance here in Washington, D.C.

So we will start with you, Mr. Smith, and then we will go across to Mr. Hackford and then to Mr. Holleyman. Mr. Smith, you are first.

STATEMENT OF ERIC H. SMITH, PRESIDENT, INTERNATIONAL INTELLECTUAL PROPERTY ALLIANCE, WASHINGTON, D.C.

Mr. SMITH. Thank you, Mr. Chairman and Senator Leahy, for again giving IIPA an opportunity to testify on the piracy problems the copyright industries are confronting globally. I am going to speak very generally on the topic and my colleagues here will speak to their particular industries in some more detail.

This oversight hearing is extremely timely, as you have mentioned, because at this very moment a delegation from China called the IPR Working Group is meeting with the U.S. Government as

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we speak. In addition, USTR has just announced its special 301 decisions. This is the congressionally-created mechanism by which our Government seeks to improve IPR protection and enforcement globally, and to nurture those creative and innovative industries and individuals who contribute so greatly to our Nation's economic growth. Finally, there are currently ongoing talks between Russia and the U.S. looking toward Russia becoming a WTO member and to secure permanent normal trade relations. I want to briefly discuss our global problems and challenges, and then turn to the dire problems we face in Russia and China.

As you know, Mr. Chairman, we represent the U.S. copyright industries. We have six member trade associations, 1,300 companies, accounting for millions of U.S. jobs. You have mentioned those numbers. I won't repeat them. These companies and the individual creators that work with them are critically dependent on having strong copyright laws in place and having those effectively enforced.

On average, the copyright industries generate over 50 percent of their revenue from outside the United States, and in 2002 contributed over $89 billion in exports and foreign sales to the U.S. economy. Given the overwhelming global demand for the products of America's creative industries, all these numbers would be significantly higher if our trading partners, particularly those like Russia and China that continue to allow piracy to flourish in their own economies, were to significantly reduce piracy rates by actually enforcing their copyright laws vigorously.

First, I want to highlight the global problem. In our 600-plus-page report which we submitted to USTR, we highlighted problems in 67 countries and their impact on the U.S. economy and U.S. jobs. Rampant piracy in most of those countries highlighted in this report constitutes the copyright industry's greatest barrier to trade, costing U.S. jobs and contributions to the U.S. economy.

In our report, we identified six priorities or challenges we face in fighting piracy in partnership with our own Government. These challenges are amply illustrated by the two countries I want to especially highlight today—Russia and China.

These challenges are, very briefly, Internet piracy and its impact on the growth of electronic commerce; optical disk piracy and the need to regulate it at the production level; the role of organized criminal syndicates in the piracy business; the problem of losses caused by unauthorized use of business software in governments and small businesses, and Mr. Holleyman will speak about that; book and journal piracy, both traditional and online; and the cross-cutting challenge of securing compliance with the WTO TRIPs Agreement, and particularly its enforcement provisions, and how the new free trade agreements are helping to achieve better protection. Our industries face all these challenges in Russia and China, two countries that are highest priorities and where we suffer huge and growing losses.

First, Russia, and the problems in what it and the U.S. Government needs to do. Mr. Chairman, Russia is about to become the new China, as you have mentioned, as far as piracy is concerned. Let's look at a few statistics.

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You have mentioned that we lose over $1.7 billion due to piracy in Russia. That was in 2004, and $6 billion over the last five years. At the same time, the U.S. has unilaterally granted Russia over $515 million in GAP benefits in 2004. With its record, Russia should not be considered eligible to receive those benefits.

As you have mentioned, piracy rates hover around 70 percent of the market, or higher, for every copyright sector. It has been recently estimated that Russia's annual manufacturing capacity for OD product now stands at 480 million disks. Demand for legitimate disks is unlikely to exceed 80 million in all formats. You can imagine what happens with the rest.

The government of Russia has said that there are 18 plants on restricted access property, military bases, where simple entry is denied law enforcement. Forensic evidence indicates that at least 24 of the 34 plants are known to be producing pirate product. Russian-produced optical disks have been positively identified in at least 27 countries, seized in 27 countries.

However, the statistics only tell a part of the story. What they do not show is the poor reaction over the past ten years of the Russian government to their piracy problems. IIPA first raised the OD problems with the Russian government in 1996 when there were just two plants. The reason the problem has been allowed to escalate to 34 plants has been the Russian government's continued and deliberate failure to act, despite repeated promises to our government and to our industries. In short, what we face in Russia is a legacy of failed commitments.

Let's look at the enforcement record. In 2004, there were eight actions taken by the Russian government against the optical disk plants, including raids and seizures of illegal materials. As Senator Leahy has said, 70 percent of the products seized went out the back door—unbelievable. All of the optical disk plants that were raided remained in operation after those raids. There are few, if any, criminal prosecutions. All that were prosecuted ended in suspended sentences. In ten years, there have been only two convictions with actual sentences.

We and the U.S. Government have recommended six straightforward steps to deal with the optical disk piracy problem. They are detailed in my written testimony. The conclusion: none of them have been done. So what needs to happen?

First, we cannot make the same mistake that was made with China, permitting Russia to enter the WTO without undertaking meaningful and WTO TRIPs-compatible enforcement actions. The actions we detail must be a pre-condition to such entry. These are not commitments we are looking for. This is action. We got commitments from China and now it is almost four years later.

Second, if Russia fails to act, it should be designated a priority foreign country after the ongoing out-of-cycle review by USTR—something that we recommended and was not done in this last round.

Third, we should deny Russia's eligibility for the generalized system of preference duty-free trade benefits. It has been five years since we filed that petition and it has been four years since USTR granted that petition. Russia has been on the Priority Watch List now for nine years. Mr. Chairman, it is time to act.

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Let me now turn to China. Mr. Chairman, we are in dire straits in China. Piracy rates have hovered at and over 90 percent, as we have discussed here, in the more than 15 years that IIPA has been engaged with the U.S. and the Chinese government. Indeed, with the new digital copying technologies and the Internet, the situation has even worsened. Every year, industries have lost conservatively between $1.5 and $2.5 billion. In 2004, it was over $2.5 billion.

China is potentially the largest market in the world and is growing at a faster pace than virtually every country in the world. We have an important, in trade jargon, comparative advantage in the area of copyright, an advantage that hasn't even begun to be realized, while, as we know, China is continually taking advantage of their comparative advantage in so many areas, with a trade surplus with the United States of $162 billion.

Of all the industry sectors represented in the U.S. economy, the copyright industries face a market more closed to them than to any other. Not only is nine-tenths of the Chinese market closed through piracy, but our industries suffer under onerous and sometimes discriminatory market access barriers. China's denial of effective market access prevents us from getting to know the market and establishing a presence that would enhance our ability to fight piracy. Even if we were to reduce piracy by half in China, under the present circumstances most of our industries could not satisfy the huge local demand because of these barriers. In short, these two problems are indelibly interlocked.

Chairman HATCH. Mr. Smith, would you try to wrap it up?

Mr. SMITH. Yes.

Chairman HATCH. We allot five minutes. You are almost ten minutes.

Mr. SMITH. We believe that the failure to use the criminal law to fight piracy is a violation of China's TRIPs obligations. We believe that the Chinese criminal law, because it does not encompass all acts of copyright piracy on a commercial scale, also violates the TRIPs Agreement. Because of all this, IIPA has urged USTR to engage in a new multilateral dialogue with China. Following USTR's announcement of the results of their out-of-cycle review, we are closely to develop the elements of a possible WTO case.

We ask two things: first, that China immediately commence a significant number of criminal actions against pirates of our products and impose deterrent penalties; and, second, that China now eliminate the onerous and destructive market access barriers that prevent U.S. copyright-based companies from doing real business in China.

Thank you very much.

[The prepared statement of Mr. Smith appears as a submission for the record.]

Chairman HATCH. Thank you, Mr. Smith.

Mr. Hackford, we will turn to you.

STATEMENT OF TAYLOR HACKFORD, BOARD MEMBER, DIRECTORS GUILD OF AMERICA, LOS ANGELES, CALIFORNIA

Mr. HACKFORD. Senator Hatch, Senator Leahy, thank you for inviting me here. I am here today on behalf of the Directors Guild of America, which represents 13,000 directors and members of the

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directorial team, which accounts for assistant directors, production managers, et cetera. Those teams work in feature films, television, commercials, documentaries and news. Our mission is to protect the economic and creative rights of directors and their teams.

I think most people tend to think of the movie industry as the glitz and glamour of Hollywood, movie stars, et cetera, but the reality is that most jobs are behind the camera and they are located all over this country. We are talking about those names that scroll up the screen at the end of a film, hundreds of names for every film, tens of thousands of people who work in this industry.

Now, those employees are just the ones that work in the film industry. There are a lot of other people, small businesses, that have their livelihood, their bread and butter, in the film industry also—cleaners that clean costumes, rental cars, trucking, many, many things. As you well know, the entertainment industry and the information industry in this country account as the second largest export that we have. All of these jobs and that industry are currently at stake, are at great risk, which you have heard about today.

Now, it is an incorrect assumption in the piracy debate, usually made by people who are interested in open access, that once a film is out and gone into the theaters, it is over and it just comes back then perhaps as profit to the studios. Nothing could be further from the truth. There is a process in the entertainment industry called residuals. This is a crucial element in our business and let me explain why.

We are not on a weekly salary, or a monthly or a yearly. We work freelance. Every single film we make, depending on its success, could be our last. Therefore, you work on a project, you put your lifeblood into it, and you hope in the long run that it is going to do well. The residuals from our productions that come back from free and pay television, through DVDs, through video cassettes—that money that comes in feeds our health and pension plan and is really the bread and butter that keeps us alive.

What we are facing today is a market where over 55 percent of the money that comes back from films comes from outside the United States. The whole issue of piracy, both within and especially from outside the United States, is seriously threatening our livelihoods, our bread and butter income.

So when pirates steal a movie—and that is exactly what it is; it is robbing—they are not just robbing revenues from the studios; they are taking our money that we need to live on and hopefully exist in the future. Moreover, it is not just the films that we make. It is about the films that have not yet been made, and let me explain.

When you go out to make a film as a film maker—and I am film director and producer—you don't just make it like this. I want to give you a case in point. I just made a film this past year called "Ray." It was a film about the life of Ray Charles. It took me 15 years to make this film.

Senator LEAHY. Incidentally, one of the best movies I have seen in years.

Mr. HACKFORD. Thank you very much, Senator.

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Senator LEAHY. I am not trying to give plugs on it, but I went to that and I have urged all my kids to go to it. I have urged all my friends to go to it. It was a tough movie.

Mr. HACKFORD. It was.

Senator LEAHY. But it was a good movie, really good.

Mr. HACKFORD. Thank you very much.

I thought today one of the things that I could do was try to put a personal face on this issue and talk about a project like "Ray" that I was personally involved in, and you can see the process of what has happened with that particular film.

As I said, it took 15 years and it was not easy, for some reason. You have seen the film and you liked the film, but it was very hard in Hollywood to find anybody who would finance it. I had a passion for this film. I believed in it. I had made the commitment to Ray Charles himself and worked with him for 15 years, and in the process I finally came to the point where I did find somebody to make the film.

In this industry, it is a huge risk. People are putting up a lot of money, and with smaller films like "Ray" this is a much bigger problem than a film like "Star Wars" that everyone knows is going to go out and play in the theater and millions and millions and millions of people are going to see it. The smaller films, the riskier films, are the ones that are most affected like this, like "Ray" was.

Now, luckily for me, I convinced an individual to actually finance the movie. He was advised by everyone not to do it. Luckily for him, the film was done very, very film. Luckily, we had a distributor, Universal, that picked the film up and did a very, very good job. So, in reality, everybody made out, but you should realize that only four out of every ten films made makes it money back from theatrical receipts. Less than that number—I think it is something like only six films out of ten ever make their money back at all. So it is a hugely risky thing.

I want to give you the case of "Ray." When Universal released the film, it was the end of October. The same week it opened, I walked down Canal Street in New York City and the video cassette was on sale, complete with the art work. These people had done all the work ahead of time, and when they got the disk they put it out. Now, we happen to know from research that Universal has done that it was videotaped at the Raceway 10 Westbury Theater, the Loews Raceway 10 in New York and the Loews Jersey Garden Theater in Elizabeth, New Jersey.

Now, they immediately took that videotape and they put it on the Web. They sent it to Russia and China, and immediately started that process, the things that you were talking about of generating it. So the fact is that it was on sale a week after its release, or the week of its release—pardon me—because I saw it the day after it was released here in New York, California, Florida, Georgia, Texas and worldwide.

Chairman HATCH. When you talk about release, you are saying in the theaters.

Mr. HACKFORD. I mean the DVD was for sale.

Chairman HATCH. Yes, because the DVD you came out with later was like three months later.

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Mr. HACKFORD. Three months later. This is an important thing. The DVD was on sale in Europe before—we didn't release the film in Europe for another two months.

Chairman HATCH. What you are saying is you had the film in the U.S. theaters. You hadn't yet hit Europe. You hadn't yet done your own DVD of it.

Mr. HACKFORD. We hadn't done our DVD.

Chairman HATCH. And a day after the film was released, you had DVDs on the street at a very discounted price.

Mr. HACKFORD. Absolutely. You had DVDs on the street.

Chairman HATCH. Without any payment of any copyright royalties at all.

Mr. HACKFORD. Nothing coming back.

Now, what then happened is three months later, at the beginning of February, we released the DVD. Immediately, that high quality—first of all, the camcorder version was not very good quality, but still that didn't stop millions of people from buying it. Then on February 1, we went out with a DVD, and immediately that went on the Web for downloads.

Now, just to give you an idea, last week, one day, May 19, on the peer-to-peer networks there were more than 476,000 requests for "Ray." Since the film was released and first pirated in October, there have been 42 million requests to download "Ray."

Chairman HATCH. That is without any payment of royalty or any copyright—

Mr. HACKFORD. Nothing, nothing. I think that kind of tells you what we are facing. If I had that much trouble raising the money to make the film—luckily, the film worked critically and commercially, and the people are going to make their money back. But those people didn't know that. They were told this was going to be a risk and they might not get it back.

Now, if you tell them that you can go out and you can make the film and before they can see anything back, millions and millions of copies—in fact, the other thing that is important to say is last year was the first time in history that DVD revenue exceeded box office. The future is clear. The DVD is going to be the profit leader in this industry.

So when I am going to an investor and trying to raise money for a film and that person already knows it is a big risk and now knows that before the film even plays in a theater, it can be on the street, it is going to be devastating to our business. And that means devastating loss of jobs and obviously, as I said before, to this country. If it is the second largest balance of trade export, it is going to be devastating to our economy, and obviously something things to be done.

Chairman HATCH. Plus, a loss of creativity, loss of star power, loss of people's opportunities to excel in the arts, et cetera.

Mr. HACKFORD. I think the important thing about the movie business—and again I don't want to put it all in commercial terms. I am an artist. I think when you put something together in a film—let's take Ray Charles. Ray Charles is to me the epitome of the American experience, and let's not talk about race. This is a blind man who in this country was able to make himself a legend,

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who was able to, through his own talent and fortitude, go out there. That is a message that you send to the world about America.

If this industry and the things that we are communicating about this country and the industry that we are creating that will bring revenue back to this country is destroyed—and it will be unless we do something—I think that, yes, I am speaking personally. Myself, my colleagues, the people I work with—and again they are not just the movie stars, but all those people that go into—I don't work alone. I am not a painter at an easel or a novelist at my typewriter working alone. It is a collaborative effort. All those people go into making my film as good as it is, and those people are going to be out of work.

So I am here today to express this personal plea to you, and I want to also thank both of you and your Committee for all the work that you have done. Your interest in this has been pioneering. The laws that you have helped enact have really helped us. People are just now starting to wake up even in my industry. But we appreciate that and the Directors Guild is here to help you in any way we possibly can in the future because we share your concern and understand the vital nature of this problem.

Chairman HATCH. Thank you.

[The prepared statement of Mr. Hackford appears as a submission for the record.]

Senator LEAHY. Mr. Hackford, I think I can probably speak for both of us in saying that if you worked hard to create something, you ought to have the satisfaction of knowing it is your creation. Now, if you do a bad job and it doesn't sell, fine. That is a risk you take, whether somebody paints a picture, writes a song, writes a book or anything else, or does computer software.

But if you have done something good, you ought to get rewarded for it. It ought to be yours, in the same way that if you have got something in your own home, you shouldn't have somebody steal it. You shouldn't have something that is your creation be stolen.

Senator Hatch and I have wrestled with this and I think we have demonstrated to the country that it has not been a partisan issue. We are very concerned about this. I want people to be able to compete in the marketplace. If their product sells, they benefit by it. If it doesn't sell, well, that is the risk they take, as anybody does who goes into the marketplace. But it shouldn't be stolen any more than if you own a furniture store and you create nice furniture; somebody shouldn't break in and steal your furniture.

Mr. Chairman, I am going to have to leave at this point. I apologize. Mr. Holleyman, of course, has been so extraordinarily valuable to this Committee over the years, to all of us here. I have read the testimony and I will leave some questions for the record. It is unfortunate. I know you have had a million things going on today and I have got a conflict, but I thank you for holding the hearing.

I can't tell you how much I want to close the door. I am a former prosecutor and I would like to just be able to go out and prosecute everybody who is doing this. You probably would, too, but I wish there was some way we could close the door. We are never going to get it completely closed, but we can do a lot better job than we are.

Thank you.

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Chairman HATCH. I just want to thank Senator Leahy because he takes a tremendous interest in these things, and we get together on these matters. We get together on a lot of things, but we particularly get together here. I don't think there is even a division between us in almost any area that affects you. I just feel it is a great privilege to work with him, as well, because he takes a great interest in these issues.

Let me just say that you are raising issues here that should affect everybody in America. This Committee is going to do everything it can, but we need more help from the intellectual property community as to how we might domestically pass some laws that might be of aid to you. We have been trying to do that, but they haven't exactly worked as well as would like them to work. They are working in some ways, but not as well as we would like.

So we need your help. We need the best thinkers in all of the aspects of the intellectual property community and the high-tech community to assist us. As you know, there is a real divide between some in the high-tech world and some in the intellectual property world, or should I say the copyright world. So we have got to bridge those gaps and try to be fair to everybody.

Let me just also say that I am also first ranking on the Senate Finance Committee and will take over as Chairman if I am fortunate enough to be reelected. We handle the trade issues and I can guarantee you I am not going to be very open to China and Russia if they are not going to clamp down and do something about it. I might as well warn the administration right now that unless they are willing to start demanding that they abide by international norms, they are going to lose a very advocate for free trade in me. I don't think it is a question of free trade as much as it is a question of thievery.

Mr. HACKFORD. Well, there is a free trade issue, too, Mr. Chairman.

Chairman HATCH. Well, there is.

Mr. HACKFORD. When they put a cap on and when they say that only 20 films from outside China can be distributed, what is also happening is the studios are thinking about going to China to make films to get around that, which means that takes jobs out of America to do that.

Chairman HATCH. That is one of their ideas to get you to go there.

Mr. HACKFORD. Yes.

Chairman HATCH. But I am very concerned about this, and it isn't just the movie industry. It is the publishing industry, it is the music industry. We have seen tremendous dislocations there.

We will turn to Mr. Holleyman, who will put a wrap-up on this.

STATEMENT OF ROBERT HOLLEYMAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER, BUSINESS SOFTWARE ALLIANCE, WASHINGTON, D.C.

Mr. HOLLEYMAN. Mr. Chairman, I want to thank you and Senator Leahy for inviting the Business Software Alliance to testify at today's hearing and for your very persistent attention to the problem of piracy over the years.

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As I think this panel has shown, piracy is an issue that affects individual creators. It affects collaborators, it affects shareholders, it affects national economies, and it affects future creators as well. Last week, the BSA and the IDC, which is the leading information technology market research firm, released a report showing that in 2004 the value of pirated software worldwide actually increased, despite a modest one-percentage-point decline in piracy rates.

In 2004, the world spent more than $59 billion for commercial packaged software. Yet, software worth over $90 billion was actually installed. So for every two dollars' worth of software purchased legitimately, one dollar's worth was obtained illegally.

The BSA has also worked with IDC in looking at the impact of reducing piracy on jobs and tax revenues. We have shown globally that a 10-point reduction in piracy can yield 1.5 million new jobs, $64 billion in taxes, and $400 billion in economic growth. And in North America alone, a 10-point reduction in software piracy would yield 145,000 new jobs, $150 billion in additional economic growth, and more than $24 billion in tax revenues.

While there are many countries that I could talk about, today I would like to focus on two—Russia and China. Both of these markets should be tremendous opportunities for our industry. The potential as software markets, and indeed as software suppliers one day, is significant, but it is today largely unfulfilled.

Russian software piracy last year—87 percent of the total market was pirated software. It has been stuck in the high 80s for several years. Russia has adopted a number of legal reforms over the past several years, and while they give us some hope that there may be improvements in the marketplace, we have yet to see that realized.

Indeed, the piracy situation on the ground in Russia is mixed. Our companies, on the one hand, are seeing some progress in addressing their channel enforcement issues by working with Russian law enforcement authorities. Yet, very little is being done to address end user organizational piracy, which is the largest single problem that the software industry faces in Russia, and indeed in every country around the world.

Internet piracy is also a growing challenge in Russia and an area where we have had little success. Pirated software from Russia is being promoted and sold all over the world using spam e-mail and delivery by e-mail. Mr. Chairman, I have examples that I have printed out of some of the spams that are being originated in Russia that are being sent to unsuspecting consumers in the United States and around the world that then link you to slick websites that advertise software for a fraction of the normal retail price. These prices, however, are high enough to convince some consumers that the offer is legitimate.

There are a whole host of other problems I can outline, but we are hopeful that the WTO accession mechanism will be the way that we can finally begin to see some improvements in Russia.

Switching to China, last year the piracy rate was 90 percent in China, down two percentage points from the year before, but still far too high. Much more needs to be done. Consider this: China is now the second largest market for personal computers in the world, but it is only the 25th largest market for software. The gap between hardware and software sales is huge and it is growing.

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I would like to recommend for specific improvements for China and its IP regime. First, they must extend criminal liability to enterprise end user piracy. It is absolutely critical that there be criminal penalties for organizational end user piracy.

Two, they have to reduce and clarify criminal thresholds. Three, they have to increase the administrative penalties for infringement. Fourth, they need to ensure that the government itself is using only legitimate software. The goal of all of this is to increase the legitimate market for software in China, and that will benefit all software suppliers, whether they are U.S. or Chinese origin.

Let me say, Mr. Chairman, before I conclude that we have looked at a lot of measures in the past of how China addresses enforcement—the number of actions they are bringing, the publicity for those actions. We think those are important, but experience has now shown that that is insufficient. We have to look creatively at new benchmarks that we can put on the table that will not only show the number of cases, but that will also show demonstrable market growth. We are working with USTR and the Commerce Department now in looking at some options to put on the table in the context of JCCT that will expand the type of benchmarks that can be used.

Let me conclude, Mr. Chairman, by saying that we make the point here and with our allies around the world that reducing piracy benefits all creators. It benefits the entire channel for the distribution of legitimate product. It benefits U.S. companies, but it benefits domestic producers.

In each of these countries, I go hand in hand with local developers to make this case, but it has been through the persistent efforts of this Committee and the U.S. Government that we have been armed with the tools that we need. We look to you for continued help and you have our pledge of support.

[The prepared statement of Mr. Holleyman appears as a submission for the record.]

Chairman HATCH. Well, thank you. A lot of people don't know in this country that we are way behind some of these other countries, including China, with regard to some of the aspects of the high-tech world. A lot of those Ph.D.s and a lot of those highly educated engineers were educated right here in America, which is good, but then they go home and they know how to suck the lifeblood out of our economy.

Mr. Hackford, just a rough estimate. How many people totally were involved, from writing, to production, to post-production, to marketing, to DVDs in the film "Ray?" Let's just use that one film.

Mr. HACKFORD. Well, during the production I would say there were 150 people that were directly—we shot the film in Louisiana, in New Orleans, and we had a crew there. But in the post-production process and in the marketing, you could probably add another 150. I mean, that is for one film.

Chairman HATCH. But that doesn't count all the people in the movie houses and everybody else. It is hundreds of thousands of people.

Mr. HACKFORD. No, no. Then, in fact, as the film goes out and plays around the country, it is an interesting question.

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Chairman HATCH. You are talking about hundreds of thousands of job for one film.

Mr. HACKFORD. In the movie industry, without question, without question. But the reality is that there is what we call a multiplier effect that I love. When we go into a community, people think it is just the crew that goes there, but when you go in, you have all the small businesses that literally make their—as I said before, make their livelihood based on films.

One of the things that is interesting that is happening right now in this country is it is spreading out from Hollywood. I mean, I happened to make "Ray" in Louisiana. They put up incentive, and thanks to you and other people we were able to get a Federal bill passed to bring jobs back to the United States.

But you can see what happens when an economy is infused. Louisiana went from $12 million a year in film production to in the last two years $500 million. People want to work in this country, and what is important is that jobs are being created in different States. The film community is not just in Hollywood, but this is a profession and the problem that I have is we create, we have the best talent in the world—and I am not talking about talent in front of the camera, I am not talking about actors. We have the best people and we have created an industry here.

Of course, we did create it from the outset, but it is still there. I would like to see that continue to flourish because it helps this country lead in the area of intellectual property.

Chairman HATCH. Well, I will go back to engineering and I will go back to experts in your field. If we don't do something to encourage kids to get into math and science, we are not going to have the engineers and we are not going to have the people who can even keep a film industry going the way it needs to go. And we are going to be out-competed all over the world, and it is inexcusable when we are the number one nation in the world in all of these aspects.

The same thing in music. You know, I know a number of writers who are just excellent and barely get by. You know actors that really are very, very good, but barely get by. There are some who hit it very big and that is great. You are one of the directors who has become very successful and wealthy in the process, but the fact of the matter is not many are able to do that.

And to find investors to go into these areas is very, very difficult because there is hardly anything more dangerous for investment than getting into the entertainment world. Unless you really know what you are doing and you really have top people, you are going to lose your shirt. It is just that simple, as a general rule, whether it is in movies, whether it is in books, whether it is in CDs, music, you name it, and it is totally unfair.

For instance, you are happy because "Ray" made some money and it made money for your investor.

Mr. HACKFORD. It could have made a lot more, as you can tell.

Chairman HATCH. Yes, and you could have become even more wealthy. But, see, that is the short-sightedness on this. What it meant is that the investor and you, if you had had the extra money, would be much more likely to take more risks and give other people an opportunity to greater films, do greater music.

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A lot of these films take music, a lot of these films take special actors, a lot of these films take all kinds of sets and a lot of these films take geographic locations. There is an awful lot that goes into it. People just think it conjures out of the air. It is like our young people—you know, I told the whole recording industry they ought to capture Napster that was getting 80 million hits a day and then educate our young people that what they are doing is thievery and use Napster to do it.

Well, gradually, we have come a long way that way, but I still see a tremendous dislocation, except maybe in country music, in the music industry, because our young people are not downloading as much in the country area as they are in others. So the country area has been pretty good.

I can't tell you the really outstanding music writers that I know who have to take other jobs because they just simply can't make it on the current royalty system and the current stealing of their copyrighted works under current conditions. So, naturally, I am very concerned about this and I am very concerned about our movie industry. There are successes, of course. Like you say, six out of ten aren't so successful.

Mr. HACKFORD. Right. As a songwriter, you know how the music industry has been savaged because there is less information and it is easier to go. But the fact is that technology marches ahead. Right now, at Cal Tech in California they have developed a technology that will allow individuals to download a high-quality digital copy of any film in three seconds.

Right now, the only thing that has held it back is that it takes a long time. But as this technology starts to become part of our system, it will just be rampant. Again, there has got to be a technological solution, in addition to an educational solution. These are all things we have to work on.

Chairman HATCH. I agree with that. There has got to be some way. And, of course, you have people in the high-tech world who don't believe in copyright, even though they couldn't exist without copyright, but they take a short-sighted viewpoint. That is why we are all watching Grokster right now. We can't wait until that Supreme Court decision comes down, and at least from my perspective hopefully they won't treat it the same as betamax because there is only one reason for Grokster's existence as far as I can see and that is to enable the pilfering of copyrighted materials, illegal downloading of copyrights materials.

And when that is so, I mean you might be able to find some peripheral use of that, but that is the primary reason for that. And our young people are being led down a primrose path, too. I hope the Supreme Court thinks about that, that if they don't come up with the right decision in Grokster, they are aiding our young people to think that everything on the Internet is free, even though it is not and even though our copyright laws teach otherwise.

I have heard young people who say, who cares? It is my computer and I can do whatever I want to do. Once you have that attitude on one thing, it permeates a lot of other things and it deteriorates society far below what our society should be.

So I personally appreciate all three of you being here today. You have laid out some pretty important problems and you have made

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some suggestions, but there are no simple solutions. We are a long way from having the trade agreements work perfectly and we are a long way from having China and Russia, two of the biggest thievery countries who just won't get this under control—and they have the capacity to do it. I know that, because they don't have nearly the stringent laws that we do and if they wanted to take care of this, they could take care of it. We know about the 30-plus facilities in Russia and if they want to take care of it, they can.

As far as I am concerned, they don't belong in the WTO until they do. I would be very strong supporters of theirs if they would straighten this out. And I have got to say if people like Orrin Hatch don't support them, they are not going to make it. It isn't that I am so great. It is just that I am in a position where I can do some things that some people can't. I just want freedom and fairness and decency and honor in our country, as well as their countries, and I am just hoping that some of them will be watching these hearings to realize that we mean business on this. We are sick and tired of it.

We want them to have a great film industry and we want them to have a great music industry, a great publishing industry, a great television industry, a great software industry, whatever you want to call intellectual property, ad infinitum. And we are willing to compete with them, but we want to do it on a fair basis.

Well, this has been a really wonderful hearing as far as I am concerned. It is highly technical maybe for some, but anybody watching it has got to say we have got to do something about these problems. And you guys are at the forefront of trying to do something about it and I just want to commend you for it, but take our request here and let's come up with some ways that will help us to pass the right laws so that we can help you more, because there are some things that we can do. And then we have to get to our young people and get them to realize there are right ways of doing things and wrong ways of doing things, and that they should be doing the right ways, not the wrong ways.

Well, with that, thank you all for your time. I am sorry to keep you so long, but it is an interesting area for, I think, so many of us, but especially for Senator Leahy and me, and we are grateful that you would come and testify today. Thanks so much.

With that, we will leave the record open for one week for additional submissions, anybody who would like to make those submissions. And if anybody has a good argument on the other side, I am interested in that, too. So we will leave the record open and recess until further notice.

[Whereupon, at 4:19 p.m., the Subcommittee was adjourned.]

[Submissions for the record follow.]

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SUBMISSIONS FOR THE RECORD

Statement of Senator Joseph R. Biden, Jr.
Subcommittee on Intellectual Property
Committee on the Judiciary
United States Senate
Hearing on "Piracy of Intellectual Property"
May 25, 2005

Good afternoon. I would like to commend you, Mr. Chairman, and you, Senator Leahy, for taking the initiative in forming this new subcommittee, devoted to the issue of intellectual property. This subject area has grown increasingly important in recent years as the role of intellectual property in our economy has grown, while at the same time the prevalence of piracy has reached unprecedented levels.

As you know, Mr. Chairman, this topic has been of particular interest to me for a long time because it combines my two primary Committee interests in the Senate – crime and foreign relations. While there is no disagreement that this is largely an international issue, there are those who do not view this as a crime problem. But that's what it is.

Every day, thieves steal millions of dollars of American intellectual property from its rightful owners. By one estimate, they stole $25-30 billion last year alone. They are stealing every bit as much as I would be stealing if I stole someone's car. American innovation and creativity need to be protected by our government no less than our personal property, our homes and our streets.

But intellectual property is not just property; it is a crucial national resource. Failing to protect it is equivalent to letting coal be stolen from our mines, or water taken from our rivers. The copyright industries alone contribute over $600 billion to our national income. That is 6% of the U.S. economy. And these industries generate jobs - almost 4% of U.S. employment.

There is so much work to be done, and we are hard at work. I commend Chairman Hatch and Senator Leahy for their efforts to legislate in this area. As you know, last year we finally enacted my Anticounterfeiting Act, which I had introduced in 2002 to plug the hole that permitted some counterfeiters to go unpunished in the United States. We need to continue updating our laws to fight these crimes.

In addition, anyone interested in intellectual property matters is watching the Supreme Court closely this spring, as it prepares to issue a decision in the important Grokster case. No matter the outcome of Grokster, it is likely that we in Congress will soon be legislating on the matters at issue in that case.

But, as I noted at the outset, this is not just a domestic issue; it is a bone of contention between the United States and some of our trading partners. Software piracy alone approaches the 90% level in both Russia and China. That is simply unacceptable. It's one reason I have joined together with Senator Smith, and Congressmen Goodlatte

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and Schiff, to form the International Anti-Piracy Caucus. In the year and a half that we have been in existence, we have worked to raise the profile of intellectual property piracy, both in the eyes of our own government and in the priorities of other key countries. We released a "watch list" of five countries with notable piracy problems; we wrote to the Secretary of Commerce to draw his attention to the problem of piracy in China; we wrote to the governments of each of the watch list countries to encourage action against piracy; we met with counterparts from Brazil who are working to stem the tide of piracy in their country; and we have written President Bush to urge him to raise the issue of piracy in his conversations with President Putin of Russia.

Ideas belong to people just as much as physical belongings do. They are a growing part of our economy, and we must protect them. I look forward to hearing from our witnesses today about what we can do to further these goals.

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Hearing Statement of Senator John Cornyn
"Piracy of Intellectual Property"
May 25, 2005

Mr. Chairman, I want to congratulate you on holding this hearing dealing with the untold harm caused by international piracy. I note that this is just one of a series you are holding focused on intellectual property – and I thank you for continuing to raise the level of attention to these important matters.

Just last week, I was pleased to join Senator Leahy to offer important legislation in our continued bipartisan effort to combat the trafficking of illegitimate goods throughout the world.

Recently, we have worked together on another matter near and dear to my heart – good government legislation related to the Freedom of Information Act, and I look forward to working with him on this legislation as well.

S.1095, the *Protecting American Goods and Services Act*, is not complicated, it is not long – but its global impact will be significant. The legislation is designed to provide law enforcement with additional tools to curb the flow of illegitimate goods.

First, the bill would make it specifically illegal to import or export unauthorized copies of copyrighted works or counterfeit goods. Second, it would make it illegal to possess counterfeit goods with the intention of selling them. Finally, the bill would more clearly specify that it is illegal to give away counterfeit goods in exchange for some future benefit – in effect, the "bartering" of counterfeit goods in such a way that avoids criminality.

Each of these items was highlighted by the Department of Justice in its October, 2004 report on its Task Force on Intellectual Property. In it, the Department describes the significant limitation law enforcement often times faces in pursuing counterfeiters and offers, among others, the principles embraced in the *Protecting American Goods and Services Act*, as possible solutions to these obstacles.

Amazingly, it is estimated that between 5% and 7% of worldwide trade is conducted with counterfeit goods and services. According to FBI estimates, counterfeiting costs U.S. businesses as much as $200 - $250 billion annually – and that costs Americans their jobs – more than 750,000 jobs according to U.S. Customs.

In recent years, this plague on global trade has grown significantly. According to the World Customs Organization and Interpol, the global trade in illegitimate goods has increased from $5.5 billion in 1992 to more than $600 billion per year today. That is - $600 billion per year illegally extracted from the global economy...

But perhaps most troubling, the counterfeit trade threatens our safety and our security. Counterfeit goods undermine our confidence in the reliability of our goods and service.

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For example, the Federal Aviation Administration estimates that 2% of the 26 million airline parts installed each year are counterfeit. And the Federal Drug Administration estimates that as much as 10% of pharmaceuticals are counterfeit. Worse yet – evidence indicates that the counterfeit trade supports terrorist activities. Indeed, Al Qaeda training manuals recommended the sale of fake goods to raise revenue.

The Cornyn-Leahy legislation, and other reforms, will help turn the tide of the growing counterfeit trade. The legislation is critically important to law enforcement – but it is even more critical for businesses, large and small, throughout America – including in my home state of Texas – as well as for ensuring the safety of consumers around the globe. Those who traffic in counterfeit goods put Americans in danger, support terrorism and undermine the health of our nation's economy. It is time to put an end to this scourge on society.

Hearings such as this help to bring these attentions to light, and I look forward to working with you, Chairman Specter, the Ranking member and all my colleagues to move this legislation forward, and in so doing, protect property rights, protect consumer safety, preserve American jobs and bolster the American economy.

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STATEMENT OF

Taylor Hackford
On Behalf of the Directors Guild of America

Before the

Committee on the Judiciary
Subcommittee on Intellectual Property

Hearing on Piracy of Intellectual Property

May 25, 2005
Washington, DC

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Senator Hatch, Senator Leahy and members of the subcommittee:

My name is Taylor Hackford and I thank you for inviting me to appear before you today to discuss the issue of international film piracy and its impact on the entertainment industry.

I am here today on behalf of the Directors Guild of America (DGA), of which I am a National Board member, member of the Western Directors Council, and the Co-Chair of the *Leadership Council.*

Founded in 1936 by the most prominent directors of the period, the Directors Guild today represents almost 13,000 directors and members of the directorial team who work in feature film, television, commercials, documentaries and news. The DGA's goal is to ensure that our craft continues unimpaired for the benefit of film and television viewers worldwide, and that our members continue to be able to earn their living giving their talent to a craft they love. The Guild does this by protecting the economic and creative rights of directors and the directorial team.

That is the very reason I am here today. The DGA places the highest priority on the prevention of wide-spread pirating of movies, television programs and other creative works. Indeed the entire film production industry – from directors, writers, actors to the studios, independent production companies, and the tens of thousands of skilled below-the-line workers– has a tremendous stake in the growing problem of film piracy.

I know that when people think of the entertainment industry, the popular image of the glitz and glamour of Hollywood comes immediately to mind, along with the wealth and lifestyle portrayed in popular magazines

But in fact that is not the reality of our industry at all. The overwhelming majority of jobs in the film industry are held by

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individuals who work behind the camera- the names that scroll by at the conclusion of a film – including such jobs as first assistant directors, unit production managers, set designers, carpenters, sound technicians, set painters, drivers, foley artists, lighting technicians, make-up artists, seamstresses, to name just a very few. We are talking about hundreds of jobs on a major motion picture.

And those are just the employees of the film production company. The making of a movie also generates substantial income for the scores of small businesses that provide supporting services and equipment that support all stages of production

An incorrect assumption has developed in the piracy debate. There seems to be an underlying belief that once a film or a television program is completed, its value to those who create it is gone. You hear this implication in the arguments of those who do not see piracy as theft but as "open access". **Nothing could be further from the truth.** The creators are very real stakeholders in the outcome of efforts to stop the frightening theft of copyrighted works.

In the entertainment industry our compensation and pension and health benefits depend greatly on residuals. Our industry's residual system—which in the DGA's case has existed for 40 years—is designed to provide appropriate compensation to those of us whose contributions are so fundamental that without us films cannot be produced.

Residuals are the fees paid for the reuse of our motion picture or television productions on free and pay television, and DVD and videocassette, in both the domestic and international markets. When films earn revenues in these markets, the income is shared among the people who work on the films.

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Each year, DGA collects millions of dollars in residual payments on behalf of its members. This represents bread and butter income to us because we work in an industry based on the concept of freelance employment. We can't count on a regular paycheck. What we can count on is ongoing income in the form of residual payments that support our families and our pension plan.

This is an important point. When pirates steal movies, they are not simply robbing movie studios of revenue; they are also taking money directly from our pockets and the pension and health plans that support us and our families.

Moreover, the effect is not just to take income from us on the movies that are made, but also to take income from us on the movies that --thanks to piracy—may never be made.

Films are not created by the snap of a finger; nor do they materialize out of thin air. For directors, writers, actors and the many craftspeople we work with, it involves years of creative effort and hard work to put a vision on the screen. For the studios and investors, it involves tens, if not hundreds, of millions of dollars to make that vision a reality.

Getting a film financed is not easy—a reality faced by every one of us who is in this business. Consider that only one in ten films ever retrieves its investment from theatrical exhibition. And four in ten films never recoup the original investment at all.

Making films requires large capital investments—and these are highly risky investments since the return can not be known at the outset. In the worldwide marketplace in which we all now live, the sale of our works in foreign markets is an essential part of being able to finance a picture. Even more essential is the ability to recoup income from sales in ancillary markets – that is home

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video, free and pay television, and foreign distribution. Quite simply without the revenue from those ancillary sales, pictures would not get made today.

Faced with these realities, the willingness and capacity of producers to invest in movies is significantly undermined when our films are pirated, either in mass production optical disc plants in other nations, or over the Internet. Rampant theft in foreign markets—theft of the very ancillary sales that are basic to the economic health of our industry is already taking its toll. When a greater share of potential income is siphoned off – stolen as a result of piracy -- risk rises, financing becomes more difficult, films are not made... and jobs are lost.

My most recent film, I have discovered, seems to be a good case in point. Last year, a film I spent 15 years of my life working on was released in the theaters. I not only directed the film, but was also a producer. Needless to say, it was a "labor of love" that I put a huge amount of my life into over a number of years. I was fortunate to have the support of Ray Charles when I made this film about his life, entitled "*Ray*". One reason it took so long to make "*Ray*" was the difficulty I had lining up financing. It is an enormous risk for any individual or company to put up tens of millions of dollars for a movie production without any clear prospects for profits.

I was fortunate with the movie "*Ray*". We had critical acclaim and did well at the theatrical box office, and importantly even better with home video sales. My co-producer and the movie's distributor will make money on the picture. But that was not certain when the decision to invest was made.

So you can imagine what it meant to all of us involved in "*Ray*" -- from myself, to my partners, to the financer, to the studio who distributed the film -- to discover that the piracy trail of our film was in place even before it opened in theaters. During "*Ray*'s" first week

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of release, I was walking along Canal Street in New York and there, right before my eyes, the DVD of "Ray" was already on sale! Film pirates had taken the time to prepare the fake DVD cover, including all the credits, photographs and logos you would see on a legitimate cover. You would have thought this was the studio-released DVD -- but that DVD was not available until February 1st, more than three months later.

I have since discovered that "*Ray*" was camcorded from day one at the Loews Raceway 10 in Westbury, New York, and at the Loews Jersey Garden Theater in Elizabeth, New Jersey. It was immediately put on the web to be downloaded at a mass production optical disc plant in Russia, or in China. So within days of the films release, copies of these stolen "camcord editions" were found not only on Canal Street, but all over New York, California, Florida, Georgia, Texas – and worldwide – in Europe, Russia, China and many other countries. Just last week on May 19th, through peer-to-peer networks, more than 476,000 requests were made to download "*Ray*". There have been 42 million such requests since my film was first pirated in October 2004. The Internet piracy of "*Ray*" has been identified in 68 countries since that time. And that's just what we have data on.

The reality we face is that a film that I, and others, worked so hard on for many years is being stolen every day around the world. That is income directly taken away from me, my financier, the studio, and scores of skilled workers on the film, and the economy of this country. Believe me, film piracy—I prefer to call it thievery—is not an abstraction to filmmakers.

The biggest problem with mass produced DVD piracy is occurring in Russian and China. If the problems in these two countries are not resolved then the problem of worldwide piracy will never be solved. If we do nothing about the rampant piracy in China and Russia is it

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not safe to assume we will soon see the same piracy in other countries?

In the last few years we have seen the real face of piracy in Russia. There has been a tremendous growth in the number of optical disc plants in Russia, rising from two known plants in 1996 to 34 plants today. Most of these plants are producing pirated discs, with a capacity that far exceeds the needs of the Russian domestic market. Over 80 percent of all DVDs marketed in Russia are estimated to be pirated.

The excess capacity is of course being shipped out of the country, making Russia one of the largest exporters of illegal discs, which show up in 27 international markets. For the film industry, the problem has been particularly acute in Europe, where demand is high and legitimate product simply can't compete.

The motion picture industry estimates over $275 million was lost last year due to Russian piracy of U.S. film and television, and the problem is growing worse. This problem is exacerbated and even encouraged by a weak legal and regulatory system and the almost complete failure of the Russian government to enforce the law.

Fortunately, the U.S. government is in a position today to leverage changes in the Russian system. We are now in bilateral trade negotiations with Russia on its accession to the World Trade Organization.

We join with others in the copyright industry in asking the members of the Judiciary Committee to strongly urge the Bush Administration to use these negotiations to secure fundamental changes in Russia's system for protecting intellectual property rights. And regardless of what changes are made in the law, Russia should not gain entry to the WTO until it enforces the law and punishes the film pirates.

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While the piracy problem in Russia has mushroomed in recent years, the problem in China—with its huge marketplace and market restrictions---simply remains out of control. Today approximately 95 percent of all films sold in China are pirated, with estimated annual losses to the industry amounting to about $300- million. Pirated DVDs of the latest U.S. movies releases are available in China immediately with their theatrical release.

As with Russia, the problem largely stems from optical disc plants producing pirated products, but with far greater capacity to ship illegal goods around the world, even including to the United States.

In China, the piracy problem is made worse because the government maintains a strict quota on foreign films, limiting such films to 20 per year. The limitation on legitimate films creates greater opportunities for pirates to fill domestic demand with illegal films.

At the same time, the U.S. is an open market for Chinese films and some such as "Crouching Tiger Hidden Dragon" have done quite well. That movie alone grossed over $125 million in the United States. Meanwhile, the total gross for all U.S. films in China amounted to about $60 million, with the Chinese government claiming 87% of that money.

Think about this situation. The United States is the largest market for Chinese goods, and China is our second largest source of imports. Our trade deficit with China last year was more than $175 billion. At the same time, the U.S. film industry is one of the nation's most successful export industries accounting for a positive trade balance of $50 billion in 2004.

Yet the nation which sells us the most goods, and with whom we have the largest trade imbalance, virtually shuts out our most successful export industry from their market. And, at the same time,

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China is the largest source of pirated products of our most successful export industries, eroding our revenues around the world.

This situation should not be allowed to continue. China should live up to its commitments made to the U.S. in the Joint Commission on Commerce and Trade in April 2004.

The U.S. should vigorously insist that China follow through with its commitments, and should pursue consultations at the World Trade Organization to discuss China's failures to deal with piracy of intellectual property. If those consultations do not produce results, we should consider launching a dispute settlement action.

In closing, I want to thank Senator Hatch, and Senator Leahy, for convening this hearing on piracy, and for the leadership on this issue that you both have shown over the years. We appreciate the work you began in the last Congress with the introduction of the "Inducing Infringement of Copyright Act". We also thank you for the enactment of the Artists Rights and Theft Prevention Act of 2005. The Directors Guild looks forward to working with you on this issue in the future.

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NEWS RELEASE

ORRIN HATCH

United States Senator for Utah

FOR IMMEDIATE RELEASE
May 25, 2005

CONTACT: Adam Elggren (202) 224-3370

Statement of Senator Orrin G. Hatch
before the
U.S. Senate Judiciary Committee
Subcommittee on Intellectual Property

"Piracy of Intellectual Propery"

Welcome to today's hearing before the Intellectual Property Subcommittee. Today we will be examining a variety of problems and challenges involving international piracy of U.S-owned intellectual property. This hearing will focus largely on copyright piracy, but I hope the subcommittee will be mindful of the serious issues in the trademark counterfeiting and patent infringement realms as well.

Piracy and counterfeiting inflict significant and widespread harms on the American economy. Theft of intellectual property abroad disadvantages this country's entrepreneurs, innovators, and creative community. Ultimately, it also harms consumers, shareholders, and American workers and their families.

The timing of this hearing was intended to coincide roughly with a number of recent developments and events relevant to our consideration of piracy issues. On April 29, 2005, the Office of the United States Trade Representative issued its decision resulting from the out-of-cycle review of China's enforcement practices and completed the "Special 301" process. Much of the focus in that process and in USTR's conclusions remains on the inadequate enforcement of intellectual property rights in Russia and China.

Russia remains on the Priority Watch List this year due to continuing problems with its legal regime, which is described as having weak intellectual property enforcement and a lack of data protection. It appears that Russia's current intellectual property regime is inconsistent with its bilateral trade obligations and likely does not conform to obligations which Russia needs to fulfill in order to join the WTO.

Other recent events that have prompted some additional interest and scrutiny on both sides of the Hill include a number of studies and reports on piracy and counterfeiting, which indicate that we are not making much headway in many areas and that suggest some disturbing

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If Russia, China, or any other government attempts to adopt this view with respect to their responsibilities to protect intellectual property under international trade law and agreements, I can assure you that public support for U.S. trade agreements will be undermined and there will be strong resistance from – and appropriate action taken by – members of Congress. To put a fine point on it, before the Congress votes in favor of Russia joining the WTO, many of us will have to be convinced that the Russian government is serious about cracking down on theft of U.S. intellectual property.

As the ranking republican on the Finance Committee and the Chairman of this subcommittee, I have a particular interest in the intellectual property problems that will be outlined today, and I intend to work with members from both sides of the aisle and in both committees to ensure that these issues receive the attention – and resolution – they merit. I know that Senator Leahy, and many others, such as Senators Cornyn and Feinstein are concerned about these problems..

I look forward to hearing from the witnesses and thank them for testifying today.

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BSA
BUSINESS SOFTWARE ALLIANCE

Testimony of Robert Holleyman
President and CEO
Business Software Alliance

Before the
Senate Intellectual Property Subcommittee

May 25, 2005

Good afternoon. My name is Robert Holleyman. I am the President and CEO of the Business Software Alliance.[1] The Business Software Alliance is an association of the world's leading software companies and their key hardware partners. BSA's members create approximately 90% of the office productivity software in use in the U.S. and around the world.

I thank the subcommittee for the opportunity to testify here today. The theft of intellectual property, commonly known as "piracy", is a matter of great concern to the business software industry. Piracy costs the industry billions of dollars in lost revenues each year. It reduces investment in creativity and innovation. And it harms national economies including our own.

In my testimony, I intend to give a brief overview of the contributions that the business software industry has made and continues to make to the global economy and to describe how piracy has undermined those contributions. I will next describe the evolving challenges the software industry faces with respect to piracy and explain the steps industry is taking to address these challenges. I will outline the challenges we face in two particularly difficult markets: China and Russia. Finally, I will summarize the lessons that we have learned regarding how best to end piracy both here at home and abroad.

First, though, let me begin by thanking the members of the subcommittee for hosting this hearing. BSA and each of its member companies commend you for recognizing the software industry's important contributions to the global economy and the serious threat posed to the industry by software piracy.

Software Industry Contributions and the Impact of Piracy

[1] The Business Software Alliance (www.bsa.org) is the foremost organization dedicated to promoting a safe and legal digital world. BSA is the voice of the world's commercial software industry and its hardware partners before governments and in the international marketplace. Its members represent one of the fastest growing industries in the world. BSA programs foster technology innovation through education and policy initiatives that promote copyright protection, cyber security, trade and e-commerce. BSA members include Adobe, Apple, Autodesk, Avid, Bentley Systems, Borland, Cadence Design Systems, Cisco Systems, CNC Software/Mastercam, Dell, Entrust, HP, IBM, Intel, Internet Security Systems, Macromedia, McAfee, Microsoft, PTC, RSA Security, SAP, SolidWorks, Sybase, Symantec, The MathWorks, UGS and VERITAS Software.

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Information technology has changed the world in which we live. It has made us more efficient, more productive and more creative. Software has been at the heart of this technology revolution. Software facilitates the dissemination of knowledge, drives global communication and promotes continued innovation. It helps us to solve problems and generate new ideas, gives us the power to create and to collaborate and fosters self-expression in a range of spheres.

The information technology sector, driven by the software industry, has also proven to be a remarkable engine for global economic growth. According to a 2003 survey on the economic impact of piracy by IDC, a major IT research firm, the IT sector employs more than nine million people worldwide in high-wage, skilled jobs, raises more than $700 billion in taxes annually and contributes nearly a trillion dollars each year to global economic prosperity. Between 1996 and 2002, the IT sector grew 26%, creating 2.6 million new jobs and adding a cumulative $6 trillion to economies around the world. Each year, the packaged software sector alone contributes in excess of $180 billion to the global economy.

While these numbers testify to the economic force of the software industry, this sector has yet to reach its full economic potential. This is due, in large part, to piracy. In 2004 we measured the global piracy rate at 35%. In many countries the piracy rate exceeded 75%, reaching highs of 90% or more in some markets. Although piracy levels in the U.S. historically have been low as compared to other countries, the figure is far from negligible. In 2004 the U.S. piracy rate was 21%. More than one in every five copies of business software in use in this country today is stolen. There are few industries that could endure theft of its products at this level.

Piracy inflicts significant financial harm on U.S. software companies. Piracy in the U.S. alone cost the software industry almost $6.6 billion in 2004. Worldwide, piracy led to estimated losses of over $32 billion. Publishers invest hundreds of millions of dollars every year and immeasurable amounts of creativity in designing, writing and bringing new products to market. They depend upon the revenue they receive from those products to obtain a return on their investment and to fund the development of new products. Piracy undermines this model.

Of course, the impact of piracy extends beyond lost sales. Pirates steal jobs and tax revenues as well as intellectual property. The IDC economic impact survey cited above found, as a general rule, that there is an inverse relationship between software piracy rates and the size of the IT sector as a share of the gross domestic product. As piracy is reduced, the software sector grows. This creates a ripple effect that stimulates other parts of the IT sector and of the economy overall. The equation is a basic one: the lower the piracy rate, the larger the IT sector and the greater the benefits. Putting this into real numbers, the IDC survey concludes that a 10 point reduction in the global piracy rate over four years could deliver 1.5 million new jobs, $64 billion in taxes and $400 billion in new economic growth. In North America alone, benefits would include 145,000 new jobs, $150 billion in additional economic growth and more than $24 billion in tax revenues.

Reducing piracy delivers indirect benefits as well. Society benefits from new technological innovations. Consumers benefit from more choices and greater competition. Internet users benefit from new ways of communication and expanded creative content made available online. And national economies benefit from enhanced productivity leading to higher standards of living.

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Piracy: Defining the Problem

In its simplest terms, "software piracy" generally refers to the reproduction or distribution of copyrighted software programs without the consent of the copyright holder. In most countries around the world, the law makes clear that when a person copies or distributes software, they must have authorization from the copyright holder through a license agreement or otherwise, unless the copyright law provides a specific exception for such activity. Otherwise, such activities constitute piracy.

Piracy of software can take several forms:

- **Organizational end-user piracy**

The business software industry's worst piracy problem traditionally has involved its primary users – large and small corporate, government and other enterprises – that pirate our members' products by making additional copies of software for their own internal usage without authorization. We commonly refer to this activity as "organizational end-user piracy".

- **Counterfeiting**

Counterfeit software, often packaged to appear nearly identical to the genuine article, continues to pose a serious problem for BSA's members. Over the past several years, BSA has seen a dramatic increase in the amount of high quality counterfeit software imported into the U.S. from overseas, especially from Asia. Compilation CD-ROMs containing a large selection of software published by different companies also pose a problem. Although compilation CDs do not exactly replicate the packaging of genuine software, unsophisticated consumers are often led to believe that they are legitimate promotional products.

- **Internet piracy**

The Internet is the future of global communication and commerce. It creates tremendous opportunities for faster, more efficient and more cost-effective distribution of information, products and services across the globe. Unfortunately, the emergence of the Internet also has added a new dimension to software piracy by permitting electronic sales and transmission of illegal software on a global scale. Today, computer users can and do download infringing copies of BSA members' products from hundreds of thousands of locations on the Internet all over the world.

- **Industry Efforts against Piracy**

The Business Software Alliance and its individual members devote significant financial and human resources to preventing piracy worldwide. Our efforts are multi-faceted.

First, we are engaged in extensive educational efforts, designed to increase public understanding of the value of intellectual property and to improve overall awareness of copyright laws, on a global basis. Among other resources, we provide school curricula to promote responsible internet behavior among students, and guides and technologies that assist end-users in ensuring that their installed software is adequately licensed. We likewise offer tips to consumers so that they can be confident that the software they acquire on-line is legitimate.

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Second, we work closely with national and international bodies to encourage adoption of laws that strengthen copyright protection and promote an environment in which the software industry can continue to innovate.

Finally, where appropriate, BSA undertakes enforcement actions against those involved in the unlawful use, distribution or sale of its members' software. On the Internet, for example, BSA conducts a far-reaching "notice and takedown" program. BSA's members have also filed suit against individuals offering pirated software for free download and over auction sites. BSA also engages in civil litigation against corporate end-users who are using our members' products without authorization.

Of course, technology plays a role in protecting intellectual property rights as well. Content owners must take responsibility to ensure that their works are not easily subject to theft, rather than rely wholly on others to protect their intellectual property. Accordingly, BSA's members have invested hundreds of millions of dollars and thousands of engineering hours in developing technologies to protect content and intellectual property. Our companies have worked diligently, voluntarily and cooperatively with content providers and consumer electronics companies to create systems that will foster the legitimate distribution of digital content. Experience clearly demonstrates, however, that there is no silver bullet technological solution that will solve the problem of piracy. Nor are government mandates the answer. Technology develops most effectively in response to market forces; government mandates would stifle innovation and retard progress.

Piracy Abroad

Last year, the worldwide rate of personal computer (PC) software piracy decreased by one percentage point to 35 percent. This occurred despite an influx of new PC users from high piracy market sectors — consumer and small business — and the increasing availability of unlicensed software on Internet peer-to-peer (P2P) file-sharing sites. That's the good news.

Unfortunately, the total value of pirated software worldwide actually increased, despite the modest decline in the piracy rate. This was a result of the fact that the global PC software industry grew over six percent and the U.S. dollar fell by more than six percent against the world's other currencies. In 2004, the world spent more than $59 billion for commercial packaged PC software. Yet, software worth over $90 billion was actually installed. For every two dollars' worth of software purchased legitimately, one dollar's worth was obtained illegally.

The software industry suffers piracy losses in countries all over the globe. Two of these stand out for having very high piracy rates, combined with high PC penetration and large potential markets: China and Russia. These countries should both be tremendous opportunities for our industry. Their potential as software markets – and, indeed as software suppliers, will remain largely unfulfilled until they bring the piracy situation under control.

- **China**

Despite repeated commitments, legal reforms, episodic crackdowns against retail piracy and the personal intervention of Vice Premier Wu, China's market is awash with pirate and counterfeit copies of practically anything that is worth pirating or counterfeiting. Nine out of every ten copies of software installed on PCs in China last year were

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pirated, representing a loss to the U.S. software industry of about $3.6 billion. This, of course, is not a complete picture of the harm caused by piracy in China, since China is also the world's leading producer and exporter of counterfeit software. Piracy on such a massive scale has significant ramifications for the U.S. software industry and our national economy.

Rampant piracy has effectively stalled growth in U.S. software exports to China, despite China's escalating use of computer and software technologies. Consider that in 1996 China was the sixth largest market for personal computers and the 26th largest for software; it is now the second largest market for personal computers but still only the 25th largest market for software. This growing gap between hardware and software sales is the inevitable consequence of a market that does not respect intellectual property rights or reward the significant investment required to develop and market innovative software products.

China's failure to protect and enforce intellectual property rights has also hindered its ability to grow a domestic software industry (a problem that China is attempting to cure through protectionist and discriminatory industrial policies). According to 2003 report by the market research firm IDC, a ten percent reduction in piracy could help the Chinese IT sector grow nearly fourfold in four years.

Two key reasons for China's failure to make significant inroads into software piracy are deficient IPR laws and an enforcement regime that is not deterrent.

The WTO TRIPs agreement requires China to criminalize copyright piracy on a commercial scale, including enterprise end use piracy of computer software. Unfortunately, end user piracy is not regarded as a crime in China, so there has never been a criminal prosecution of this activity.

TRIPs also requires enforcement of intellectual property rights to be deterrent in practice. Through a combination of inadequate dedication of resources and lack of significant penalties for piracy, China's enforcement regime simply does not deter piracy.

As the U.S. government works implements its strategy for addressing the piracy problem in China, BSA urges the government to demand the following four improvements to China's IPR regime:

Extend criminal liability to enterprise end user piracy. The relevant provisions of China's criminal code - Articles 217 and 218 - do not treat corporate end user piracy as a criminal offense, despite its devastating effect on software industry revenues and growth. China's failure to extend criminal remedies to enterprise end user piracy violates its WTO-TRIPS obligations and should be rectified immediately.

Reduce and clarify criminal thresholds. In late December, the Supreme People's Court and Supreme People's Procuratorate released amended Interpretations of Articles 217 and 218 of the criminal code which lower the thresholds for establishing a criminal copyright violation. Unfortunately the thresholds are still too high, particularly because the phrase "illegal income" is unclear and in certain cases (e.g., enterprise end user piracy) may be difficult to prove.

Increase administrative resources and penalties. Administrative enforcement actions against software piracy can be brought by the National Copyright

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Administration of China (NCAC) and local Copyright Administrations (CAs). In our experience, however, neither the NCAC nor the local CAs has the resources or interest to exercise this authority. When administrative actions are taken, fines are rarely issued and the outcome is rarely publicized. The end result is that administrative actions provide virtually no deterrent value.

Legalize the government sector and state-owned enterprises (SOEs). BSA and its member companies are heartened by China's commitments to legalize software use within the public sector, which represents China's largest consumer of software. These policies should also extend to SOEs. The assurances on government legalization will be of limited value, however, if China proceeds with its proposal to impose severe restrictions on procurement of software from non-Chinese suppliers.

All of these steps are necessary to address unacceptable software piracy rates in China that cost the U.S. software industry billions of dollars in lost exports and stifle the development of a domestic software industry. No single step is sufficient on its own. The goal, of course, is to increase the legitimate market for software in China, to the benefit of all suppliers, Chinese and foreign. Ultimately, China's success or failure on this issue must be measured against that goal, not against the completion of any particular step along the way. To this end, we are working to develop new benchmarks to measure progress on this issue.

- **Russia**

At 87%, Russia's software piracy rate is only a three points lower than that in China, and has not improved over the past several years. Russia has adopted a number of legal reforms over the past several years and it is our hope that, once they come fully into force, they will lead to improvements in the marketplace.

In 2003, the Russian criminal code was amended to clarify the previously ambiguous standard for triggering a criminal infringement case. In 2004 Russia adopted copyright law amendments that, in addition to extending protection to certain pre-existing works and sound recordings, implement a number of provisions of the WIPO Internet Treaties. This amendment included the creation of an exclusive right of making available, which will be critical to enforcement against Internet piracy once it goes into effect in September 2006.

The piracy situation on the ground in Russia is mixed. Our companies that engage in channel enforcement have reported that they are receiving cooperation from Russian law enforcement authorities, and are achieving some successes. There is little enforcement against end-user piracy in Russia, but we are working in Russia to change that.

Internet piracy is one piracy challenge in Russia where industry efforts have met with little success in the past few years. The business software industry faces a persistent problem of pirated software promoted and sold all over the world using unsolicited e-mail advertisements (spam) and via mail-order. The spam emails link consumers to slick websites that advertise "OEM versions" software for a fraction of the normal retail price. The prices, however, are high enough to convince some consumers that the offer is legitimate.

These spam e-mails originate from an organization operating under various names: CD Cheap, OEM CD Shop, OEM Software, and other aliases. The spam and scam operation

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is apparently run by a well-connected, sophisticated Russian criminal network operating in Moscow and in the Sverdlovsk region. In January and February 2004 two police raids and related arrests were carried out in Yekaterinburg, near Sverdlovsk, but the key figures were not touched and there was no noticeable impact on this criminal enterprise. The FBI has opened a case file on this operation and is attempting to work with Russian law enforcement.

BSA urges the U.S. government to use the leverage provided by Russia's WTO accession negotiations to obtain binding commitments in the Working Party report to resolve the range of outstanding IPR problems. The Russian government should begin addressing these issues immediately, in order remove this continuing irritant from Russo-American trade relations.

The Role of Government

Multilateral and bilateral trade alliances must be fully backed by governments' firm commitment to respect and enforce intellectual property rights within the public and private sectors; to treat the manufacture and sale of counterfeit software as a crime warranting tough enforcement and penalties; and to ensure that its laws and enforcement regimes adequately address all forms of piracy. The Administration and Congress can help promote this commitment to intellectual property protection by:

- ensuring that governments worldwide fulfill their obligations under the WTO TRIPs Agreement by adopting and implementing laws that provide for effective enforcement against piracy;
- encouraging implementation of the WIPO Copyright Treaty and strong criminal enforcement of the measures therein; and
- urging countries to dedicate resources to the investigation and prosecution of piracy in all its forms, as well as to training, technical assistance and mutual cooperation.

- **Strong, workable enforcement regimes, as required by TRIPs**

While substantive copyright protections are essential to bring piracy rates down, experience has demonstrated that these protections are meaningless without adequate mechanisms to enforce them. The 1994 World Trade Organization Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPs) provides the framework for such mechanisms.

TRIPs requires that intellectual property rights enforcement regimes meet specific "results-oriented" performance standards. Specifically, each member's enforcement regime must "permit effective action against infringement" and "constitute a deterrent to further infringements." Moreover, enforcement procedures cannot be "unnecessarily complicated or costly," or "entail unreasonable time limits or unwarranted delays." Thus, in assessing TRIPs compliance, it is critical to review and monitor all aspects of a country's enforcement regime, including the adequacy of procedural remedies and penalties, as well as their effectiveness in deterring piracy.

- **Full and faithful implementation of the WIPO Copyright Treaty**

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In direct response to the growing threat of Internet piracy, the international community in 1996 adopted the WIPO Copyright Treaty to ensure protection of copyrighted works in the digital age. Among other measures, the WIPO Treaty (i) makes clear that a copyrighted work can be placed on an interactive network only with the consent of the relevant right holder; (ii) makes clear that the Berne Convention's reproduction right applies to electronic uses of works; (iii) protects all forms of expression of computer programs; and (iv) prohibits "hacking" of technical protections that have been applied to works. These measures ensure that authors' rights will be respected in cyberspace, and are urgently needed on a global basis. While many countries have taken steps toward improving and enforcing laws in this regard, much more remains to be done.

- **Dedicated resources to fight piracy**

Ending the theft of intellectual property is a low priority in many countries. Piracy investigations are often delegated to law enforcement units with little or no training in intellectual property crime and given local rather than national attention, in competition with many other types of crime for attention and resources. Although copyright crimes often involve cross-border activities, there is frequently a lack of coordination among various countries' law enforcement agencies when investigating and prosecuting pirates. Even where procedures for cross-border coordination do exist, such procedures can be cumbersome and ineffective.

To ensure effective action against piracy, national authorities should establish specialized intellectual property enforcement units at a national rather than local level, who can react quickly and knowledgeably to incidents of IP crime. Better training of law enforcement and the judiciary is equally important, to ensure these bodies are equipped to deal with these cases. Likewise, better cross-border cooperation among police and other government officials, and improved availability of evidence and judgments for cross-border use, are also essential.

Conclusion

Software contributes profoundly to the world in which we live. It allows us to share, to create and to innovate in ways previously unimaginable. Software-driven productivity strengthens national economies, including our own, and makes them more competitive and more prosperous. Unfortunately, piracy prevents the software industry from realizing its full potential. We urge the U.S. Government and other governments worldwide to help us solve this problem. We thank you for the efforts made to date.

Thank you again for the opportunity to testify here today. I look forward to your questions and to continued dialogue on this important topic in future.

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Statement of Senator Patrick Leahy
Intellectual Property Subcommittee of the Committee on the Judiciary
Hearing on "Piracy of Intellectual Property"
May 25, 2005

More and more Americans today "think globally" as they enjoy the fruits of others' creativity and innovation. Unfortunately, those who profit by stealing intellectual property are doing exactly the same thing. The technological advances of the Digital Age have eliminated many of the barriers between buyers and sellers. Digital content, today, be it software or music or video, can be distributed almost instantly via the Internet, and optical discs can be reproduced almost perfectly in massive numbers. Thus, piracy has blossomed into a global problem as well, and because the United States is the world leader in intellectual property, we are – or at least we ought to be – acutely aware of its impact on U.S. industries and our citizens' own creativity and innovation.

Intellectual property is vital to the health and strength of the U.S. economy, and the estimated financial losses in a number of industries due to piracy are significant. According to the International Intellectual Property Alliance, in 2002 the various copyright industries accounted for 12 percent of the U.S. Gross Domestic Product (about $1.25 trillion) and employed nearly 11.5 million workers. As profitable as these industries are, the U.S. loses hundreds of billions of dollars to piracy every year. The Business Software Alliance estimates its losses at $30 billion in software sales annually, and the MPAA estimates that it loses $3 billion a year to piracy. The International Intellectual Property Alliance reports that the U.S. lost more than $13 billion in trade due to copyright piracy in 2003. And the FBI estimates that we lose $200-$250 billion annually to counterfeiting alone. These numbers reflect a crisis that demands immediate and meaningful solutions.

Much of our focus today will be on China and Russia, and for good reason. In 2000, when China entered the World Trade Organization, I expressed concerns about China's record on human rights and labor rights. When ultimately I voted in favor of establishing Permanent Normal Trade Relations, I noted that isolationist policies do not work. For several years now, we have been engaging China in attempts to improve its record on piracy. Instead of progress, however, the United States Trade Representative's 2005 Special 301 Report placed China on its Priority Watch List. The report notes that while China has expended significant efforts, we have not seen the meaningful reduction in infringement that China promised to attain: "China's inadequate IPR enforcement is resulting in infringement levels at 90 percent or above for virtually every form of intellectual property..." This has resulted in estimated losses of $2.5 billion to $3.8 billion annually in pirated copyrighted works.

Russia, too, is on USTR's Priority Watch List. The Special 301 report notes that while Russia has passed numerous laws designed to improve intellectual property protection, enhanced enforcement has not followed. The piracy rate for the recording industry is 66 percent; for the movie industry that rate is 80 percent. Among the many problems in Russia is the fact that of the pirated goods that are confiscated by law enforcement, 70

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percent get returned to the market. Meaningful enforcement needs to involve more than a revolving door. The copyright industries estimate losses in Russia of $1.7 billion dollars.

I remain committed to working on solutions to these problems. Last week, Senator Cornyn and I introduced S. 1095, the Protecting American Goods and Services Act of 2005, which will criminalize possession of counterfeit goods with intent to traffic, close off loopholes under current law in the definition of "trafficking", and criminalize the importation and exportation of counterfeit goods. In 1996, I worked with Senator Hatch to pass the Anti-counterfeiting Consumer Protection Act, which addressed counterfeiting by amending several sections of our criminal and tariff codes.

Intellectual property theft is more than a problem faced by a few. It is a crisis with the potential to drastically impact our economy, and both Congress and this Administration must work to ensure that we are up to the task of fighting increasingly sophisticated piracy operations. To that end, I am pleased that we have two distinguished panels of witnesses today. My hope is that from these witnesses both in and out of government we will hear not only about the size of the problem but about solutions to this growing scourge. Does the United States Trade Representative have adequate tools to address this issue? Do we need to strengthen our domestic laws through legislation like the bill Senator Cornyn and I recently introduced? Must we engage more vigorously with China, and Russia, and other countries too lax in their IP enforcement?

I suspect the answers are all "yes," and I am eager to "think globally" with all of you about how to take the next steps toward improving the situation.

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Testimony of

James Mendenhall

General Counsel for the Office of the U.S. Trade Representative (Acting)

Before the

Committee on the Judiciary

United States Senate

May 25, 2005

Global Piracy of Intellectual Property Rights:

Challenges, Enforcement Efforts and Results

Good afternoon Mr. Chairman, Senator Leahy and Members of the Committee. Thank you for the opportunity to speak to you today about the challenges posed by piracy of intellectual property rights (IPR), and the enforcement tools that USTR and other agencies are utilizing to protect U.S. IPRs in foreign markets.

The theft of intellectual property worldwide is an enormous and growing problem. As a result of this criminal activity, many foreign markets for products protected by IPRs are simply evaporating. In China, industry estimates that piracy levels in many sectors are close to or exceed 90 percent. In Russia, piracy levels for movies and music have also continued to increase, as well as overall losses to copyright-related industries. That said, the protection of IPRs in some countries has actually improved. Yet, while these improvements have sometimes been dramatic, the levels of piracy and counterfeiting in many countries remain unacceptably high.

We understand the growing sense of frustration among U.S. industry and Congress about the lack of enforcement of IPRs by our trading partners. USTR and other agencies are continuing to work to address this situation – one made complex not only by its sheer scale but by the multiple underlying causes.

A little over a year ago in testimony before this subcommittee, I outlined key challenges facing the United States on protection of IPRs such as the global nature of pirate operations and distribution chains and the lack of the rule of law that allow criminal enterprises to flourish in countries such as China and Russia without effective enforcement or deterrent penalties. These challenges still remain and in the case of piracy, technological advances have allowed pirates to further streamline and expand their operations. Over the past year USTR, working with other agencies, has vigorously

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utilized the Special 301 process and other tools at our disposal, and initiated new efforts to strengthen enforcement. I would like to provide an update on our recent efforts as well as some examples of success in combating and reducing levels of piracy and counterfeiting in our trading partners.

Tools and Measures to Combat Piracy and Strengthen Enforcement

USTR has taken a comprehensive, multi-faceted approach to address the complexity of the global piracy problem. We have been vigorously employing all tools and resources at our disposal to bring pressure to bear on countries to reform their intellectual property regimes, and we will continue to do so.

Special 301/Section 301

As we do in April of each year, USTR issued the 2005 Special 301 Report on April 29, which catalogues the IPR problems in dozens of countries around the world and places them in a hierarchy – ranging from the lowest ranking of Watch List ("WL") to the mid-level Priority Watch List ("PWL") to the ranking reserved for the worst offenders, Priority Foreign Country. The 2005 report lists 52 trading partners and gives special attention to the need for significantly improved enforcement against piracy and counterfeiting. This year, we identified 1 Priority Foreign Country; 14 on the Priority Watch List and 36 on the Watch List (see attachment at the end for a list of the countries designated in the Special 301 Report). Two countries are being monitored under Section 306 and USTR will conduct 7 "Out-of-Cycle" reviews (OCRs), namely for Canada, EC, Indonesia, Philippines, Russia, Saudi Arabia and Ukraine.

As I just mentioned, Priority Foreign Country is the most serious designation; USTR is obligated to decide whether to initiate an investigation under section 301 against any country designated a PFC. Priority Watch List indicates that the United States has a high level of significant concerns. Watch List indicates that there are serious IPR issues in that country that warrant attention. "Section 306 monitoring" indicates that a country is taking action to address concerns raised in connection with a section 301 investigation and are monitoring whether that country is satisfactorily implementing those actions. USTR conducts OCRs for countries that appear to be on the verge of having their status on the Special 301 list changed because of either significant improvements or problems.

A country's ranking in the report sends a message to the world, including potential investors, about a country's commitment to IPR protection. We have used this exercise to great effect, as each year we see countries coming forward with reforms or reform proposals to avoid elevation on the list.

For example, after elevating Korea to PWL last year, it took significant steps over the past several months to strengthen protection and enforcement of IPR such as, introducing legislation that will explicitly protect sound recordings transmitted over the Internet (using both peer-to-peer and web casting services); implementing regulations to

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address film piracy; and increasing enforcement activities against institutions using illegal software. Taiwan is another example of where we achieved positive results utilizing the Special 301 process. In response to our out-of-cycle review, Taiwan's legislature approved a number of amendments to its copyright law that provide greater protection for copyrighted works and increase penalties for infringers. In addition, Taiwan authorities made permanent an IPR-specific task force that has increased the frequency and effectiveness of raids against manufacturers, distributors, and sellers of pirated products.

We have also used the Special 301 Report to highlight the longstanding and serious problems of optical media piracy in Pakistan, Malaysia and the Philippines. Over the past year both Malaysia and the Philippines have made measurable progress in enforcement against optical media piracy I am particularly pleased to report here today that five days after the release of this year's Special 301 Report, Pakistan officials raided six optical media plants in Karachi and seized over 150,000 discs of pirated software, movies and DVDs, and over 6000 stampers. In addition, authorities made several arrests and the plants have been sealed and placed under 24 hour police surveillance. A follow up raid on the registered office and warehouse of one of the plants seized another 5,500 stampers and more pirated optical media.

In yet another example, Canada RCMP officers recently seized more than $800,000 worth of goods, including more than 30,000 DVDs, 3,000 video games and 1,600 multi-game cartridges, suspected of being bootlegged. The seizure came days after the United States put Canada on the watch list due to concerns over weak enforcement of IPR.

Finally, Ukraine, which is designated as a PFC and has been under sanctions since 2001, has recently indicated that it is committed to address our long-standing piracy concerns as a result of the new government's desire to have these sanctions removed and is currently involved in reforming its optical disc laws.

Trade Agreements

Another very useful tool is our free trade agreements and ongoing FTA negotiations. In the past three years, we have completed and received Congressional approval of free trade agreements with Chile, Singapore, Australia and Morocco, have concluded negotiations with Bahrain and CAFTA-DR and have launched free trade agreement negotiations with 13 more countries (Panama, Thailand, the Andeans, UAE, Oman, and SACU countries). Consistent with the guidance Congress provided in the Bipartisan Trade Promotion Authority Act of 2002, we require that our free trade agreement partners bring their IPR regimes up to standards consistent with U.S. law.

Our FTAs contain the highest level of IPR protection of any international agreements in the world, and they directly address many of the key challenges regarding enforcement which I discussed earlier. They contain provisions dealing with the whole range of IPR, including such issues as curbing the use of equipment used to circumvent

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anti-counterfeiting technology and dealing with sector-specific problems such as optical disk or broadcast piracy. They also strengthen enforcement by streamlining procedural rules for bringing copyright claims, and providing for higher damage awards(including statutory damages), expeditious *ex parte* searches to gather evidence, and civil remedies to seize and destroy infringing goods. Our FTAs also provide for improved border enforcement to stop imports and exports of pirate and counterfeit goods and stronger criminal enforcement.

We recognize that in order for these FTA provisions to be effective, they must be properly implemented and enforced. Over the past year, we have directed our efforts in ensuring that our new FTA partners meet their obligations both in implementation and enforcement. We have spent many hours working closely with Australia, Singapore and Chile and have been successful in ensuring that their implementing legislation fully meets their FTA obligations to protect and enforce IPR. We have also – with support and cooperation from our embassies and industry – heightened our vigilance to quickly respond to concerns over possible lack of compliance or enforcement of FTA obligations. As we continue to make progress in concluding new FTAs, we realize that a key priority must be to enforce our FTA partners' compliance with their obligations to protect IPR.

WTO

USTR has the lead in working closely with other agencies in addressing IPR issues multilaterally through the WTO.

The initiation of dispute settlement proceedings is the most forceful expression in the WTO of dissatisfaction with a country's IPR protection and can be an effective way to achieve reform. USTR has brought 12 TRIPS-related dispute settlement cases against 11 countries and the EC. Of these 12 cases, one is in consultations, eight were favorably resolved by mutually-agreed solutions between the parties, and three resulted in favorable rulings for the United States. Just a few months ago, a WTO panel upheld the U.S. WTO challenge against an EC regulation on food names – i.e., the EC regulation on geographical indications for food and agricultural products – that unfairly discriminated against foreign producers and products. This finding is an important victory for all American food producers of quality regional products – who are entitled to equal access to the EC system of protection for geographical indications – and also for all U.S. producers owning trademarks in Europe. In nearly all of the 11 cases, U.S. concerns were addressed via changes in laws or regulations by the other party.

We also regularly review countries' IPR laws and practices through the WTO Trade Policy Review Mechanism (TPRM). WTO members recently reviewed included China late last year. In addition, the TRIPS Council regularly reviews implementing legislation, providing a forum for USTR to provide comments on existing and draft legislation and an opportunity for bilateral meetings to discuss specific concerns.

Preference Programs

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USTR also administers the Generalized System of Preferences (GSP) program and other tariff preference programs. The "carrot" of preserving GSP benefits is an effective incentive for countries to protect IPR. In fact, the filing of a GSP review petition or the initiation of a GSP review has in some cases produced positive results. For example, in response to an extended GSP review of Brazil this past year, the Government of Brazil adopted a new National Action Plan to enforce copyrights and reduce piracy. According to our industry, the Brazilian Government appears to be moving in the right direction and is now committing significant fiscal and personnel resources to anti-piracy efforts. The recent efforts to integrate the enforcement efforts and informational exchange channels of the Federal Police, Federal Highway Patrol, and Internal Revenue Service, are evidence of that the Plan is being implemented. Over the past two months hundreds of thousands of pirated products have been seized and destroyed, and dozens of individuals have been arrested.

India, expressing its desire to have GSP benefits reinstated, just passed a new patent law, providing patent protection for pharmaceutical products thus providing this form of intellectual property to our innovative pharmaceutical companies.

The Strategy Targeting Organized Piracy (STOP!) Initiative

Through a new initiative, the Administration is taking comprehensive action to block trade around the world in pirated and counterfeit goods. The Strategy Targeting Organized Piracy (STOP!) Initiative is a U.S. government-wide initiative begun in October 2004 to empower U.S. businesses to secure and enforce their intellectual property rights in overseas markets, to stop fakes at U.S. borders, to expose international counterfeiters and pirates, to keep global supply chains free of infringing goods, to dismantle criminal enterprises that steal U.S. intellectual property and to reach out to like-minded U.S. trading partners in order to build an international coalition to stop counterfeiting and piracy worldwide.

Last month, a delegation representing the seven federal agencies participating in STOP! visited Singapore, Hong Kong, Japan and Korea generating much interest and fruitful discussions. A few countries proposed avenues of cooperation, one in particular in the area of peer-to-peer file sharing that may be useful to our copyright concerns. In the coming months, we will continue our outreach so as to determine the interests of other countries for activities that provide opportunities for cooperation. Next month we will be sending a similar delegation to Europe.

I would now like to turn to two particular countries that pose the greatest challenges to protecting and enforcing American IPRs.

China

As Ambassador Portman stated in his confirmation hearing testimony, IPR is a top priority in our trade relationship with China. We have a number of challenges to

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resolve in this relationship that, as you are all aware, have been ongoing for some time. A chief concern among these challenges is the rampant piracy of our movies, music and software. Illustrative of this point are industry statistics showing that last year 85 percent of the sound recordings and 95 percent of films in China were pirate product. These are disconcerting figures which as Ambassador Portman stated we will focus on cutting. The reported loss of sales affecting U.S. industry ranges from $2.5 to $3.5 billion annually as described in our Special 301 Out-of-Cycle Review (OCR). Such losses are not sustainable and, as demonstrated by the report's more aggressive stance, are of significant concern. We want and look forward to working closely with you and your staff in combating the theft of American innovations in China.

The Special 301 OCR

On April 29, USTR reported the results of its OCR on the IPR situation in China. In this report, we concluded that while China has undertaken a number of serious efforts at the national level to address our IPR concerns, particularly by amending laws and increasing raids against those selling pirated goods and operating illegal production facilities, China is still not deterring rampant piracy. Our industries report that piracy and counterfeiting remain at high levels, a situation hurting our individual right holders, and small and medium size businesses the hardest. As a consequence, we outlined five actions to address our concerns:

1) Working with U.S. industry and other stakeholders with an eye toward utilizing WTO procedures to ensure that China is in compliance with its WTO TRIPS obligations.

2) Invoking the transparency provisions of the WTO TRIPS Agreement, which will require China to produce detailed information on certain aspects of IPR enforcement that affect U.S. rights under the TRIPS Agreement.

3) Elevating China onto the Priority Watch List on the basis of serious concerns about China's compliance with its WTO TRIPS obligations and commitments China made at the April 2004 U.S.-China Joint Commission on Commerce and Trade (JCCT) to achieve a significant reduction in IPR infringement throughout China, and make progress in other areas.

4) Continuing to monitor China's implementation of its commitments under our 1992 and 1995 bilateral agreements (including additional commitments made in 1996).

5) Using the JCCT, including its IPR Working Group, to secure new, specific commitments to significantly improve IPR protection and the enforcement environment in China.

China must expend the political capital necessary to deliver on its promise to "substantially reduce IPR infringement." China's Vice Premier Wu Yi committed to this

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at the April 2004 JCCT and in our 1995 bilateral Memorandum of Understanding on IPR. In order to achieve this goal, China must resolve critical deficiencies in IPR protection and enforcement, while providing for a level of transparency that allows for a thorough accounting. We will work with our counterparts on the Chinese side, beginning with tomorrow's JCCT IPR Working Group, to impress upon China that patience within the Administration and on Capital Hill has run and that now is the time for results.

Working with Industry

On the domestic front, we are working with the U.S. copyright industry to identify problems and address trade complaints related to China, as we did during the OCR. This includes cooperating with companies and associations to monitor China's WTO TRIPS implementation, and using WTO procedures to address our serious concerns about China's compliance. Industry's daily operations throughout China provide insight into that country's IPR regime, particularly at the local and provincial levels, where piracy is most egregious. This dialogue points to serious concerns with China's implementation of Articles 41 and 61 of its TRIPS obligations to provide that for effective enforcement of IPR including remedies that produce deterrence against pirating.

TRIPS Transparency Provision

In the next couple of weeks, we will begin the process of filing a request for information under TRIPS transparency provisions (Article 63) so that China must provide information on its IPR regime and recognize the serious deficiencies in its system. The request will focus on specific judicial decisions and administrative rulings that pertain to IPR, including penalties, fines and prison terms actually imposed in individual IPR infringement cases. We believe such a request should address some of the concerns industry has had with complaints it has leveled in the Chinese system, while demonstrating to the Chinese our belief that a transparent IPR regime is a staple of good governance.

China's response to our request will be the first public test of whether it is serious about addressing rampant piracy and counterfeiting. It will also compel its officials to revisit China's enforcement practices, the IPR violations it pursues and the results of these cases. We look forward to China's earliest response to that request.

The Priority Watch List

China's placement on the Priority Watch List (PWL) indicates that particular problems exist in that country with respect to IPR protection, enforcement and market access. Copyright concerns include:

1. Market access and investment barriers that prevent the copyright industry from serving China's market in a timely manner.

2. China's exports of pirated movies, music and software.

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3. China's failure to impose penalties that deter or punish, or incapacitate these thieves.

4. Rapid growth of Internet piracy.

Monitoring U.S.-China Agreements

We will continue monitoring China's yearly performance in the Special 301 process in part based upon commitments it made in our bilateral agreements. Although the importance of these agreements has decreased since China became a member of the WTO in December 2001 (requiring adherence to TRIPS), some of the provisions in these agreements remain significant.

The JCCT IPR Working Group

In our OCR Report, we identified for China six specific results that in our view would be evidence of promoting better IPR protection. During this week's JCCT IPR Working Group meetings, we will provide the Chinese suggestions on how to achieve the results we're seeking and impress upon them the importance of action. Among others, we are looking for China to enhance its criminal enforcement system, provide for a deterrent administrative enforcement system, allow for fair market access for legitimate products, secure its borders against exports of pirated products, protect copyrights in the context of the Internet, and increase the transparency of its legal system. China must now take ownership of these concerns and exercise the political leadership needed to show improvements in stopping piracy.

Simultaneously during the JCCT IPR Working Group's meetings, we will share our technical expertise with China on how to meet the many challenges in its IPR regime. Along with representatives from the Departments of Commerce (including the U.S. Patent and Trademark Office), Food and Drug Administration, Homeland Security (Customs and Border Protection), Library of Congress (Copyright Office), Justice, and State, we will cooperate where possible to ensure that China addresses the concerns raised.

Finally, we ask Congress to join us in encouraging industry's robust participation in each of these efforts through increased monitoring, data collection and devoting resources to this effort. Their engagement and support on IPR issues this year is key to our efforts to improve IPR protection in China.

Russia

We also remain very concerned about high levels of piracy of optical media (CDs and DVDs) and the growing problem with Internet piracy of copyrighted works in Russia. Protection and enforcement of American IPRs in Russia is an issue that is of

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utmost concern to USTR and the Administration. Due to the importance of this issue and the prevalence of piracy in Russia, Presidents Bush and Putin have discussed improving protection of IPRs in Russia at several recent summits, including at their meeting earlier this month in Moscow. Successfully combating the rampant piracy and counterfeiting that currently exists in Russia is a top priority.

The level of copyright piracy in Russia has increased dramatically and the adverse effects on American owners of copyrights are compounded by the fact that Russia has become a major exporter of pirated materials. In addition to sales in Russia of illegal music, movies, and computer software, Russia's pirates are exporting large volumes of illegal products to other markets. As a result, Russia is on the 2005 Special 301 Priority Watch List. In addition, due to the severity of the problem in Russia, the Administration will conduct an out-of-cycle review this year to monitor progress by Russia on numerous IPR issues. We are also continuing interagency review of a petition filed by the U.S. copyright industries to withdraw some or all of Russia's GSP benefits.

USTR Efforts

USTR and other agencies have been and will continue to be very engaged with the Russian Government at all levels to develop an effective IPR regime and strengthen enforcement in Russia. We have an ongoing bilateral working group with the Russian Federal Service on Intellectual Property, Patents, and Trademarks (Rospatent), the agency responsible for most IPR matters in Russia, which has convened several times this spring to discuss a wide range of IPR issues. Recent discussions have focused on Russia's enforcement regime, legislative deficiencies – including the need for a comprehensive regulatory regime on optical media production, and Internet piracy.

We are also working on IPR issues in the context of Russia's WTO accession negotiations. We have continuing concerns that Russia's current IPR regime does not meet WTO requirements related to protection of undisclosed pharmaceutical testing data, geographic indications and enforcement. We are raising these and other concerns in the accession negotiations and have made it clear to the Russian Government that progress on IPR will be necessary to complete the accession process.

Supplementing these efforts directly with Russia, the Administration is also seeking to address Russia's growing exports of pirated and counterfeit products as part the STOP! Initiative I mentioned earlier.

Our work has brought about some improvements, particularly with respect to the content of Russia's laws, but much more will need to be done in order to reduce the level of piracy and counterfeiting. As part of its effort to bring Russia's IPR regime into compliance with the obligations of the TRIPS Agreement, Russia amended its Copyright Law in 2004 to provide protection for pre-existing works and sound recordings. Russia has amended a number of other laws as well, including its laws on patents and protection of computer software and databases. Although these amendments demonstrate Russia's

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commitment to strengthening its IPR laws, further improvements in Russia's laws are necessary.

Stronger Enforcement Measures Necessary

On the enforcement side, we have seen far less progress. While Russian law enforcement agencies have taken some actions, including an increased number of raids by police, these actions have not deterred the significant increase in piracy that our industry has observed in Russia. Enforcement efforts in Russia must increase dramatically in order to combat rising piracy and counterfeiting levels. We need to see improvements in enforcement of Russia's criminal laws against piracy and counterfeiting, improved enforcement at the border to prevent exports of pirated and counterfeit products and better administrative and civil procedures for IPR enforcement, such as providing for *ex parte* procedures in civil cases.

We are very concerned with the amount of excess optical media capacity in Russia and with Russia's lack of a comprehensive regulatory regime to control illegal optical media operations. Our industry estimates that the capacity of known plants in Russia is 371.6 million discs while legitimate domestic demand is around only 30 million discs. Illegal optical media from Russia has been found in markets around the world. Russia lacks an effective system for inspection of optical media production plants to ensure that only authorized product is being made.

On the criminal enforcement side, we see frequent delays in prosecutions and then imposition of minimal penalties, including many suspended sentences. Frequently, pirated goods that have been seized in a case are not destroyed, but are returned to the market. The U.S. copyright industry estimates that 70 percent of seized pirated product goes back into the stream of commerce. We are also seeing an increase in piracy on the Internet. Several major illegal websites are operating out of Russia, one of which our industry reports is now the largest portal for pirated product in the world. We have raised these issues with Russia and are seeking decisive actions to address these growing problems, such as inspecting optical media plants, permanently shutting down illegal production, and taking down Internet sites that are spreading pirated material.

We share in our industries' frustration over the lack of significant progress on the part of Russia's authorities. USTR is committed to utilizing effectively the tools currently available to us to press Russia to act immediately to implement concrete measures to combat piracy and counterfeiting operations and reduce the losses to U.S. industries. Despite our close engagement and continued work with the Russian Government, Russia has made little progress in permanently closing down illegal production and bringing offenders to justice. Political will at the highest levels will be needed in order to see a reduction in piracy levels in the near term.

USTR will continue to monitor Russia's progress in bringing its IPR regime in line with international standards through the Special 301 out-of-cycle review, the ongoing GSP review, bilateral IPR working group discussion and WTO accession discussions.

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Progress will be critical for our bilateral relationship with Russia and will have implications for Russia's accession to the WTO. Ultimately, success will depend on the political will of Russia's leaders to tackle the underlying problems of corruption and organized crime. We remain committed to working with the Congress and this committee in particular in pressing Russia to combat and reduce the unacceptable levels of piracy and counterfeiting which plague our industry.

Conclusion

Dealing with the problem of piracy requires a comprehensive, intensive and sustained effort. The new USTR Ambassador Portman has identified enforcement of IPR and ensuring compliance with obligations by our trading partners such as China and Russia as a top priority. We are strongly committed to continuing to bring all of USTR's weapons to bear on this issue and to maintain the pressure year after year. We have made progress, but enormous challenges remain.

I look forward to working with you and your staffs to continue to devise solutions for dealing with this critical matter.

Thank you.

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Special 301 Country Designations

Priority Foreign Country

Currently, one country (Ukraine) is designated to be in this category and remains subject to $75 million in sanctions.

Note: Countries identified as Priority Foreign Countries can be subjected to a Section 301 investigation and face the possible threat of trade sanctions. These are countries that fail to enter into good faith negotiations or make significant progress in bilateral or multilateral negotiations to provide adequate and effective protection of IPR.

Priority Watch List

Fourteen trading partners have been placed on the Priority Watch List. These countries are: Argentina, Brazil, China, Egypt, India, Indonesia, Israel, Kuwait, Lebanon, Pakistan, the Philippines, Russia, Turkey, and Venezuela.

Note: Countries on the Priority Watch List do not provide an adequate level of IPR protection or enforcement, or market access for persons relying on intellectual property protection.

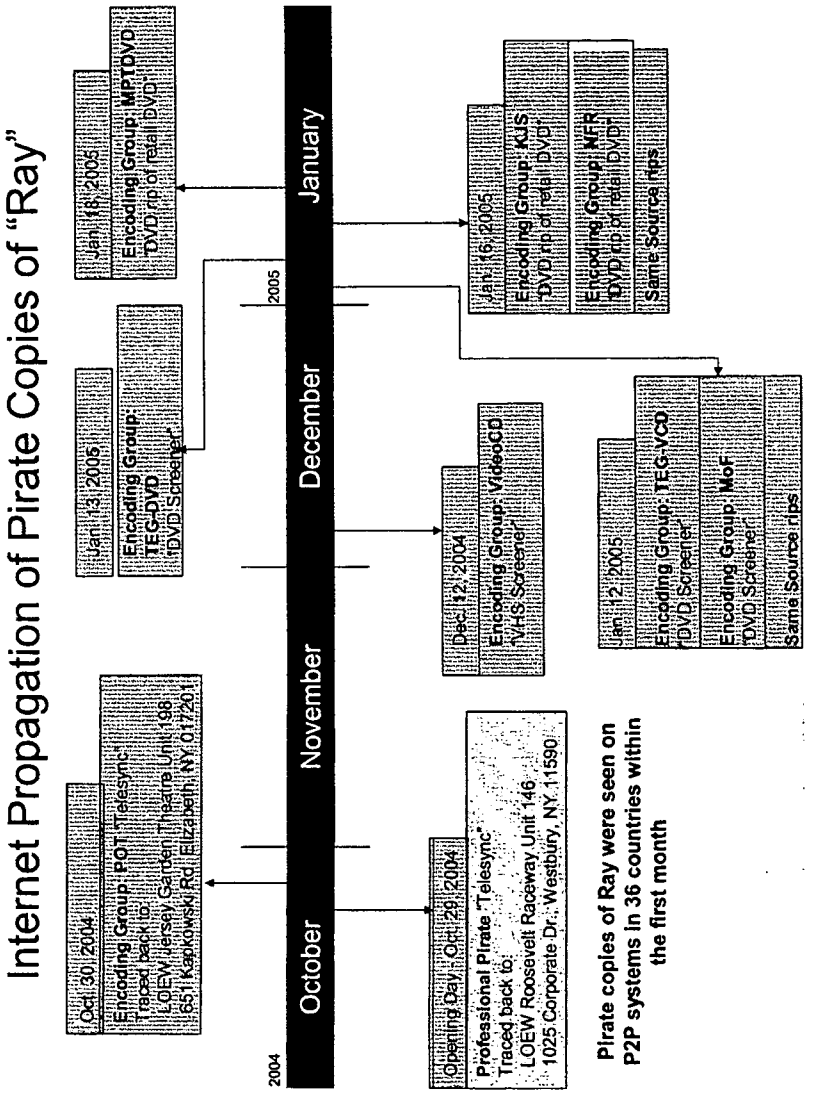
Watch List

Thirty-six trading partners are placed on the Watch List. These countries: Azerbaijan, Bahamas, Belarus, Belize, Bolivia, Bulgaria, Canada, Chile, Colombia, Costa Rica, Croatia, Dominican Republic, Ecuador, European Union, Guatemala, Hungary, Italy, Jamaica, Kazakhstan, Korea, Latvia, Lithuania, Malaysia, Mexico, Peru, Poland, Romania, Saudi Arabia, Slovakia, Taiwan, Tajikistan, Thailand, Turkmenistan, Uruguay, Uzbekistan, and Vietnam.

Note: Countries on the Watch List merit bilateral attention to address underlying IPR problems.

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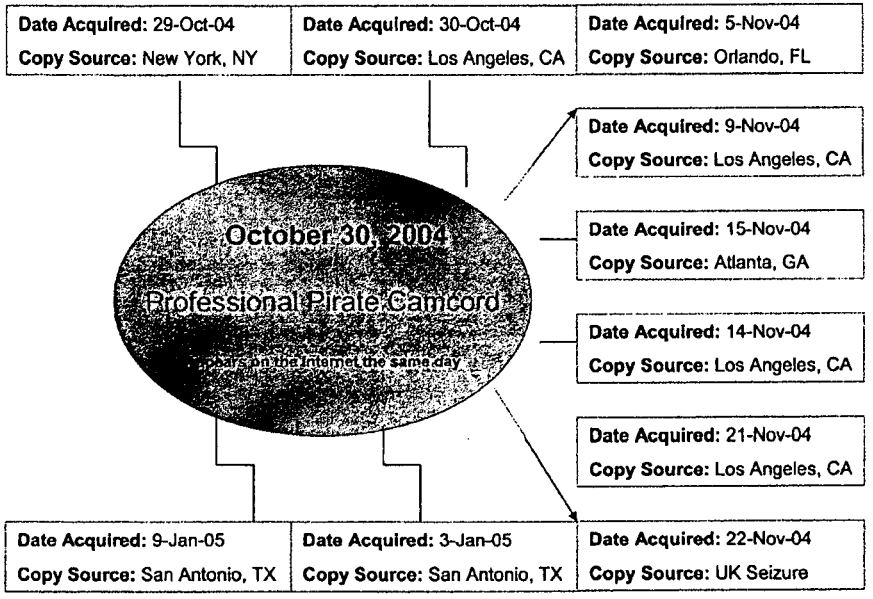


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Global DVD Piracy & Propagation

from just one source



Pirate DVDs of Ray are to be found in every major market around the world

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Impact of Internet Piracy of Ray

- 476,746 P2P requests to download Ray on Thursday, May 19, 2005.
- Over 23,000 copies may have been download just on Thursday (if only 5% succeeded in downloading)
- Over 42 million requests to download since it was first pirated in October 2004.
- 21,720 copyright complaints and DMCA notices have been sent regarding P2P infringements of Ray. (as of May 12, 2005)
- The Internet piracy of Ray has been identified in 68 countries since October 2004.

Testimony of Marybeth Peters
Register of Copyrights
Before the
U.S. Senate Judiciary Committee
Subcommittee on Intellectual Property
May 25, 2005

"Piracy of Intellectual Property"

Mr. Chairman, Senator Leahy, Members of the Subcommittee, thank you for the opportunity to speak with you today about one of the most pressing issues in copyright today – international piracy. It is always a pleasure to appear before you, and I was pleased to see the reinstallment of the Subcommittee, and wanted to congratulate you on your Chairmanship.

I. Introduction

Mr. Chairman, in the nearly forty years that I have worked in the Copyright Office, piracy, and especially global piracy, is probably the most enduring problem I have encountered. As with some other illegal activities, there will always be at least a small segment of any population who cannot be deterred from this theft of others' creativity. Thus, I fear that it is simply not realistic to speak of eliminating all piracy around the world, or even within the United States.

What we can and should strive for is the reduction of piracy to the lowest levels possible; levels that will not rob authors and copyright owners of the incentive to create and distribute the works that have made America's creative industries the envy of the world. The Copyright Office has a long history of working toward this goal, both on its own initiative and in cooperation with the other agencies of the Federal Government. My testimony today will describe those efforts and their effectiveness.

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II. Legal Framework

Broadly speaking, there are two elements to the protection of copyright. The first element is a legal framework that provides the basic rights to copyright owners and establishes procedures for the enforcement of those rights. Those procedures must provide the opportunity to obtain adequate remedies when those rights are violated as well as the possibility of punitive monetary judgments and, in appropriate cases, imprisonment of the infringer. The second element of copyright protection is the application of these legal rules to ensure that copyright owners have actual, effective protection against infringement of their rights.

In the ten years since the conclusion of the Uruguay Round of the WTO, and the concomitant adoption of the TRIPS Agreement,[1] there has been tremendous improvement worldwide in countries' legal framework for copyright protection. By incorporating the substantive copyright obligations of the Berne Convention, and supplementing them with civil, criminal, and border enforcement obligations, TRIPS established a minimum standard against which all countries' copyright regimes could be judged.

Since 1995, the number of WTO member countries has nearly doubled. By including the TRIPS Agreement in the WTO obligations, and thus subjecting the obligations therein to international dispute resolution, we have been able to advance copyright protection in all 148 WTO member countries further and faster than would have been possible without it.

The Copyright Office is proud of its contributions to this success, which include participation in the negotiation of the TRIPS Agreement and other copyright treaties and agreements, as well as training of foreign officials. Our main program for training

[1] Trade Related aspects of Intellectual Property.

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foreign copyright officials is our International Copyright Institute ("ICI"). This week-long program exposes foreign officials from developing countries and countries in transition to a wealth of copyright knowledge and information, presented by U.S. Government, and foreign and domestic industry experts. Thanks to the Congress, we are able to attract the best participants from around the world by offering this training program at no cost to them or their governments.

Part of the reason the ICI is such a success is that it is not merely a week of lectures. We provide ample time for the delegates to interact and learn from each other. Similarly, we learn valuable information about the law in their countries, including new developments not necessarily available to the public. Perhaps most important of all, we strengthen the relationship with those countries. Many ICI participants have been high-ranking officials or have gone on to high-level government positions. The relationships we establish at the ICI enhance our ability to negotiate with the officials and countries we have hosted.

In addition to the ICI, the Copyright Office makes its experts available to speak around the world at various conferences and training programs. In the past twelve months, we have spoken at WIPO seminars, academic conferences, and events sponsored by other U.S. Government agencies, such as a State Department Intellectual Property Roundtable and the Patent and Trademark Office's Visiting Scholars program. I personally have been very active in the State Department's Distinguished Speaker program, giving presentations in Chile and Uruguay last year, and am scheduled to speak in Germany, Brussels, and Brazil this year.

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We also supported USTR's free trade agreement ("FTA") negotiations by providing technical assistance to our negotiating partners. We were pleased to send experts to the two intellectual property and telecommunications programs that the State Department organized for its embassy officers throughout Europe and east Asia.

The Copyright Office is also a major contributor to the strengthening of copyright protection through international organizations, notably the World Intellectual Property Organization ("WIPO"). The Copyright Office played a key role in the negotiation of the WIPO Copyright Treaty ("WCT") and the WIPO Performances and Phonograms Treaty ("WPPT"). Those treaties supplemented the Berne Convention and the TRIPS agreement with updated obligations that are especially important in the digital age. As you know, the United States implemented the WCT and WPPT through the Digital Millennium Copyright Act ("DMCA"), which stands as a model for the world. Those treaties and the model of the DMCA have also been the source of a substantial improvement of the legal framework for the protection of copyright in numerous countries around the world. The work at WIPO neither began nor ended with the WCT and the WPPT, and the Copyright Office continues to work in support of the proposed treaties on audio-visual performances and on broadcasting, cablecasting, and webcasting, among many other initiatives.

There are also many opportunities to promote copyright protection through the World Trade Organization ("WTO"). The Copyright Office works closely with the U.S. Trade Representative's Office ("USTR") to take full advantage of each of them. As countries not currently in the WTO seek to join, we evaluate their existing copyright laws, advise USTR of TRIPS deficiencies, and support pre-accession negotiations. Once countries are WTO members, they are subject to a periodic review of their laws. Again,

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we advise USTR of any TRIPS deficiencies and draft questions for those countries, seeking explanations from their governments and highlighting the problems in a global forum. Most seriously, if and when the dispute resolution procedure of the WTO is invoked for a copyright issue, we support USTR in this litigation effort with our expertise.

The Copyright Office also works hand-in-hand with USTR on bilateral and regional trade negotiations, including negotiations and implementation of FTAs. In the past twelve months, we participated in bilateral negotiations with Russia, Saudi Arabia, China, South Korea, Japan, Taiwan, Philippines, Vietnam, Germany, Israel, Kazakstan, Brazil, Yemen, and Kuwait. During that time, we played a key role in negotiating the intellectual property chapters of the FTAs with Panama, the Andean FTA group, Oman, United Arab Emirates, and Thailand. We have also worked hard to ensure the proper and full implementation of our FTAs, most notably with Singapore and Morocco.

I am confident that we have a lot to show for our efforts and I am proud of that. American creative industries now have improved legal regimes around the world, increasing their opportunity to sell their products and services on a level playing field. This generates an incentive to create and distribute new and better works for the benefit of Americans and the world. It also creates jobs, both here and abroad.

My discussion of the legal frameworks for protecting copyright would not be complete if I did not add a few words about the U.S. Copyright Act. While there are many ways to approach an issue and many good laws around the world, I believe that on the whole, the U.S Copyright Act does the best job of providing appropriate protections

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to authors and copyright owners, while still allowing for fair and reasonable use of copyrighted materials.

But our law is not perfect, and when we go to other countries seeking improved copyright protection, they are quick to point out the deficiencies and gaps in our law. For example, the U.S. has not amended its law to remove a provision of section 110(5), an exemption for performing musical works in public places like bars and restaurants that was broadened in 1998. A dispute resolution panel of the WTO ruled that the expansion of the exemption was inconsistent with the United States' TRIPS obligations. Also, although we ask foreign governments to extend all the rights they afford under their law to their domestic right holders in sound recordings to American right holders as well, many countries point out that the scope of such rights under U.S. law is narrower than theirs, depriving their right holders of the reciprocal protections in the United States. I know that these are controversial subjects, but if we are going to take a frank look at how to solve the problems of international piracy, we need to look at our own deficiencies as well.

III. Enforcement

The second element to the protection of copyright is the enforcement of the rights provided by the law. We all recognize that without adequate and effective enforcement, the laws are not worth very much. Accordingly, we place a great deal of emphasis on enforcement in our conversations with foreign officials.

The TRIPS agreement was the first international instrument to contain extensive copyright enforcement obligations, covering the necessary authority of policing, customs, and judicial authorities, setting standards for the application of criminal penalties, and

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establishing the overall standard that countries must provide "effective action against any act of infringement... and remedies which constitute a deterrent to further infringements."[2] The TRIPS agreement has been a tremendously valuable tool in advancing the development of legal structures to support enforcement of copyright around the world. There remains, however, substantial work to be done in making sure that those structures provide *effective* enforcement of copyright.

Our FTAs have built upon the TRIPS enforcement text by adding specificity to what is found in TRIPS, and other obligations not found in TRIPS at all. For example, where TRIPS requires criminal penalties for all "wilful... copyright piracy on a commercial scale..."[3], the FTAs specify that criminal penalties must be available for all wilful infringements for purposes of commercial advantage or private financial gain, or significant wilful infringements, regardless of motivation. This reflects the experience in the U.S. in dealing effectively with various forms of piracy and is broader than many countries' existing criminal copyright provisions.

The FTAs also provide us with the flexibility to address enforcement problems that are particularly problematic in a given country or region. For example, some of our FTAs include a side letter imposing a unilateral obligation on our trading partner to regulate the manufacture of optical discs.[4] This is a reflection of the fact that much of the world's pirated optical discs are manufactured in certain regions, perhaps most notably, southeast Asia.

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[2] TRIPS Art. 41(1).
[3] TRIPS Art. 61.
[4] The phrase "optical disc" is an umbrella term that includes DVDs, CDs, CD-ROMs, VCDs, etc. containing movies, recorded music, computer programs, and videogames.

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In another example, one that is specific to a single country, there is a provision in the Singapore FTA which was carefully crafted to address the serious concerns with pirated products being trans-shipped through Singapore and out to the rest of the region and the world.

A. Serious Challenges Remain

Despite all these accomplishments, the fact remains that copyright enforcement in too many countries around the world is extremely lax, allowing staggeringly high piracy rates and massive losses to American companies. In its most recent Special 301 submission, the International Intellectual Property Alliance ("IIPA") estimated that global piracy cost U.S. copyright industries over $13 billion in 2004 alone.

1. China

China is a good example of how laws are not enough -- enforcement is absolutely essential to the protection of copyright. As China joined the WTO in 2001, the Copyright Office worked with the USTR-led interagency team to provide technical advice and to urge the Chinese government to amend its law to be TRIPS-compliant. While it fell short in several important respects, the law is more than sufficient to provide some meaningful protection to copyrighted works if it is properly enforced. Unfortunately, China's enforcement efforts remain inadequate as is illustrated by the industry reports that the piracy rates continue to hover around ninety percent for all forms of copyrighted works, as they have for years.

Last year, China made a number of commitments to improve various aspects of its intellectual property regime, most notably in regards to enforcement. Shortly before the meetings at which those commitments were made, the Copyright Office hosted a

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delegation of Chinese copyright officials led by the National Copyright Administration of China ("NCAC"). We have enjoyed a cooperative relationship with the NCAC for nearly 25 years, and that relationship has helped to promote greater understanding between our governments. We have learned, though, that China's government is complex, and that the NCAC frequently does not have the final say on copyright policy and enforcement in China.

China's implementation of last year's commitments has been incomplete. For example, a major impediment to increased criminal copyright prosecutions has been a series of Judicial Interpretations of the criminal code, which set minimum monetary thresholds for the scope of infringements capable of giving rise to a criminal conviction. While a new set of interpretations with lower thresholds was issued, it contains several flaws, such as calculating whether the thresholds are met based on the artificially low pirate price, rather than the price of the legitimate version of the product being infringed. Further, while Vice Premier Wu Yi did hold public events to draw attention to the problem of piracy in China, the government has still not ratified the WCT or WPPT.

2. Russia

Russia has been on the Special 301 Priority Watch List since 1997. Today Russia's copyright piracy problem remains one of the most serious of any country in the world. According to the IIPA, piracy rates in Russia for most sectors are estimated at around 80% in 2004 and losses exceed $1.7 billion. In the past few years there has been an explosion in the growth of illegal optical media disc plants run by organized crime syndicates with widespread distribution channels. Russia has also developed a serious

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online piracy problem, as exemplified by the offering of pirated materials on the website, "allofmp3.com," which has yet to be taken down by Russian authorities.

The U.S. Copyright Office is a committed member of the United States Government interagency efforts to combat intellectual property violations in Russia. There have been some positive steps in Russia which include passing copyright amendments last year that, among other things, remedied a long-standing and serious deficiency in the protection of pre-existing works and sound recordings of U.S. right holders. Statements by President Putin and other high-ranking government officials indicate that the Government of Russia comprehends the serious adverse effects of piracy and counterfeiting on U.S. companies, Russia's domestic creative industry and its economy. Not all of these encouraging statements have produced the desired results, such as the Russian Government's statement that it would eradicate all music piracy within two years. Now, two years since then, piracy has not decreased, but instead has increased by 30%, and industry estimates that Russia is now the world's largest exporter of pirated music products. Nevertheless, we must encourage the Russian Government to remain committed, and meet its enforcement problems head-on. We will continue to work with USTR using every possible forum to build on the positive steps Russian lawmakers have taken.

B. Treaties Cannot Compel Enforcement

For all the progress that we have made through TRIPS, the WCT and WPPT, and our FTAs, the fact remains that enforcement requires action. Laws do not enforce themselves. In my experience, there are two causes of inadequate enforcement: lack of competent police, prosecutors, and/or judges and lack of political will to enforce

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copyright. We do our best through the training programs I have described to address the first problem. The second, lack of political will, is much more difficult.

I firmly believe that both history and logic demonstrate that a good system of copyright protection is a critical ingredient to developing vibrant domestic creative industries. Just recently, Bill Gates spoke at the Library of Congress and questions were raised concerning outsourcing. He responded that Microsoft would continue to operate out of the United States because the United States is the country with the most respect for intellectual property. That statement is a testament to how intellectual property goes hand-in-hand with substantial economic development.

We must recognize the reality that some countries do not share this view. They sacrifice the long term social and economic development benefits in favor of instant gratification; pirate operations provide jobs and income in many developing countries. Some also take the unfortunate view that paying for legitimate copies of works is just an exercise in sending money out of their country to foreign right holders. This approach undermines the ability of copyright to encourage and develop a nation's own creative industries and culture. It also overlooks the benefits of tax revenue from legitimate business and the good jobs and income that come with the increase in foreign investment that is encouraged by a good regime of copyright protection..

Such countries are simply unwilling to commit resources to provide effective enforcement of copyright. At best, they will do the minimum they need to do in order to prevent excessive trade friction with the United States or other trading partners. In recent years, some like-minded countries have worked together to present arguments on the international level that seek to weaken existing international standards of copyright

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protection. Couched in terms of encouraging development or cultural diversity, these arguments are premised on the notion that copyright protection is antithetical to the interests of developing countries. What we are facing is an attempted backlash against the TRIPS agreement and our other successes. While we need to continue to work hard for short-term progress on enforcement in individual countries, we must also keep a close eye on these attempts to undermine established international standards of copyright protection.

IV. Not all Piracy is Alike

Before I conclude, Mr. Chairman, I would like to distinguish the type of piracy we see in the United States and what we see in many other countries. To be sure, piracy anywhere is serious and cause for concern. I have testified extensively on the very real dangers of domestic piracy, particularly the massive amount of piracy that dominates many peer-to-peer networks. As you know, these issues have given rise to the type of vigorous public debate on which the United States prides itself. But all too often, what we see abroad bears no resemblance to college students downloading their favorite songs and movies.

Much of the foreign piracy about which we are speaking today is done by for-profit, criminal syndicates. Factories throughout China, southeast Asia, Russia, and elsewhere are churning out millions of copies of copyrighted works, sometimes before they are even released by the right holders. These operations are almost certainly involved in other criminal activities. Several industry reports in recent years suggest that dueling pirate operations have carried out mob-style "hits" against their criminal

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competitors. And, although the information is sketchy at best, there have been a series of rumored ties between pirating operations and terrorist organizations.

What is problematic is that some American commentators who are prone to hyperbole about what they see as an imbalance in the U.S. Copyright Act are providing arguments and rationalizations that foreign governments use to defend their failure to address this type of organized crime. The confusion wrought by the imprecision and lack of clarity in these commentators' statements is not helpful to our achieving the goal for which there is no credible opposition: dramatic reduction in organized piracy of U.S. copyrighted works abroad.

V. Conclusion

International piracy poses a tremendous threat to the prosperity of one of America's most vibrant economic sectors: its creative industries. Accordingly, it deserves our utmost attention. This attention must be consistent and long-term if it is to be successful. At the same time, we must be realistic in the goals that are set, lest we become discouraged in spite of our successes. While it is not realistic to expect to eliminate all piracy, I do believe that we can continue to improve the global situation, to the benefit of authors and right-holders here in the United States and throughout the world.

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STATEMENT OF

STEPHEN M. PINKOS

DEPUTY UNDER SECRETARY OF COMMERCE FOR INTELLECTUAL PROPERTY
AND
DEPUTY DIRECTOR OF THE UNITED STATES PATENT AND TRADEMARK OFFICE

BEFORE THE

COMMITTEE ON THE JUDICIARY
SUBCOMMITTEE ON INTELLECTUAL PROPERTY

United States Senate

"Piracy of Intellectual Property"

MAY 25, 2005

Introduction

Chairman Hatch, Ranking Member Leahy, and Members of the Subcommittee:

Thank you for this opportunity to appear before you to discuss international intellectual property (IP) piracy and counterfeiting problems and the Department of Commerce's role in protecting IP abroad. Secretary Gutierrez is keenly aware of the increasing significance of IP protection for American businesses and innovators and has made combating piracy and counterfeiting a top priority for the entire Department. As Deputy Under Secretary of Commerce for Intellectual Property and Deputy Director of the United States Patent and Trademark Office (USPTO), I am dedicated to marshalling U.S. government efforts to reduce the toll that IP theft takes on American IP owners. I am very appreciative of the Subcommittee's interest in addressing additional ways to protect U.S. IP owners' assets, and I commend you for holding today's hearing on IP piracy and counterfeiting, with an emphasis on China and Russia.

Scope of Global IP Piracy and Counterfeiting Problem

Increasingly, both the United States and our trading partners are relying on IP to drive economic growth. This is because competitive success in a market economy depends more and more on the IP assets held by an institution -- from the skills of its employees to the results of its latest research. IP-based businesses, such as the software and entertainment industries, now represent the largest single sector of the U.S. economy.

According to the International Intellectual Property Alliance, U.S. copyright industries continue to lead the U.S. economy in their contributions to job growth, gross domestic product (GDP), and foreign sales/exports. Between 1977 and 2001, the U.S. copyright industries' share of the GDP grew at an annual rate more than twice as fast as the rest of the U.S. economy. In 2002, the U.S. "core" copyright industries' activities accounted for approximately 6 percent of the U.S. GDP

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($626.6 billion).[1] In 2002, the U.S. copyright industries achieved estimated foreign sales and exports of $89 billion, leading all major industry sectors, including motor vehicles (equipment and parts), aircraft and aircraft parts, and the agricultural sector.[2]

Unfortunately, the economic benefits of capitalizing on intellectual property rights (IPR) have captured the attention of pirates, organized crime, and terrorists. The global criminal nature of IP piracy has effects in other areas as well. As former U.S. Attorney General John Ashcroft reported: "In addition to threatening our economic and personal well being, intellectual property crime is a lucrative venture for organized criminal enterprises. And as law enforcement has moved to cut off the traditional means of fund-raising by terrorists, the immense profit margins from intellectual property crimes risk becoming a potential source for terrorist financing."

USPTO and DOC Efforts to Combat Problem

Given these threats to U.S. economic interests and our national security, the USPTO and our colleagues in the Department of Commerce are working hard to curb IP crime and strengthen IP enforcement in every corner of the globe. Indeed, former Secretary Evans heavily emphasized this issue, and Secretary Gutierrez has indicated it is a top priority for the entire Department. Because American IP owners compete in a global marketplace, we must expand our efforts to promote IP protection internationally. We must make sure that American IP owners have sufficient knowledge and legal tools to fight piracy and counterfeiting. We also must provide foreign countries technical assistance on drafting and implementing effective IP laws and promoting the effective enforcement of IP rights.

American Inventors Protection Act of 1999

The passage of the American Inventors Protection Act of 1999 (AIPA) (P.L. 106-113) set the stage for the USPTO to advise the President, through the Secretary of Commerce, and all Federal agencies, on national and international IP policy issues, including IP protection in other countries. USPTO is also authorized by the AIPA to provide guidance, conduct programs and studies, and otherwise interact with foreign IP offices and international intergovernmental organizations on matters involving the protection of intellectual property.

Our established Offices of International Relations and Enforcement carry out the functions authorized by the AIPA. These include (1) working with Congress to implement international IP treaties; (2) providing technical assistance to foreign governments that are looking to develop or improve their IP laws and systems; (3) training foreign IP officials on IP enforcement; (4) advising the Department of State and the Office of the U.S. Trade Representative (USTR) on drafting/reviewing of IP sections in bilateral investment treaties and trade agreements; (5) advising USTR on intellectual property issues in the World Trade Organization (WTO); and (6) working with USTR and industry on the annual review of IP protection and enforcement under the Special 301 provisions of the Trade Act of 1974. The USPTO also represents the United States in United Nation bodies, such as the World Intellectual Property Organization (WIPO), to help set the international standards for IP protection and enforcement.

[1] "Copyright Industries in the U.S. Economy: The 2004 Report," Stephen E. Siwek, Economists Inc., prepared for the International Intellectual Property Alliance. "Core" industries include: newspapers, publishing, recording, music, motion pictures, radio, television broadcasting and computer software.
[2] "Id.

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National Intellectual Property Law Enforcement Coordination Council (NIPLECC)

The USPTO serves as the co-chair of the National Intellectual Property Law Enforcement Coordination Council (NIPLECC), which is tasked with coordinating domestic and international intellectual property law enforcement. NIPLECC was launched in 1999 to ensure the effective and efficient enforcement of intellectual property in the United States and worldwide. NIPLECC's coordination activities ensure that government enforcement efforts are consensus-based and non-duplicative. NIPLECC has developed a comprehensive database that includes all recent IP law enforcement training provided by the U.S. government and many associations to developing and least developed nations. It is also developing legislative suggestions to improve domestic IP laws related to enforcement. We look forward to continuing our efforts in NIPLECC.

Strategy Targeting Organized Piracy (STOP)

Further, the Strategy Targeting Organized Piracy (STOP) Initiative, which has been developed over the last year, is the most comprehensive U.S. government-wide initiative ever advanced to demolish the criminal networks that traffic in fakes, stop trade in pirated and counterfeit goods at America's borders, block bogus goods around the world, and help small businesses secure and enforce their rights in overseas markets. I will discuss this important initiative in more detail later.

Enforcement Training and Technical Assistance

The USPTO provides a variety of IP enforcement training and technical assistance activities. These programs are designed to foster respect for IP, encourage governmental and right holders' efforts to combat infringement, and promote best practices in the enforcement of IPR. Our technical assistance and capacity building initiatives grew out of a desire to promote IP protection and assist developing countries in meeting their obligations under the WTO's Trade-Related Aspects of Intellectual Property Rights (TRIPs) Agreement. In addition, we have responded to an increasing number of requests by foreign governments for such training and technical assistance activities. Our efforts have had positive results in some countries, measured by decreasing levels of IP piracy and counterfeiting, and the implementation of stronger legal protections in many of the countries in which we have provided such training. Still, much work remains, including in China and Russia, where IP theft has not decreased.

Today, our efforts are aimed at: (1) assisting developing and least developed countries to meet international standards in the protection and enforcement of IP; and (2) assisting administrative, judicial, and law enforcement officials in addressing their enforcement issues.

Trade-Related Aspects of Intellectual Property Rights Agreement (TRIPs)

At the conclusion of the Uruguay Round in 1994, the resulting TRIPs Agreement presented WTO members with new obligations and challenges. The TRIPs Agreement sets minimum standards of protection for the various forms of IP and requires WTO members to provide for "enforcement procedures ... that permit effective action against any act of infringement of intellectual property rights." The TRIPs Agreement includes detailed provisions on civil, criminal and border enforcement measures designed to provide the owners of IP with the tools to protect and enforce their rights. Today, Developing Countries obligations' under the TRIPs Agreement have fully

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entered into force. Least Developed Countries have until 2006 to comply with the bulk of the provisions, including the enforcement obligations.

Over the last several years, the USPTO has assisted countries around the world in establishing adequate enforcement mechanisms to meet their obligations under the TRIPs Agreement. In bilateral negotiations, we work closely with USTR to seek assurances from our trading partners of even higher levels of IP enforcement than those set forth in the TRIPs Agreement. We provide technical advice through the annual Special 301 process, the GSP review, the TRIPs Council review of implementing enforcement legislation, and in the negotiation of free trade agreements (FTAs).

Our approach to the on-going FTA negotiations has been to build upon the TRIPs Agreement. In other words, our negotiating position is that these trade agreements should follow a "TRIPs Plus" format by, among other things, expanding the minimum standards set out in the TRIPs Agreement. For example, by incorporating provisions of the WIPO Copyright Treaty and WIPO Performances and Phonograms Treaty, the FTA updates copyright protections and enforcement for the digital environment. In our advisory capacity, we will continue to work with the Department of State and USTR to conclude FTAs that reflect the level of protection and enforcement of IP rights in the United States.

Intellectual Property Issues and USPTO Approach in China and Russia

Due to the rapid increases in piracy and counterfeiting in China and Russia, we recognize that U.S. companies face enormous IPR protection and enforcement challenges in these countries and that their losses are mounting daily. At the same time, the pressures of the competitive global marketplace, criminal elements, and protectionist and non-tariff barriers, make these challenges increasingly more sophisticated. That is why the USPTO's team of experts has developed comprehensive work-plans to address the rising IP problems facing these countries. While the USPTO does not have the lead on trade policy issues, which is the mandate of USTR, we have devoted significant resources to making progress in improving China and Russia's IPR regimes for our industries, right holders and this Administration.

The Bush Administration understands that IP is a vital component of our nation's economy and that this Administration's focus on combating global piracy and counterfeiting has produced a solid track record of real results. The STOP Initiative, which I mentioned earlier and will discuss in more detail later, is a continuation of these efforts by providing additional tools to protect American workers from counterfeiters and pirates who are robbing billions of dollars from the U.S. economy.

China

The U.S. has long been concerned about IP protection dating back to the founding of our country. For example, Gilbert Stuart's Athenaeum portrait of George Washington was replicated without authorization by a Philadelphia merchant, who was later sued for copyright infringement. Our first engagement with China on IP dates back to the early 20th century. In early 1903, at the end of the Qing dynasty, the U.S. government entered into the first bilateral agreement between China and the United States to protect IP. Our first commercial agreements in the 1970s with the People's Republic of China contemplated that China improve its IP system. Our current Ambassador to China, Clark Randt, was involved in some of these early negotiations.

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Unfortunately, problems persist and our concerns about IP enforcement in China continue to grow. Despite China's membership in the WTO and its requirement to comply with the TRIPs Agreement, as well as a series of bilateral commitments made over the past 10 or more years, the lack of effective IP enforcement in China is a major problem for U.S. business interests, costing billions of dollars in lost revenue and perhaps tens of thousands of U.S. jobs. While China has done a generally good job of creating laws to comply with its WTO commitments, IP enforcement problems remain pervasive. These problems run the gamut from rampant piracy of movies and business software to counterfeiting of consumer goods, electrical equipment, automotive parts, and pharmaceuticals.

I was very pleased that Secretary Gutierrez stated the following during his confirmation hearing with respect to intellectual property rights: "We actually lived through this as a food company, ironically, where we found that our brand was actually being copied and used in some markets and obviously without any authorization. One of the great assets that we have as a country is our brands, our technology. I think this is a matter to focus on. I think it is a big issue." Secretary Gutierrez also cited IP protection as a key issue in U.S. trade ties with China, and he has reiterated his commitment to addressing this issue to me.

IP Problem in China

Estimates from the computer software and automotive parts industries are illustrative of the scope of the problem. The software industry estimates that more than 90 percent of all software installed on computers in China in 2003 was pirated.[3] The automotive parts industries estimate that counterfeit automotive parts production costs the industry billions of dollars in lost sales. China is a leader in counterfeit goods in this industry.

In the automotive arena, most counterfeiting involves parts that need to be replaced frequently, such as oil filters, headlamps, batteries, brake pads, fan belts, windshields, and spark plugs. For example, DaimlerChrysler, BMW, Audi, Volvo, Mitsubishi, and Toyota report that even though a factory in Guangdong Province has been raided three times in a two-and-a-half-year period, it has been allowed to continue making windshields stamped with their brand names for sale in the world market. One industry group estimates that legitimate automotive companies could hire 210,000 more employees if the counterfeit auto parts trade is eradicated.[4]

According to the World Health Organization (WHO), 10 percent of the medicines in the world are counterfeit, with China being one of the main centers of counterfeit production. Rudolph Giuliani offered the following testimony before a Senate Committee in June of last year:

> "An August 30, 2002, Washington Post story cites the Shenzhen Evening News in reporting that an estimated 192,000 people died in China in 2001 because of counterfeit drugs. Another news story reported that as much as 50 percent of China's drug supply is counterfeit (Investor's Business Daily dated October 20, 2003)."[5]

[3] Ibid. Key Findings: BSA and IDC Global Software Piracy Study.
[4] Motor and Equipment Manufacturers Association, September 2003.
[5] *See* Statement of Rudolph W. Giuliani before the Senate Government Affairs Committee, Permanent Investigations Subcommittee, *Oversight Hearing on Safety of Internet Drugs* (July 16, 2003).

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While no definitive statistics exist on total U.S. job losses attributable to IP piracy and counterfeiting in China, there is no doubt piracy and counterfeiting deprive the government of billions of dollars of much needed tax revenue, cost thousands of jobs, and injure the domestic software industries.

China's Enforcement Issues

The Chinese IPR enforcement environment today is complicated by a variety of different Chinese and foreign interests, including Chinese industrial policies, trade policies, the interests of foreign investors, and the interests of Chinese domestic enterprises. In this environment, our right holders increasingly look to adequate enforcement of criminal IPR laws in implementation of China's WTO commitments as a key to reducing counterfeiting and piracy rates in China. China, it should be noted, does not lack for quantitative enforcement. Each year, tens of thousands of enforcement actions are undertaken. However, these actions are typically pursued by administrative agencies, which impose non-deterrent penalties.

This Administration has been pressing China to impose prison sentences and/or stiffer fines on violators of IPR since fines and other penalties imposed are too modest and provide little or no deterrence. In December 2004, two branches of China's government – the Supreme People's Court and Supreme People's Procuratorate (prosecutor) issued a new "Judicial Interpretation" for criminal IPR infringements. The new Interpretation expanded the scope of violations punishable by prison sentences by lowering the value threshold necessary to initiate a prosecution, but on the enforcement side took a significant step backwards with respect to violations committed by repeat offenders. The new Interpretation was also deficient in many other areas of concern to industry and foreign governments, including, for example, coordination among China's civil and administrative systems as well as the relationship with other IP laws. Furthermore, the new Interpretation complicated matters by allowing infringing goods to be valued based on their street value, not their legitimate value, thus sanctioning declarations by the infringer as a measure for determining whether or not Chinese valuation thresholds were met dictating prosecution. Equally disconcerting was that unfinished or offsite products were exempt in assessing that value.

Many of the challenges that China encounters are at least partially due to deficiencies in its own system, including extensive corruption, local protectionism, and lack of interagency coordination. Some of the issues we have raised with Chinese colleagues include: the use of mandatory sentencing guidelines for IPR crimes; support for specialized IPR courts which have greater independence from local financing and control; establishing appropriate procedures for investigation, prosecution, and conviction of IPR criminals; and effectively addressing trans-border IPR crime, as well IP crime committed over the Internet.

It is important to recognize that there is a Chinese domestic constituency also seeking enhanced IPR protection and enforcement, and that pirates and counterfeiters do not necessarily discriminate against Americans or just against Americans lacking political influence. As the economy grows, domestic interest in IP, particularly in the more developed cities on China's seaboard, is increasing dramatically. China's deficient IP protection and enforcement hinders Chinese software engineers, inventors, and movie producers who have to struggle with a severely deficient domestic market as their principal source of income. Chinese IP owners have become increasingly vocal proponents of stronger IP protection. One indication that IPR is attaining increased domestic importance is the number of trademark applications received by the Chinese Trademark Office (CTO). For the past two years, the CTO received more trademark applications than any country in the world. The State

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Intellectual Property Office is also growing rapidly and receives some of the highest number of filings for patent applications worldwide.

Growing domestic interest in IP protection and enforcement may be of small comfort to U.S. industry when the impact of piracy and counterfeiting on U.S. industry appears to be growing. U.S. Government statistics show a worsening situation. For example, USTR's 2004 Special 301 Report states that during 2003, 66 percent of all of the IPR-infringing goods seized at the U.S. border came from China.[6] Many industries also increasingly suspect that the Chinese government, by restricting market access, is providing free rein for counterfeiters, pirates, and criminals to exploit the void created by the lack of legitimate products. Many U.S. companies also complain of industrial policies that help create conditions for production of infringing products. Counterfeit Viagra, for example, dominates the Chinese market, while the legitimate product has been hampered by market access restrictions. Pirated movies appear in the Chinese market long before censors have approved the legitimate product. Other high-tech companies complain of standards setting, such as in wireless networking technology, which limits introduction of legitimate products or mandates technology transfer.

USPTO's Efforts in China

Under the direction of this Administration, the USPTO has been working extensively to reduce piracy and counterfeiting activity in China. First, we provide technical support to all agencies of the U.S. Government that are addressing these issues, including USTR, the Department of Commerce/International Trade Administration (ITA), the U.S. Department of Justice, the Department of Homeland Security, and the State Department.

The USPTO has an established team of experts on Chinese IP matters, which includes IP attorneys with detailed knowledge and background on patents, trademarks, copyrights, enforcement issues, and WTO/WIPO issues. Our cooperation with other U.S. government agencies extends beyond the trade agenda to providing support on strategies and to addressing transnational crime and transnational trade in counterfeit goods, as well as other issues.

TRIPS review. For example, we take an active role in the annual review of China's TRIPs commitments at the WTO, including primary responsibility for drafting many of the TRIPs-related questions. Three USPTO officials attended China's WTO review last year. We also actively participate in the APEC Intellectual Property Experts Group, which plays a constructive role in developing regional standards for IP, including cooperation on enforcement matters. Further IP initiatives in China supported by the USPTO are described below.

IP attorney at U.S. embassy. For two summers, with the active support of U.S. Ambassador Clark Randt, we stationed one of our IP enforcement attorneys, who is fluent in Mandarin, in our embassy in Beijing to help with IP enforcement issues in the region. Last fall, the USPTO was proud to continue this support by detailing this individual as attaché to the U.S. Embassy in Beijing for a three-year appointment to continue our Government's efforts to combat piracy and counterfeiting. This is the first time the USPTO has sent an official abroad for an extended period of time to assist in improving IP protection in a specific country, which highlights the seriousness of IP violations in China. Having an attaché stationed in China has enhanced the USPTO's ability to work with

[6] http://www.ustr.gov/Document_Library/Reports_Publications/2004/2004_Special_301/2004_Special_301_Report_Section_306.html.

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Chinese government officials to improve IP laws and enforcement procedures in addition to assisting U.S. businesses to better understand the challenges of protecting and enforcing their IPR in China.

Meetings with Enforcement Officials and Other Influences. One of the greatest challenges in China is ensuring that localities fully enforce national laws. To that end, the USPTO has held meetings with numerous local copyright, trademark, judicial, police, and prosecutorial enforcement officials throughout China to ensure that local officials fully understand their international obligations. We have hosted numerous delegations at the USPTO, with the objective of addressing this challenge. We have also worked with U.S. non-governmental organizations in support of rule of law efforts and training programs, including a Temple University program and Franklin Pierce Law School's annual summer program on intellectual property law in Beijing for American and Chinese law students.

Training. Recent efforts in China that we have supported include: training on criminal IPR with the support of the British Government and China's Ministry of Public Security; training on patent data protection and patent linkage with the State Intellectual Property Office and State Food and Drug Administration; training on "business methods patents" with the State Banking Regulatory Commission, State Council Legislative Affairs Office and the Development Bank of China; training with the World Customs Organization on border measures and criminal IPR; participation in Chinese sponsored programs on IP protection in Shanghai and on IPR strategies for multinational companies in Beijing; and a joint U.S. Semiconductor Industry Association and Chinese Semiconductor Industry Association training program on IPR in high tech industries, to name but a few.

Bilateral meetings with trade groups. We have also participated in a range of bilateral meetings and consultations with visiting U.S. trade associations such as the Intellectual Property Owners, U.S. Information Technology Office, Research and Development Pharmaceutical Association of China, Quality Brands Protection Committee, American Bar Association, International Federation of Phonographic Industries, Motion Pictures Association, Entertainment Software Association, Business Software Association, Association of American Publishers, U.S. Chamber of Commerce, to name just a few. We have also worked with some of these organizations to host enforcement conferences in such major cities as Beijing, Shanghai, Guangzhou, Wuhan, Nanjing, and Chengdu.

Both domestically and in Beijing, we have provided briefings for visiting congressional and judicial delegations, and we have provided training for State Department and Commerce Department officials at our various consulates, including participation at a regional training program in Hong Kong sponsored by the Economic Bureau of the State Department. Working with the Department of Commerce's Technology Administration and the International Intellectual Property Institute, we have provided technical assistance on copyright protection in Dalian and Shenzhen.

Public relations efforts. The USPTO continues to work through our own office of public affairs and the public diplomacy offices of the Embassy and consulates on providing an informed perspective on IP matters to the Chinese public and Chinese decision makers. Additionally, we are supporting State Department efforts to provide informational materials on U.S. IP practices to the Chinese public. We have also had several meetings at Chinese Universities. Under Secretary of Commerce for Intellectual Property and Director Jon W. Dudas delivered a talk at Qinghua University, one of China's leading law and engineering institutions, on IP protection. In addition, my staff has delivered presentations at Sichuan Normal University Law Faculty, Qinghua Law Faculty, People's

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University and other institutions, as well as appearing on several television shows and being featured in newspaper articles.

Supporting Businesses and Working with Law Enforcement in China

Apart from these advocacy and training efforts, we are involved in developing practical strategies to support our businesses in handling problems in China. We have worked extensively with the Commerce Department on improving methods for handling business complaints involving unfair IP practices in China and have become involved with the STOP Initiative whereby we handle complaints involving IP, many of which involve China. We have worked on two leading programs associated with the U.S. Embassy involving IP: a "toolkit" on IP matters for U.S. businesses on the Embassy's website, and the "IPR Roundtable" that the Ambassador hosts each year.

Meetings in China. We have held meetings at the Canton Trade Fair to discuss IPR enforcement and complaints filed. We continue working with ITA, the American Bar Association, and many other organizations to provide better assistance to U.S. small and medium businesses. USPTO attorneys have been meeting with other foreign missions and trade associations to exchange ideas on innovative ways to promote better protection of IPR in China.

Training programs for American businesses. We have participated in training programs for our business people in the United States, to better enable them to forcefully address the IPR challenges they experience in China and, when necessary, bring well-founded complaints to our attention. Typically in conjunction with the Department of Commerce, members of our China team have participated in programs in such cities as: Cincinnati, Ohio; Grand Rapids and Pontiac, Michigan; Charlotte, North Carolina; Miami, Florida; Minneapolis, Minnesota; Wichita, Kansas; St. Louis, Missouri; New York City and Long Island, New York; Waterbury, Connecticut; Boston, Massachusetts; Providence, Rhode Island; Portsmouth, New Hampshire; Fresno, San Jose and San Francisco, California; Salt Lake City, Utah; and Washington, D.C. A major focus of these efforts has been to address problems of small and medium enterprises, although larger enterprises have also benefited from participation in many of these programs as well.

Workshops about China. In addition to our work with the Department of Commerce, our China team is planning to roll out a series of intensive China workshops and seminars in several cities throughout the United States in 2005-2006. The first of these seminars is planned for Detroit, Michigan, in June. The program will provide companies with information about several useful topics, ranging from an overview of the IP protection and enforcement environment in China, specific information on how to file patent and trademark applications in China, how to use China's administrative and judicial systems to enforce IPR, and useful tips about how to locate and hire a local company to investigate IP infringement in China.

Another activity, as part of our ongoing efforts to assist U.S. businesses and IP owners in protecting their rights overseas, includes a seminar on the Chinese criminal justice system for IP offenses that we held in February of this year. The seminar introduced the Chinese criminal justice system to U.S. industry, government agencies, IP owners, and legal practitioners and included information on the recently amended Judicial Interpretation so they may better understand the system and use this information to their full advantage to combat counterfeiting and piracy. We sponsored a follow up program in April of this year.

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Our China team has supported a number of programs to advise our companies on how to file a criminal IPR case in China. These programs have already been held in Guangzhou, Beijing, and Hong Kong with an additional program planned for Shanghai. In addition, we provide support to our own law enforcement authorities where possible on IP criminal matters. For example, we have supported the Joint Liaison Group on criminal justice cooperation in its efforts to facilitate better criminal IPR cooperation, and joined in training programs run by a number of different government agencies on criminal IPR matters. Our China team works closely with the Customs Attaché and Legal Attaché at the U.S. embassy as well as the Bureau of International Narcotics and Law Enforcement at the State Department on these matters.

More United States Government Efforts in China. Like Secretary Gutierrez, former Secretary of Commerce Evans believed in the strong enforcement of our trade laws and took innovative and proactive measures to strengthen the enforcement and compliance of our trade agreements. During his tenure, he tasked Commerce agencies, such as USPTO and the new Investigations and Compliance Unit within ITA's Market Access and Compliance Group, to coordinate their efforts to vigorously pursue allegations of IPR violations wherever they occur, especially in China.

Delegations to China. In 2003, then-Commerce Secretary Evans led a mission to China and highlighted China's lack of IPR enforcement. The Secretary met with high-ranking Chinese officials and reiterated a continuing concern -- that effective IPR protection requires that criminal penalties for IP theft and fines are large enough to be a deterrent, rather than a business expense.

As a follow-up to the October 2003 trip, Under Secretary and Director Jon W. Dudas led two delegations in 2004 for consultations with senior officials at China's patent, trademark, copyright, and other IP agencies. Our delegation also met with U.S. companies facing IP issues in China. The primary focus of these trips was to further the Administration's goals of improving the IP environment for U.S. companies doing business in China, and specifically of addressing widespread counterfeiting and piracy. We discussed several issues, including the need for improved criminal, civil, and administrative enforcement, the need for protecting copyrights over the Internet and China's accession to the WIPO Internet Treaties.

In January 2005, Under Secretary Dudas traveled to Beijing as part of a second Evans-led delegation. He was fortunate to be able to meet with Chinese Premier Wen Jiabao and Vice Premier Wu Yi to discuss concerns over China's enforcement of IPR of American businesses. Ambassador Randt also hosted the third roundtable on Intellectual Property Rights, which was attended more than 250 government officials and business and industry representatives from the USPTO, the European Union, Japan, and China's IP agencies. In addition to providing the luncheon keynote address during the January roundtable, Under Secretary Dudas announced the USPTO's new plans for IP technical assistance for Chinese IP-related agencies. He was pleased that the USPTO's offers of cooperative assistance were well received, and we are in the process of implementing these as well.

U.S.-China Joint Commission on Commerce and Trade (JCCT) Working Group on IPR

In an effort to address problems in China, the U.S. and China created a "working group on IPR" that resulted from the April 2004 session of U.S.-China Joint Commission on Commerce and Trade. We are pleased that Under Secretary Dudas co-chairs this working group with Deputy U.S. Trade Representative Josette Shiner.

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Through the JCCT and other avenues, the U.S. hopes to continue to work with closely with China to improve the situation for U.S. rights holders. During the April 2004 session of the JCCT, China presented an action plan designed to address the piracy and counterfeiting problems faced by U.S. companies. Under the plan, China committed to: (1) significantly reduce IPR infringement levels; (2) issue a judicial interpretation for criminal enforcement of IPR cases by end of year; (3) conduct nation-wide enforcement campaigns; (4) ratify and implement the WIPO Internet Treaties as soon as possible, and (5) agree to establish an IPR working group under the JCCT. In line with the JCCT mandate, the working group will seek to ensure that China significantly reduces IPR infringement to levels consistent with standards required by WTO rules.

Challenges and Recommendations concerning China

While our trips to China have been well received, and we are pleased to note a continuing and increasing awareness among Chinese officials of the importance of IP protection and enforcement, we have not yet seen significant progress on most of the key issues. These issues include enhanced criminal enforcement, a deterrent administrative enforcement system, protecting copyrights over the Internet, and stopping the export of counterfeit goods. We are also interested in other developments, such as China's efforts to develop an IPR Strategic Plan for development of its IP assets, other industrial policy goals, legislative efforts to draft a Civil Code that may include IPR, and general rule of law efforts that could significantly affect the protection of IPR over the long run.

While we fully recognize that China needs to make drastic improvements in its IPR system to ensure that our right holders are fairly protected, we should not underestimate the steps that our businesses and government can take to reduce the risks of piracy and counterfeiting. The USPTO will continue working with small and medium-sized companies on how best to protect their valuable IP rights in China. One particular example is for companies to register all their trademarks promptly in China, especially their Chinese language trademarks. Given the fast pace of China's economic development and the huge volume of trademark applications in China, companies should file for their marks early in their marketing cycle.

Globalization means that competitors can retrieve information about products not yet introduced in their country from a U.S. company's web site. Counterfeiting and piracy also originates from employees, agents, or distributors who have taken confidential information to engage in a competing operation. China's practice regarding protection of trade secrets by former employees who have signed non-compete agreements is different from the United States. We will continue to educate companies on how best to protect their intellectual property rights.

It is especially important we encourage our industries to work with us and the other U.S. agencies involved in improving China's IP protection and enforcement environment by: urging the fair and transparent implementation of China's IPR system; fully exploiting this system; providing us with detailed information on its deficiencies in order to reduce future risks of such activities; and supporting our bilateral and multilateral efforts to reduce the impact of these problems.

Russia

As indicated by the listing of Russia as a priority watch list country in the 2005 Special 301 Report, copyright piracy in Russia is of serious concern. In 2004, industry estimates that more than $1.7

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billion in losses occurred in Russia.[7] Due to poor enforcement, industry calculates more than $7 billion in losses to the copyright industries in the last eight years. Estimated copyright piracy levels in the Russian Federation in 2004 were estimated by industry at 80 percent for motion pictures, 66 percent for records and music, 87 percent for business software, and 73 percent for entertainment software. The production of optical media in Russia far exceeds legitimate demand. According to industry, in the last three years, the number of optical disc plants that manufacture and distribute optical media has more than doubled. In the past four years, production capacity of optical media in Russia has nearly tripled.

Issues in Russia

While the Russian government has made significant progress in improving the legal framework for IP protection, current laws and regulations in the Russian Federation have not had a significant impact on controlling illegal optical disc production. Although raids and seizures at optical disc plants increased last year, in most cases, according to industry, plants continue to operate after the raids and little meaningful action is taken against the plant operators. These raids did not have an appreciable effect on reducing optical disc piracy, especially in cases where effective prosecution by the Procuracy were lacking. Industry reports that piratical product seized from raids sometimes returns to the market. The lack of effective criminal enforcement of IP theft in the Russian Federation is a concern. The involvement of organized crime in the manufacture, distribution and exportation of piratical entertainment software is also of concern.

The banning of street sales, including kiosks of audio and audiovisual products, was encouraging, initially; but industry reports that the prohibition is not regularly enforced and that pirated music compact discs continue to be available on the streets. In 2004, the industry reported that 1,300 administrative raids against music pirates were undertaken, resulting in numerous administrative actions. The average administrative penalty in these cases was approximately $50. This level of fines cannot be considered a deterrent to piratical activity. The majority of administrative actions involving storeowners and sellers averaged $200. Unfortunately, industry reports that the supply and distribution sources are rarely pursued. Effective enforcement of IPR at the borders of the Russian Federation is in need of improvement as well. Industry indicates that piratical optical media was forensically identified as being exported from Russia to over 25 countries.

Russian steps to reform and deficiencies

Last year, Russia took some steps in reforming its laws for compliance with the 1992 U.S.-Russian bilateral trade agreement. For example, Russia did amend its laws on trademarks, appellations of origin, patents, designs for integrated circuits, plant varieties, computer software, and databases.

Serious concerns remain about Russia's denial of national treatment for protection of geographical indications (GIs). Further, significant shortcomings remain with Russia's trademark laws, especially provisions dealing with geographical indications. There do not seem to be any provisions in the Russian law that ensures that the principles of priority and exclusivity are preserved for trademarks and geographical indications. These rights are required under the TRIPs Agreement, which requires that owners of trademarks established prior to a later in time GI should be able to assert the exclusivity of their prior rights.

[7] http://www.iipa.com/rbc/2005/2005SPEC301RUSSIA.pdf

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IPR Initiatives concerning Russia

USPTO continues to provide capacity building assistance to the Russian Federation focusing on the enforcement of IPR. In December 2001, we hosted the United States-Russia Intellectual Property Rights Enforcement program in Washington in cooperation with the Commercial Law Development Program. The conference was attended by Russian officials representing various government agencies involved in the enforcement of intellectual property rights in Russia. The conference included a discussion of judicial administration issues involving IPR, discovery, interim measures and damages in civil infringement cases, arbitration, deterrent criminal penalties and border measures.

In November 2002, we cosponsored and participated in a United Nations Economic Commission for Europe seminar in Moscow on IPR enforcement in Russia. The seminar was attended by Russian government officials representing the State Duma and the Ministries of Defense, Culture, Education, and Science. This summer, USPTO will be co-sponsoring a three-day workshop in St. Petersburg on border enforcement of IPR in coordination with the International Intellectual Property Institute, U.S. Customs and Border Protection and Russian Customs.

In addition, the U.S. Embassy in Moscow has had ongoing collaboration with relevant Russian entities to provide training to the Russian law enforcement agencies and the Procuracy on IPR enforcement. The Embassy sponsored a series of seminars last year, both in Moscow and in the regions, and plans to offer more training this year.

With U.S. copyright industries losing more than $1 billion a year to copyright piracy in Russia, we look forward to increased effective enforcement efforts in Russia. We continue to urge the closure of plants producing illegal optical discs, increased raids and prosecution of optical disc piracy, and the adoption and implementation of an effective optical media regulation and enforcement regime. Moreover, any organized crime involvement in counterfeit goods and piratical works must be addressed through increased investigative efforts and stronger criminal penalties. The Russian government must also strengthen its border enforcement, combat counterfeiting and piracy, and address deficiencies in its intellectual protection laws. We have enjoyed a cooperative working relationship with the Russian Federal Service on Intellectual Property, Patents, and Trademarks headed by Boris Simonov, and we continue a productive dialogue with him and the Russian law enforcement agencies on ways to improve Russia's IP record. However, for our efforts to be truly effective in reducing IP violations in Russia, we need genuine commitment from all levels of the Russian government to view this as a priority problem and take meaningful steps to combat it.

The Global STOP Initiative

We are pleased to discuss with you the STOP Initiative, the most comprehensive intergovernmental agency initiative ever advanced to smash the criminal networks that traffic in fakes, stop trade in pirated and counterfeit goods at America's borders, block bogus goods around the world, and help small businesses secure and enforce their rights in overseas markets. There are several important features of the STOP Initiative that I'll mention:

Hotline and Website

First, the USPTO participates heavily in this initiative by managing a hotline, 1-866-999-HALT, established by the Department of Commerce to help business protect their IPR at home and

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overseas. The goal of the hotline is to empower U.S. business to secure and enforce their IPR by providing them the information they need to secure their patents, copyright and trademarks, and to enforce these rights here in the U.S. and abroad.

Callers receive information from IP attorneys with regional expertise on how to secure patents, trademarks, and copyrights, and on the enforcement of these rights. Businesses and innovators now have access to a place to learn more about the risks of global piracy and counterfeiting and how to protect their IP rights in both individual countries and in multiple countries through international treaties. In addition, we have established a link from our USPTO website to www.stopfakes.gov on the Department of Commerce's website, which provides in depth detail of the STOP Initiative.

No Trade in Fakes Program

The Department of Commerce is in charge of another important component of the STOP Initiative, the no-trade-in-fakes program that is being developed in cooperation with the private sector. This is a voluntary, industry-driven set of guidelines and a corporate compliance program that participating companies will use to ensure their supply chains and retail networks are free of counterfeit or pirated goods.

Increasing and Communicating Enforcement

The STOP Initiative will raise the stakes for international IP thieves by more aggressively pursuing perpetrators of IP crimes and dismantling criminal enterprises. STOP also seeks to increase global awareness of the risks and consequences of IP crimes through public awareness campaigns, and creating and operating a website publicizing information about international criminal IP enforcement actions.

Building Coalitions

The ultimate success of the STOP Initiative involves building coalitions with many of our like-minded trading partners, such as Japan, the United Kingdom, and France, who have all recently launched similar initiatives. We are seeking to continue working with our partners in the G-8, Organization for Economic Cooperation and Development (OECD) and the Asia-Pacific Economic Cooperation (APEC) forum. Cooperation on new initiatives to improve the global intellectual property environment is essential to disrupting the operations of pirates and counterfeiters.

International Outreach

A delegation of U.S. officials from seven federal agencies, including myself, recently kicked-off our international outreach effort to promote STOP internationally. Last month we visited various capitals in Asia generating much interest and fruitful discussions. On each leg of the trip, U.S. officials shared information on our efforts to combat the theft of inventions, brands and ideas. This first leg abroad is advancing our commitment by enlisting our trading partners in an aggressive, unified fight against intellectual property theft. Outreach to Asia will be followed by visits to other capitals later in the year, for example, next month we plan on visiting Europe. We have tentatively planned that countries receptive to cooperation on STOP will be invited to attend a meeting in Washington, D.C. (likely in the fall of 2005) designed to formalize their participation and finalize a work plan.

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Future STOP Activities

The USPTO has several future planned activities supporting our initiatives under STOP. The first involves our public outreach efforts. In addition to our China-related workshops and seminars for 2005-2006, my staff will also be embarking on an educational road show to various cities in the United States to educate small- and medium-sized business on what IPR are, why they are important, and how to protect and enforce these rights domestically and internationally. The first of these workshops took place earlier this week in Salt Lake City, Utah, and already, we have found an enormous amount of interest in the program. We will replicate this program in other cities throughout several regions of the U.S. in the coming months.

We continue to work in WIPO to seek to simplify, streamline, and improve the cost efficiency of the trademark application process across borders to provide more efficient and less burdensome systems for right holders.

We will continue to work closely with the IP community, STOP team, and you to promote a legislative agenda that is designed to meet the huge challenge of combating piracy and counterfeiting. Tougher enforcement of our international trade laws is necessary for the growth of our economy and the creation of new jobs. In order to fully implement the STOP Initiative, it may be necessary to reassess current legislation.

Conclusion

Mr. Chairman, the requirements on the Department of Commerce and USPTO's expertise in the international arena have grown dramatically in the last few years. These demands will continue to increase in the next few years, along with our obligations to meet our core patent and trademark examination functions.

As we look to the future, however, let me conclude on a positive note. Although by all accounts counterfeiting and piracy appear to be growth "industries," there have been some recent successes in attacking the problem. Between 2001 and 2002, the software industry estimates that software piracy in Indonesia decreased from 89 percent to 68 percent. In South Africa, it fell from 63 percent to 36 percent. The motion picture industry has reported a decrease in piracy levels in Qatar from 30 percent in 2001 to 15 percent in 2002. In Bahrain, there have been dramatic and systemic improvements in IP protection and enforcement over the past few years. These include the signing of numerous international IP conventions and the virtual elimination of copyright piracy and counterfeiting in retail establishments.

There is some reason for optimism. I remain hopeful that with the continued support and partnership of the Subcommittee, we will be able to do even more to provide American businesses and entrepreneurs with the IP knowledge and protection they need. Clearly, in terms of the economy and national security, much is at stake. That is why our dedicated team of experts will continue to work tirelessly to protect American products all around the globe.

Thank you very much.

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Written Statement

of

Eric H. Smith
President, International Intellectual Property Alliance (IIPA)

before the

Subcommittee on Intellectual Property
Senate Judiciary Committee
on

"Piracy of Intellectual Property"

May 25, 2005

Chairman Hatch, Senator Leahy and other distinguished Committee members, IIPA and its members thank you for the opportunity to appear today to speak to the damage that global piracy does to the U.S. economy, U.S. jobs, and to the U.S. copyright industries. This oversight hearing is extremely timely since at this very moment, a delegation from China, called the IPR Working Group, headed by Madame Ma of MOFCOM, is meeting with the U.S. government as part of the Joint Commission on Commerce and Trade (JCCT) process. In addition, USTR has just announced its decisions in the Special 301 process which is, as you know, the Congressionally-created mechanism by which our government seeks to improve IPR protection and enforcement globally and to nurture those creative and innovative industries and individuals who contribute so greatly to our nation's economic growth. We think it is particularly important that Russia, China and other key trading partners are made aware of the keen interest of the U.S. Senate in these issues, and particularly, to illuminate the ongoing talks with China – and with Russia in the WTO accession process.

IIPA represents the U.S. copyright industries. Its six member trade associations consist of over 1,300 U.S. companies, accounting for millions of U.S. jobs. The copyright industries, in 2002, contributed over $625 billion to the GDP, or 6% of the U.S. economy and almost 5.5 million jobs or 4% of U.S. employment. These companies and the individual creators that work with them are critically dependent on having strong copyright laws in place around the world and having those laws effectively enforced. On average, the copyright industries generate over 50% of their revenue from outside the U.S., contributing over $89 billion in exports and foreign sales to the U.S. economy. Given the overwhelming global demand for the products of America's

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creative industries, all these numbers would be significantly higher if our trading partners, particularly those, like China and Russia, that continue to allow piracy to flourish in their own economies, were to significantly reduce piracy rates by actually enforcing their copyright laws vigorously.

IIPA's Special 301 Report on Global Piracy

I have appended to my written testimony a copy the transmittal letter covering IIPA's comprehensive February 2005 Special 301 submission on piracy in 67 of our key trading partners. This 600-plus page report, which IIPA submits annually to USTR, details specific statutory and enforcement deficiencies in these countries and highlights their impact on the overall U.S. economy and on the U.S. creative industries. The entire report can be found on the IIPA website at www.iipa.com. In the attached transmittal letter, IIPA summarizes the key global priorities of our industries and summarizes the conclusions of the overall report. It highlights that our industries conservatively lost an estimated $12 billion in these countries/territories in 2004 (data for all countries was not available) and IIPA estimates that its global losses in all countries were an estimated $25-30 billion.

Rampant piracy in most of the countries highlighted in this report constitute the copyright industries' greatest barrier to trade, costing U.S. jobs and contributions to the U.S. economy. This Subcommittee is aware that part of this damage is due to inadequate laws on the books in some countries, including with respect to effective legal protection for copyrighted material transmitted over the Internet. Today, however, unlike in the 1980's and 1990's, the problem has less to do with inadequate laws and more with ineffective and non-deterrent enforcement systems. This is particularly true in two countries that IIPA highlights in its report and which we wish to highlight in this statement, namely Russia and China. Before doing so, however, let me set out the six areas that reflect the copyright industries' initiatives/priorities and global challenges (further detailed in the transmittal letter to our Special 301 report).

- A major priority/challenge is in the area of Internet piracy, as it impacts the future of electronic commerce. Internet piracy is growing at alarming rates as more and more of the world's population gets connected to the Internet. The first order of business to combat this problem is to establish an effective legal infrastructure which includes ratification and full implementation of the WIPO "Internet" treaties (the WIPO Copyright Treaty and the WIPO Performances and Phonograms Treaty). While the treaties are now fully in force, much work needs to be done to secure further ratifications by our trading partners and full implementation of the treaties' obligations. The healthy growth of e-commerce – critically dependent on securing a safe environment for the global transmission of valuable data, much of it protected by copyright laws – hangs in the balance.

- Optical disk piracy and the effective regulation of optical disk production in countries that have been unable to effectively deal with this problem is another key challenge and priority. Global production capacity far outstrips global demand; using that excess capacity for pirate production has flooded the world's market with pirate optical disks containing all types of copyright material. Securing effective regulation of plants in

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problem countries and enforcement is an ongoing initiative and challenge for the U.S. government and the copyright industries.

- Piracy by organized crime syndicates is rife particularly throughout Asia and Central Asia and Eastern Europe. Because piracy is so lucrative and in many of these countries enforcement is weak or governments are not strong enough to combat these syndicates effectively, they have taken over the business of piracy, as but another part of their illegal activities including the financing of terrorism. Our report details many examples of how organized crime syndicates go about the business of piracy. Only government intervention and government cooperation internationally can stem this growing problem – the private sector is unable to do so on its own. The U.S. government must be at the center of this effort.

- The unauthorized use of business and productivity software by governments, state-owned enterprises and private sector companies causes the largest losses globally to one of the most productive and fastest-growing sectors of our economy. IIPA member, the Business Software Alliance, just recently announced that the global personal computer packaged software industry (beyond just U.S. software publishers) lost more than $32 billion in 2004 (counting both business and consumer software).

- Piracy of books and journals, in English and in translation, by traditional printing means and by commercial photocopying of entire editions, remains a major problem for the U.S. publishing industry. Increasingly sophisticated technologies allow for pirate hard copies of books that are becoming more and more competitive with authorized editions. In addition, publishers are suffering from significant online piracy, mostly in the form of peer to peer trading or commercial sale of scanned versions of bestsellers and academic texts. This type of piracy also affects professional and scholarly journals already put into electronic form by the legitimate publisher, as sites containing these products are compromised by unauthorized users. Piracy of both hard copies and electronic files deprives the publishing industry and our economy of both revenue and jobs.

- Finally, a cross-cutting priority/challenge, affecting all our industries, is bringing all countries into compliance with their enforcement obligations in the WTO TRIPS Agreement and by using the U.S.'s Free Trade Agreement process to raise the level of statutory protection to encompass new technological challenges, like the Internet, and to obligate governments, in return for more open access to the U.S. market, to "open" their markets by significantly improving the enforcement of their copyright and related laws to significantly reduce the high rates of piracy. Piracy severely inhibits the growth of the copyright industries in these countries, including our own companies.

I would now like to turn the subcommittee's attention to two countries where our piracy problems are truly severe and growing. These countries provide vivid illustrations of all the challenges referred to above. They are Russia and China. I will speak first about Russia because Congress has a direct role to play in determining whether Russia should be a WTO member and receive PNTR status when it has failed to meet even its minimal enforcement obligations under the WTO TRIPS Agreement.

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Russia: The New China

Russia's copyright piracy problem has become enormous. IIPA has worked on U.S. – Russian copyright matters for over 16 years trying to improve the legal regime in Russia – including adoption of better copyright and related enforcement laws, as well as working to improve on-the-ground enforcement. The present piracy problem in Russia is the worst it has been in our 16 years experience. Piracy of all copyright materials – motion pictures, records and music, business and entertainment software, and books – is at levels ranging from a low of about 66% to a high of 87% – totally unacceptable for a country and economy the size and sophistication of Russia.

Let me begin by describing the scope and nature of the problem in Russia from our vantage point.

Scope and Nature of the Piracy Problem in Russia

Russia has one of the worst piracy problems of any country in the world, second only to China. The IIPA estimates that the copyright industry lost over $1.7 billion due to piracy last year, and over $6 billion in the last five years in Russia. As noted, the piracy rates hover around 70% of the market or higher for every copyright sector. In short, Russia's criminal enforcement system has failed to stem persistent commercial piracy.

The number of optical disk (i.e., CD and/or DVD) plants in Russia has more than doubled in just the last three years to number at present, at least 34 plants, including eight dedicated DVD plants. There are a total of 80 known operational production lines. Production capacity has nearly tripled as criminal operations have encountered little hindrance in expanding their activities. Even more troubling, IIPA is aware of nine production plants located on the facilities of the Russian government, so-called restricted access regime enterprises (although the Russian government has publicly acknowledged that there may be as many as 18 such plants). Russia's annual manufacturing capacity now stands conservatively at over 370 million CDs and additionally over 30 million DVDs, despite the fact that the demand for legitimate disks is unlikely to exceed 80 million in all formats.

Forensic evidence indicates that at least 24 of the 34 plants are known to be producing pirate product. Of course, without proper surprise inspection procedures in place, there is no way of knowing for certain the size and scope of what all the plants are producing. Russian-produced optical disks (CDs) have been positively identified in at least 27 countries. So, the harm illegal Russian plants are doing far exceeds the Russian marketplace.

In 2004, there were eight actions taken by the Russian government against the optical disk ("OD") CD/DVD plants, including raids and seizures of illegal materials according to our industry, and Russian government, reports. The raids would appear to be a positive step, but the outcome of the raids is telling:

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First, 70% or more of the seized material ends up back in the marketplace either through lax enforcement (or corruption), laws permitting charitable sales of such property, or the conclusion without prosecution of criminal investigations. As an example, over one million of the2.5 million illegal CD and DVD copies seized in a raid last year "disappeared" before the case went to trial.

Second, all of the optical disk plants that were raided in 2004 remained in operation after those raids. In some cases, truckloads of illegal material were seized from the same plants by Russian government enforcement officials – and still these same plants remain in operation.

Third, the plant owners remain unscathed by the criminal justice system. A few people employed by the plants were convicted – after extensive delays in criminal investigations – but all received suspended sentences. So, there is no deterrence to continuing to conduct commercial piracy in Russia at present.

In fact, the recording industry reports that in the past two years, of the 24 cases they are cooperating on, 21 of those 24 cases remain without a resolution – that is, no prosecutions of the operators of illegal CD plants, as investigations have dragged on. In the other three cases, the pirate CDs were destroyed, but no deterrent sentences were handed down. The only exception to this pattern (which has been true for years) was in June 2002 when the Disk Press MSK plant (raided in September 1999) was finally closed and a Zelenograd court handed down 4-year prison sentences to two operators of the plant. In February 2004, there was a one-year conditional sentence given to a manager of the Zelenograd plant which was raided in December 2002, resulting in the seizure of 234,493 pirate CDs (over 59,000 were music CDs). The more typical case is that of the Synograph plant, raided in October 2000. There was a four year criminal investigation aimed at the director of the plant; a court hearing is scheduled for 2005, and the plant is still in operation.

The optical disk problem that IIPA confronts in Russia is one that has been regulated in virtually all other countries where we have found these levels of massive production of pirate product – countries like Taiwan, China, Hong Kong, Macau, Bulgaria and Malaysia. Russia's regulation of the plants is virtually non-existent, and based on a weak 2002 licensing law. Quite simply, Russia is the largest un-regulated and un-enforced producer of pirate optical disk product in the world.

To solve this problem, Russia must undertake vigorous criminal enforcement backed by the highest political officials in the government, since much of the piracy is undertaken by organized criminal syndicates. For example, according to the ESA, Russian crime syndicate pirates of videogame material are so well-entrenched that they "label" their product. The MPA reports that producers of motion picture DVDs produce export-only copies of DVDs because they are in seven or eight foreign languages, not including Russian.

Most of our description of piracy in Russia has been limited to problems pertaining to hard-copy piracy, but there are growing problems related to digital piracy as well. In fact, the world's largest server-based pirate music website – allofmp3.com – remains in operation after a criminal prosecutor in early 2005 reviewed the case and determined (wrongly) that current

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Russian copyright law could not prosecute or prevent this type of activity. This decision not to prosecute has been upheld on appeal. In fact, this interpretation of the Russian law is contrary to all the assurances the Russian government gave the U.S. government and private sector during the years-long adoption of amendments to the 1993 Copyright Law; those amendments were finally adopted in July 2004.

The business software industry, represented by IIPA member, BSA is confronting its own unique digital piracy problem relating to copyright enforcement. In short, the Russian government has failed to take effective action against the broad distribution of counterfeit software over the Internet, primarily through unsolicited e-mails (spam) originating from groups operating in Russia. Separately, BSA has had success with Russian law enforcement agencies taking action against channel piracy (i.e., illegal software preloaded on computers sold in the marketplace), not only in the Moscow area, but also in other Russian regions, and has made some progress in software legalization in the public sector.

The book publishing industry, represented by IIPA member, AAP reports widespread piracy of an array of reference works and textbooks, increasingly a large market in Russia as the penetration of English-language materials in the market grows. Lax enforcement, including poor border enforcement – endemic to all copyright sectors – results in the import (and export) of illegal materials. In the book industry this includes unlicensed imports of pirated reprints from neighboring countries, and pirated reference books and medical texts; there is also widespread illegal commercial photocopying, especially in the academic sector.

We have indicated the devastating consequences to the U.S. copyright owners and authors. The harm to the Russian economy is enormous as well. The motion picture industry alone estimates lost tax revenues on DVDs and videos in Russia was $130 million last year. In another study undertaken by the software industry, it was estimated that if levels of piracy could be reduced to regional norms (that is, realistic levels); ten of thousands of jobs and several hundred million dollars in tax revenues would be realized from that sector alone in Russia.

The Russian Government's Legacy of Failed Commitments

The performance of the Russian government over the past decade can be summed up as representing a legacy of failed commitments on obligations to the United States and the broader international community. A short list of these failed commitments is as follows:

Optical Disk Enforcement Commitments: The most egregious problem is that illegal production has devastated the domestic Russian market, and exports of Russian-produced pirated optical media (CDs, DVDs, etc.) are causing serious damage to legitimate market worldwide, as witnessed by the huge amount of pirated material originating in Russia that is found abroad.

In 1996, IIPA first identified optical disk plant production as a problem and suggested the need for an enforcement "action plan" to address this problem, including legislative reforms. Two optical disk ("OD") plants were identified in IIPA's February 1996 Special 301 Report. As noted, there are now 34 CD plants, with a total capacity of 370 million disks per year.

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At all levels of the Russian government there have been promises to address this problem (starting in 1999) including a pledge, never met, in 2002 to issue an "action plan"— but to date, there has been virtually no action taken against the plants, no comprehensive plan of action issued by the Russian government, and no legislative reforms on this point have even been introduced. Now ten years after IIPA (and the U.S. government) raised the issue, there is no excuse for why the Russian government has been unable to properly license and inspect all the known (now 34) plants, and to close and repeal the licenses of those engaged in illegal production and distribution, as well as to criminally prosecute the plant owners and operators.

As one example of the failure to regulate the plants: late in 2004, in bilateral talks with the U.S. government and IIPA, the Russian government promised it would "meet with the 18 plants" (their figure) on restricted access (i.e., military) property to ascertain the legal or illegal status of their production, and to report back to the U.S. government. The meeting, scheduled for December, was cancelled and has not been rescheduled. The reason: the Russian government confessed it was unable to determine all the owners of the plants from its records (because of its inadequate licensing law) and therefore could not identify with whom the government needed to meet.

Promised Legal Reforms: The Russian government has for 13 years, obligated itself in bilateral and multilateral negotiations to adopt necessary legal reforms. A short list of the failed commitments relating to legal reforms includes:

In 1995, the Russian government agreed to provide *ex parte* search provisions – critical enforcement tools, especially in the software industry. These were adopted in part in the Arbitration Procedures Code in 2002, however the proper provisions were never implemented and are absent from the Civil Procedure Code (enacted in 2003).

In 1995, the Russian government agreed to provide the police and prosecutors with proper authority to confiscate illegal material and *ex officio* authority to commence criminal investigations. The 1996 Criminal Procedure Code reversed that authority, and required right holders to formally press charges to commence investigations in some instances, thus thwarting effective enforcement.

In 1995, Russia acceded to the Berne Convention but failed to comply with Article 18 to provide protection for pre-existing works. That same year, Russia acceded to the Geneva Phonograms Convention but provided no protection for pre-existing foreign sound recordings prior to the accession date of March 13, 1995. These were commitments Russia made to the U.S. government in the 1992 Bilateral NTR Trade Agreement – Russia agreed to have these commitments in place by the end of 1992. Finally, in July 2004, Russia adopted provisions to its law to provide protection for foreign pre-existing works and sound recordings – however, the 12 year delay in adopting these provisions has resulted in flooding the marketplace with illegal product that will take years to enforce, even if Russian enforcement were effective (which it is not).

In the 1992 Bilateral NTR Trade Agreement, the Russian government committed to provide effective criminal penalties and enforcement. In 1996, Criminal Code amendments were

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adopted (after a 1995 veto) but a deficient provision (a "grave harm" threshold) prevented effective enforcement. In 2003 an amendment to "fix" the grave harm provision was finally adopted, but implementation of these criminal provisions remains a matter of concern, and there is no initiative to use these tools, if they even work properly, as part of effective enforcement.

In short, the Russian government has made promise after promise to the U.S. (and other foreign) governments to develop an effective legal regime, including strong copyright and enforcement laws, and strong on-the-ground enforcement. It has failed to meet its commitments while it has enjoyed trade benefits and preferences with the U.S. that are the *quid pro quo* for these benefits and preferences.

Steps the Russian Government Can Take to Properly Enforce IPR Crimes – Focusing on Optical Disk Piracy

There are six critical steps that the Russian government could take immediately to effectively confront its optical disk piracy problem:

- Inspect, on a regular, unannounced and continuous basis, each of the 34 known OD plants, and immediate close and seize the machinery of any found to be used to produce pirate product (some of these steps require additional legislative or regulatory measures);

- Announce, from the office of the President, that fighting copyright piracy is a priority for the country and law enforcement authorities, and instruct the Inter-Ministerial Commission, headed by the Prime Minister, to deliver reports every three months to the President on what steps have been taken to address the problem;

- Adopt in the Supreme Court a decree setting forth sentencing guidelines for judges—advising the courts to impose deterrent penal sanctions as provided under the penal code as amended (Article 146);

- Immediately take down websites offering infringing copyright materials, such as allofmp3.com, and criminally prosecute those responsible;

- Initiate investigations into and criminal prosecutions of organized criminal syndicates that control piracy operations in Russia (including operations that export pirate material to markets outside Russia); and

- Introduce either via executive order or legislation, the necessary modifications of the optical disk licensing regime so that it clearly provides more effective control over the operations of the plants, including the granting of licenses to legal plants and withdrawing and sanctioning of illegal plants; stricter controls on the importation of polycarbonate and machinery; mandatory seizure and destruction of machinery used to produce pirate materials; and the introduction of criminal penalties for the owners of such plants.

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There are, obviously, may other steps the Russian government could take to combat commercial piracy in Russia, including, but not only related to, optical disk piracy. These steps, including other enforcement and legal reforms necessary in Russia, are detailed in our Special 301 Report of February 2005 (see www.iipa.com/rbc/2005/2005SPE301RUSSIA.pdf)

We also want to address one issue that has been raised by certain senior members of the Russian Government in our meetings, which raises serious questions about its commitment to fighting piracy. We have seen a number of reports in which Russian officials have suggested that the prices for legitimate goods and the lack of local manufacturing of legitimate products are to blame for the piracy problem. This comment reflects both an ignorance of what is happening in the marketplace, and a misunderstanding of the nature of the problem that we confront in Russia. The organized criminal enterprises manufacturing and distributing pirate product are largely servicing foreign markets (local manufacturing capacity is at least a multiple of six or seven times that of local demand), making the Russian price for legitimate materials wholly irrelevant to their motivation or profitability. As noted earlier, Russian manufactured product has been found in over 27 countries over the past two years.

In addition, existing efforts by certain industries to offer low cost Russian editions have not had the effect of reducing local piracy rates. The record industry, for example, is already manufacturing locally, and sells legitimate copies for an average price of $6.00 to $8.00 U.S. dollars—a price that is extremely low not just in relation to prices for music elsewhere, but also with respect to other consumer goods sold in Russia. It is not the price of legitimate product that is creating opportunities for piracy—it is the opportunity for easy profits that has brought criminal enterprises into this business, and Russia should stop offering such excuses for its continuing inaction.

Another matter that the Russian government continues to raise is the need for the U.S. copyright industries to use civil remedies for effective enforcement. The copyright industries (especially the record industry) have recently attempted to bring civil cases against illegal plant operators – although procedural hurdles are significant.

However, in no country of the world, including Russia, can copyright owners be left to civil remedies in lieu of criminal remedies to effectively address large-scale organized crime commercial piracy. The government of Russia needs to play a major role in an effective criminal enforcement regime. The copyright industries generally report good police cooperation with raids and seizures, mostly of smaller quantities (with some exceptions) of material, but prosecutorial and other procedural delays and non-deterrent sentencing by judges remains a major hindrance to effective enforcement.

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What Can the U.S. Government Do?

There are three things the U.S. government can do to mandate Russia compliance with international norms and obligations to provide "adequate and effective protection and enforcement" for U.S. copyright material:

- Condition Russia's entry into the World Trade Organization (WTO) on meaningful copyright law enforcement;
- Designate Russia as a Priority Foreign Country (PFC) after the on-going out of cycle review by U.S.T.R.; and
- Deny Russia's eligibility for the Generalized System of Preferences (GSP) duty-free trade benefits.

1. Condition Russia's Entry into the World Trade Organization (WTO) on Meaningful Progress in Enforcing its Copyright Laws

The Russian IPR regime is not in compliance with the WTO TRIPS obligations, especially pertaining to enforcement. As a consequence, the U.S. government should not assent to Russia's accession into the World Trade Organization until its copyright regime, both legislative and enforcement, is brought into compliance with the WTO TRIPS obligations. It is essential that we learn from the China experience. WTO accession should simply not take place until the necessary TRIPS-mandated actions—and not just commitments—have taken place.

Russia is not providing adequate and effective enforcement as required for entry into the WTO, certainly not the enforcement standards required as "effective" (Articles 41 through 61 of TRIPS).

The U.S. can and should condition Russia's entry into the WTO on Russia making positive and meaningful enforcement progress – for example, by licensing and inspecting all the known 34 optical disk plants, closing those engaged in illegal activities, and criminally prosecuting those involved in this commercial illegal activity, and ensuring imposition of deterrent (not suspended) sentences.

2. Designate Russia as a Priority Foreign Country (PFC) When the Current Out-of-Cycle Review is Complete

The U.S. Trade Representative's announcement on April 29, 2005 that Russia would be left on the Priority Watch List (for the ninth straight year) noted "[w]e will continue to monitor Russia's progress in bringing its IPR regime in line with international standards through out-of-cycle review, the ongoing GSP review that was initiated by USTR in 2001, and WTO accession discussions."

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The situation has gotten significantly worse, not better, in the past few years. IIPA recommended in February, and continues to recommend as part of the out-of-cycle review, that it is time to designate Russia a Priority Foreign Country to force Russia to properly enforce its laws or face the trade sanction consequences.

3. Remove Russia's Eligibility for Generalized System of Preferences (GSP) Benefits

In August of 2000, IIPA filed a petition asking the U.S. government to open an investigation into Russia's practices and outlining a variety of ways in which Russia failed (and continues to fail) to meet the GSP criterion of providing adequate and effective protection for intellectual property. That petition was accepted by the U.S. government on January 10, 2001. IIPA has since testified twice before the U.S. government GSP interagency committee (March 2001; September 2003) and submitted a number of materials and briefs in this matter since then.

IIPA believes it is time to revoke Russia's eligibility from the GSP program. Russia is not providing the U.S. GSP mandated "adequate and effective protection" as required by Sections 502(b) and 502(c) of the 1974 Trade Act (the intellectual property provisions in the GSP statute are at 19 U.S.C. §§ 2462(b) and (c)).

It has been almost five years since the IIPA petition was filed, and over four years since the U.S. government accepted the petition, which at least as a threshold matter, acknowledged the potential of Russia's shortcomings under the GSP program. The Russian government has had years to move to fix these problems and they have not done so adequately.

* * * *

Unfortunately, the Russian piracy problem has been allowed to grow significantly worse in the past ten years, and the IIPA members' losses have continued to increase. Most obviously, the past five years have witnessed an explosion of optical disk manufacturing capacity without the concomitant controls to ensure that this capacity was used only for legitimate purposes.

Russia's anti-piracy efforts remain severely hampered by flawed legislation, ineffective enforcement by the Russian authorities and insufficient deterrent penalties in the courts. The Russian government needs to address legal reforms in the copyright law (even after the adoption of the 2004 amendments), the criminal code, the criminal procedure code, and the administrative code, but more importantly, it needs to provide stronger and more effective enforcement compatible with international norms, and WTO TRIPS (and the WIPO digital treaties). The Russian government has taken a few steps towards addressing copyright piracy, such as adopting improvements in its copyright law in 2004, and including by taking some actions against pirate optical disk plants, adopting a ban on the sale of certain products at kiosks and other street locations. This is a start, but it is only that. IIPA suggests that the U.S. government should adopt positions, and a timetable, to ensure that Russia is significantly moving towards achieving meaningful and lasting progress to meet its international obligations – especially IPR enforcement.

In sum, Russia's commercial piracy problem must be addressed immediately by the Russian authorities. IIPA recommends that the U.S. government take the necessary trade steps

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to deny Russia trade benefits (such as GSP) and entry into the World Trade Organization until Russia takes clear and effective steps to bring this illegal activity under control. This country can no longer afford inaction.

Piracy in China: A Lack of Political Will?

IIPA's comprehensive report on the piracy and legal situation in China as of February 2005 can be found on the IIPA website at www.iipa.com/rbc/2005SPE301PRCrev.pdf. In that report, IIPA called, *inter alia*, for entering into a new, multilateral dialogue in the WTO with the Chinese government as a way to persuade it to take aggressive action – as promised in the Joint Commission on Commerce and Trade (JCCT) meetings over one year ago – to significantly reduce the rate of piracy in all IPR sectors including the copyright sector. We then provided a summary review of what had happened in China over the last year to redeem that commitment. Our conclusion: China has failed to comply with its commitment made over one year ago in the JCCT to significantly reduce piracy rates. While some modest reductions have occurred in some sectors, by no measure have piracy rates been significantly reduced. In fact little has changed in the marketplace for our members and their companies, despite reports of increased raiding activity and seizures of many pirate products. In my testimony today, I would like, for the record, to update that report and in the process to summarize it where appropriate. Our report tells the sad, frustrating story of the failure of an enforcement system to deter rampant piracy in the potentially largest market in the world.

Recent Actions by the U.S. Government on China

On April 29, 2005, USTR issued its decision resulting from the out-of-cycle review of China's enforcement practices announced on May 3, 2004. USTR reflected in this decision its deep concern over China's lack of progress in the enforcement area by elevating China to the Priority Watch List. It also announced a number of other initiatives, one of which was to work closely with our industries with an eye on utilizing WTO procedures to bring China into compliance with its WTO obligations. Since that time we have met with USTR to begin this process and will work intensively with USTR toward the mutual goal of bringing China into compliance with its WTO TRIPS obligations, its bilateral obligations to the U.S. in the 1995 and 1996 IPR agreement and action plan, and its commitments made to our government in the JCCT process.

This process has now commenced in earnest. USTR will also be seeking information from the Chinese government under the transparency provisions of the TRIPS agreement, and is committed to using the JCCT process to encourage the Chinese government to implement key reforms on both the enforcement and the all-important market access front.

The Chinese Marketplace for Copyright Products: A Record of Frustration and Failure

Mr. Chairman, our industries are deeply frustrated by the lack of real progress by China in taking effective action to deter piracy and to open up its market to legitimate cultural and high

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technology copyright products. China remains one of the most closed markets in the world for the U.S. copyright industries. Onerous market access restrictions affect all our industries. Notwithstanding Premier Wen's pledge to address the $162 billion trade imbalance between the U.S. and China by increasing China's imports from the U.S., China is retaining – and, in some sectors, augmenting – market access restrictions for creative and high-tech products that represent America's comparative advantage.

Copyright piracy represents perhaps the largest barrier to effective market access in China. An average (and truly staggering) 90% piracy rate has persisted for years despite repeated "strike hard" enforcement campaigns, steamroller campaigns, and public statements from many high level government officials supporting stronger enforcement. While our Special 301 submission highlights the current situation in China, I wanted to give you a brief flavor of what copyright companies confront in trying to do business in China in face of these trade barriers and these inexcusably high piracy levels.

The Plight of the Copyright Industries Due to Piracy in China

The Business Software Industry

Taking the business software industry first – one of our nation's most productive and important creative sectors: The software industry faces piracy rates in China of 90%, one of the highest in the world for that industry. China leads the world in the production and export of counterfeit software – software packages that are purposely designed to replicate the original legitimate product. Losses to U.S. software publishers were estimated by IIPA member, the Business Software Alliance (BSA), at $1.47 billion in 2004. China was the 6th largest market in the world for personal computers and ranked 26th in legitimate software sales. This increasing disparity not only damages the U.S. industry but hurts Chinese software developers as well.

China has failed to criminalize the most damaging type of piracy to the business software industry – the unauthorized use of software within businesses and government institutions. This is a violation of the TRIPS Agreement. Combined with the total absence of a criminal remedy is the absence of all but a few administrative actions against this type of piracy with woefully low and non-deterrent fines. As a consequence, piracy rates continue to remain at staggering levels.

To make matters worse, China is on the verge of shutting down access for U.S. and other foreign companies to the largest purchaser of software in China: the Chinese government. It would accomplish this by adopting draft government procurement regulations that would expressly favor Chinese software only. In short, the situation for this critical copyright sector is truly dire in China with no significant improvement in sight.

The Motion Picture Industry

The U.S. motion picture industry is facing a 95% piracy rate in China (the highest in the Asia Pacific region, and among the highest in the world) which represents a worsening of the situation from the previous year. Losses to just the motion picture industry, from 1998 through 2004, are estimated at over $1 billion (not including losses from Internet piracy, which are

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growing alarmingly). While raids and seizures have increased somewhat following Vice Premier Wu Yi's 2004 enforcement campaign, administrative fines remain far too low to deter pirate activity and, as I will describe later, criminal cases have been extremely rare despite Chinese promises to use this TRIPS-required remedy. According to a recent newspaper report, the legitimate home video market in China represents about 5% of the estimated total market of $1.3 billion (which is itself a very conservative estimate). Of the 83 optical disk factories licensed by the government (and an unknown number of "underground" unlicensed plants), many continue to churn out pirate DVDs. The export of pirated home video product, which had slowed to a trickle after the U.S. Section 301 action (and threatened retaliation) in 1995-96, has resumed and is growing. The total optical disk plant production capacity, a significant amount of which is devoted to producing pirate product, is now close to 2.7 billion units annually. Optical disks sourced in China and containing pirated films have been seized in over 25 countries around the world. The massive quantity of pirated movie product available in China is evidenced by the fact that pirate prices start around $0.60 per unit, the lowest price in Asia. As with the other copyright industries, any enforcement that occurs is conducted by administrative agencies, with overlapping jurisdiction and often little coordination, and fines imposed are a mere "cost of doing business." A recent study, conducted by IIPA member, the Motion Picture Association (MPA) revealed that the average fine imposed per pirate home video product (DVD, VCD) seized in raids resulting from MPA complaints is only slightly higher than the cost of purchasing a blank disk – clearly of no deterrent value. The lack of deterrent administrative penalties is a key reason, in addition to the almost complete lack of criminal enforcement that piracy rates persist at 90% of the market and above.

Accompanying and reinforcing this piracy situation are onerous market access restrictions, including a Government-owned, monopoly importer, very limited competition in distribution, and a quota of 20 theatrical films allowed into China annually on commercial terms. The pirates capture 100% of the market for films not permitted legally in China. Even those films permitted theatrical release suffer piracy rates of 70-75%, because of the long delays before most American films are given screen time. Another consequence of the lack of competition in importation and distribution is the non-competitive pricing in the Chinese market. Cumbersome licensing requirements burdens the retail sale of legal home entertainment product, holding down revenue potential and helping keep the market in the hands of the pirates. These barriers and those to all our industries must be removed in the JCCT process.

The Entertainment Software Industry

The entertainment software industry, one of the fastest growing copyright-based industries, faces similar high piracy rates and estimates the value of pirated videogames in the market at $510 million in 2004. Demand for entertainment software products is growing rapidly but is being soaked up primarily by the pirates. This demand is exemplified by the exploding popularity of "massively multiplayer online role-playing games" (MMORPGs) where literally thousands of players can compete against one another simultaneously. Demand for MMORPGs in China grew at 40-45% over expectations in 2004. This increasing demand has fueled, in part, the growth of Internet cafés in China. (It is estimated that there are close to 200,000 Internet cafes in the country, with a seating capacity of between 100-300 seats, of which 60% are involved in game play.) While U.S. game publishers, represented by IIPA member, the

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Entertainment Software Association (ESA), have engaged in some licensing of the cafes, the vast majority of the product used is pirated, either available at the café or downloadable from the Internet. This dire situation has been all the more exasperating since the Chinese government extensively regulates the activities of these Internet cafes and often and vigorously revokes licenses for actions the government deems inappropriate. However, as far as we know, the government has never sought to include in this extensive regulatory scheme prohibitions against the widespread and blatant piracy at these cafes in its business licenses (which are otherwise very thorough). Moreover, no copyright enforcement of any kind has occurred. The legal infrastructure governing the Internet still is not helpful to copyright enforcement. Takedown of pirate sites is negligible; penalties non-existent.

Cartridge-based handheld games are also hard hit by the pirates with manufacturing and assembly operations throughout China with exports throughout Asia, Latin America, the Middle East and Europe. Enforcement attempts have been relatively successful in terms of raids and seizures but, like with other industries, administrative fines are non-deterrent and criminal enforcement action very rarely undertaken, even against factories generating millions of dollars in illicit profits. Entertainment software products are also subject to a protracted content review process, by two separate agencies contributing to market entry delays. Given the immediate nature of the demand and lifecycle of best selling games, this leaves the pirates virtually uncontested in the market prior to the official release of a new title. There are also Internet and investment restrictions that must be significantly eased or abolished.

The Book Publishing Industry

The U.S. book publishing industry, represented by IIPA member, the Association of American Publishers (AAP), faces both significant printing of pirated books, in both English and translated editions, and massive commercial photocopying of textbooks and reference books on and near university campuses. There are over 500 licensed state-owned publishers in China. There are a few privately-owned publishers that must buy publishing rights from the state-owned publishers. U.S. publishers issued a significant number of translation licenses in 2004, but the numbers remain far below China's potential. All the best selling books are virtually immediately pirated by outlaw "printers" and made available through independent bookstores, stalls and street vendors. To give an example, the local Chinese publisher of the famous self-help bestseller Who Moved My Cheese estimates sales of over 3 million copies in China. It is estimated, however, that the pirates sold another 6 million copies, and that there were between 70 and 100 *different* pirated editions on the market! The Harry Potter® books and other best sellers like Senator and President Clinton's books, Living History and My Life, John Grisham's books, former General Electric President Jack Welch's biography Winning and others all face a similar fate

English language textbooks are also heavily photocopied in their entirety, often at on-campus textbook centers actively or tacitly sanctioned by the universities. In addition, there are several known websites making available scanned versions of entire textbooks for download.

Enforcement against this vast piracy is spotty and all done administratively through the local and national copyright bureaus. Any resulting administrative fines are non-deterrent. We

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know of no criminal enforcement against piracy of books not originating in China (books for which the copyright is held by a foreign entity).

Finally, the book publishing industry faces significant market access barriers – U.S. publishers are not permitted to publish, sign authors, or print their books directly in China. These restrictions vastly increase the cost of doing legitimate business, hindering U.S. publishers' abilities to tailor products to the Chinese market and make products available that have any hope of competing in the marketplace with pirated materials.

The Recording Industry

The recording industry, represented by IIPA member, the Recording Industry Association of America (RIAA) did experience a minor reduction in the piracy rate for sound recordings, from 90% in 2003 to 85% in 2004 in "hard goods" piracy, but with significant increases in Internet piracy. Losses remain in excess of $200 million per year from continued optical disk manufacture and distribution within the Chinese market and significant levels of audiocassette piracy (still an important format in China). The recording industry faces many of the same problems with optical disk piracy confronting the motion picture industry. Millions of pirated music CDs are readily available throughout China. Some of these pirate products have found their way into the export market. China continues to rely on its failed administrative enforcement system, which relies on numerous inspections, product seizures and, when the pirate doesn't flee, the imposition of small, non-deterrent fines.

Internet piracy in China, as in other countries in the world, has become a huge problem for the recording industry. Thousands of active websites such as www.9sky.com and www.chinaMP3.com are giving away, or offering links to, thousands of pirated songs. (These not-for-profit acts of piracy are not criminalized in China, as they are, for example, in the U.S.). International criminal syndicates are apparently using Chinese servers to hide their illicit activity (www.boxup.com) and many Asian pirate sites are doing a thriving business in China, such as www.kuro.com from Taiwan.

Market access restrictions are severe, contributing to piracy and market losses. U.S. record companies cannot "publish" or release a recording without permission of a state owned company and cannot manufacture, distribute or engage in retailing of its products, which artificially segments the market and makes it extraordinarily difficult for this world class industry to participate in the Chinese market. Its products are subject to censorship while domestic (as well as pirate) recordings are not – a national treatment violation.

All in all, the copyright industries estimate their total losses in excess of $2.5 billion in 2004 due to piracy in China. The simple fact remains that these losses and the 90% piracy rates will NOT be significantly reduced without subjecting major piracy to criminal enforcement accompanied by deterrent penalties and substantially increasing the administrative fines specified in the copyright law and imposing them in practice. To date, even after the JCCT commitments, this has NOT happened and there is a real question whether the Chinese government as a whole (Vice Premier Wu Yi has been a staunch defender of better enforcement) can muster the political will to take these absolutely necessary actions – actions that have been key to significant

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reductions in piracy levels in other countries in which our companies operate. China cannot exempt itself from the rules – that enforcement against piracy requires deterrence and criminal remedies. The global community recognized this when it fashioned the Article 61 criminal obligation in TRIPS and it has proven to be the case in practice.

Actions to Be Taken by the Chinese Government

If piracy rates are to be significantly reduced as committed by Vice Premier Wu Yi in the JCCT and if China is to come into compliance with its TRIPS obligations, it must take the following actions.

- China should significantly liberalize and implement its market access and investment rules, including and in addition to those already made in the WTO, and improve the overall business climate in China to permit effective operations by all copyright industries. This should be a major objective in the JCCT.

- Immediately amend the new Judicial Interpretations to include sound recordings.

- Immediately commence criminal prosecutions using both the monetary and new copy thresholds and carry these forward promptly to impose deterrent penalties. The Economic Crime Division of the Public Security Bureau should be made responsible for all criminal copyright enforcement and be provided sufficient resources and training to very substantially increase criminal enforcement under the new Judicial Interpretations.

- Under the leadership of Vice Premier Wu Yi, constitute a single interagency authority at the national and provincial/local levels to undertake administrative enforcement against piracy of all works. This authority would have the would have the full authority to administer fines and to refer cases to the Ministry of Public Security and the Supreme People's Procuratorate for criminal prosecution, under referral guidelines that are equal to or better than the Judicial Interpretations. Such authority must have the full backing of the Party Central Committee and the State Council. Far greater resources must be provided to this enforcement authority. All administrative enforcement, and enforcement by Customs at the border, must be significantly strengthened.[1]

- Adopt, in a transparent manner with the opportunity of public comment, a full and comprehensive set of regulations governing protection and enforcement on the Internet, including the liability of Internet Service Providers, which follow the recommendations made in IIPA's Special 301 submission, including effective "notice and takedown" mechanisms and without unreasonable administrative evidentiary burdens. Establish within this single interagency authority described above special units (at the national, provincial and local levels), whose purpose is to enforce the law and these new regulations against piracy on the Internet.

[1] In the area of trademark enforcement undertaken by one ESA member company and involving handheld and cartridge based games, the new Judicial Interpretations are unclear on whether the authorities are able to seize components and parts that make up the counterfeit products. This is essential and must be clarified.

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- Amend the Criminal Law to comply with the TRIPS Article 61 requirement to make criminal all acts of "copyright piracy on a commercial scale." These must include infringing acts not currently covered, such as end user software piracy and Internet offenses conducted without a profit motive. Also amend the Criminal Code provisions requiring proof of a sale, to require instead proof of commercial intent, such as possession with the intent to distribute.

- Significantly increase administrative penalties/remedies, including shop closures and monetary fines and impose them at deterrent levels.

- Permit private companies and trade associations to undertake anti-piracy investigations on the same basis as local companies and trade associations.

- Through amended copyright legislation or regulations, correct the deficiencies in China's implementation of the WCT and WPPT, and ratify the two treaties.

- Significantly ease evidentiary burdens in civil cases, including establishing a presumption with respect to subsistence and ownership of copyright and, ideally, permitting use of a U.S. copyright certificate, and ensure that evidentiary requirements are consistently applied by judges and are available in a transparent manner to litigants.

The copyright industries will be working closely with USTR to prepare the necessary elements of a WTO case should the TRIPS obligations of China described above and in our submission not be fully implemented. This work is now ongoing.

* * * *

Chairman Hatch, we are grateful for the your support and that of members of this Subcommittee in working with IIPA and its members to meet the global copyright and enforcement challenges we have highlighted and in working with us to monitor and encourage both Russia and China's sorely-needed progress. The Congress, the Administration and the private sector must work together to ensure that they take these actions. It is in no one's interest for these issues to escalate into further trade confrontation.

Thank you.

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