

## **OUT-OF-CYCLE REVIEW RESULTS**

### **CHINA**

In its 2004 Special 301 report, USTR announced that it would conduct an out-of-cycle review (OCR) in early 2005 to evaluate China's implementation of its commitments made at the 15th annual meeting of the Joint Commission on Commerce and Trade (JCCT) in April 2004. During the OCR process, USTR requested detailed information on the prevalence of IPR infringement in China and the strengths and weaknesses of China's IPR protection and enforcement regimes. USTR also engaged with dozens of rights holders, interested members of the public and with Congress. This section contains USTR's analysis, findings and recommendations.

The United States recognizes that China, under the leadership of Vice Premier Wu Yi, has expended significant effort to improve the protection of IPR in China. Indeed, these efforts have resulted in progress in some areas. The United States remains gravely concerned, however, that China has not resolved critical deficiencies in IPR protection and enforcement and, as a result, infringements remain at epidemic levels. Accordingly, the United States concludes that there has not been a significant reduction in IPR infringements throughout China, as it committed to do at the April 2004 JCCT. Therefore, the United States will:

- Work with U.S. industry and other stakeholders with an eye toward utilizing WTO procedures to bring China into compliance with its WTO TRIPS obligations, particularly those requiring transparency and a criminal IPR enforcement system with deterrent effect.
- Invoke the transparency provisions of the WTO TRIPS Agreement, which will require China to produce detailed documentation on certain aspects of IPR enforcement that affects U.S. rights under the TRIPS Agreement.
- Elevate 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 JCCT to achieve a significant reduction in IPR infringement throughout China, and make progress in other areas.
- Maintain Section 306 monitoring of China's implementation of its 1992 and 1995 bilateral agreements with the United States (including additional commitments made in 1996).
- Use the JCCT, including the IPR Working Group, to secure new, specific commitments concerning additional actions that China will take to significantly improve IPR protection and enforcement, particularly over the next quarter. China's fulfillment of these commitments will be a centerpiece of the 2005 JCCT.

China agreed at the April 2004 JCCT to take the following specific steps:

- Significantly reduce IPR infringement levels across the country;

- Subject a greater range of violations to criminal investigation and penalties, and apply criminal sanctions to the import, export, storage and distribution of pirated and counterfeit products and to on-line piracy;
- Crack down on IPR violators through nationwide enforcement actions, increased customs enforcement actions and making it easier for rights holders to secure effective border enforcement;
- Improve protection of electronic works by ratifying and implementing the WIPO Internet Treaties as soon as possible, and by extending to local governments the existing ban on the use of pirated software by the central government and provincial agencies;
- Launch a national IPR education campaign; and
- Establish an IPR working group under the JCCT to consult and cooperate with the United States on the full range of IPR issues.

During the OCR, USTR systematically collected and evaluated facts relevant to assessing China's progress in fulfilling its JCCT commitments, its WTO obligations and its commitments under the 1992 and 1995 bilateral agreements with the United States (including additional commitments made in 1996). Through a letter and questionnaire to U.S. industry groups and a subsequent Federal Register Notice, USTR requested detailed information on the prevalence of IPR infringement in China generally, as well as on individual cases of IPR infringement. USTR received 34 submissions from industry, a number of which were very useful in USTR's review.

USTR has now completed the OCR, and is reporting the results in conjunction with this year's annual Special 301 review for China.

### **Infringement Levels Remain Unacceptably High**

China's inadequate IPR enforcement is resulting in infringement levels at 90 percent or above for virtually every form of intellectual property, according to the OCR submissions that USTR received.

Overall piracy rates in China have not declined significantly since WTO accession, and in some sectors have increased from already extremely high levels. OCR submissions report estimated U.S. losses due to piracy of copyrighted materials alone ranging between \$2.5 billion and \$3.8 billion annually. Internet piracy is quickly becoming the number one threat to the copyright industry according to OCR submissions. End-user piracy of business software and other copyright materials, such as books and journals, remains a key concern.

OCR submissions also confirm that China has not yet achieved a significant reduction in trademark counterfeiting. On the contrary, in 2004, the value of Chinese counterfeits coming into U.S. markets seized by the United States increased 47 percent from US\$94 million to US\$134 million. These seizures continued to account for 67 percent of all U.S. Customs' IPR seizures in 2004. China's counterfeit products threaten public health and safety in the United

States, in China and throughout the world. Batteries, pharmaceuticals, auto parts, industrial equipment and many other counterfeit products from China come to our shores. The OCR submissions aver, for example, that foreign pharmaceutical companies lost 10-15 percent of annual revenues in China due to increased counterfeiting.

### **Evaluation of TRIPS Obligations and 2004 JCCT Commitments**

#### **Transparency**

Article 63 of the TRIPS Agreement requires laws, regulations and final judicial decisions and administrative rulings of general application pertaining to IPR infringement be made publicly available to rights holders. Despite this requirement, lack of transparent information on IPR infringement levels and enforcement activities in China continues to be an acute problem. Several OCR submissions express concern regarding the Chinese Government's unwillingness to provide sufficiently detailed enforcement information. For example, one industry group observed that "[a]lthough Chinese authorities have undertaken some administrative enforcement actions against pirates, the Government's refusal to share information about ... the ultimate outcomes of these actions makes it very difficult for rights holders to assess the deterrent impact of China's enforcement efforts."

Transparency in rulemaking is also a continuing problem. Government entities responsible for drafting rules often refuse to make drafts widely available for public comment, and instead limit their "consultations" to pre-selected industry and trade associations. A prime example is China's drafting of the criminal judicial interpretation. During the 2003 Transitional Review of China's WTO/TRIPS compliance, China pledged to increase transparency by making draft judicial interpretations on IPR matters available for public comment. Despite this pledge made in Geneva and numerous requests from the United States and rights holders, China refused to release a draft of its December 2004 judicial interpretation for public comment. In addition, guidelines for the examination of patents and trademarks are not publicly available, and numerous local rules, such as those governing trade secrets, are inconsistent with national law, regulations or rules, resulting in uncertainty and confusion for rights holders.

#### **Criminal Enforcement**

Article 61 of the TRIPS Agreement requires a criminal IPR enforcement system with deterrent effect. Presently, however, criminal enforcement in China has not demonstrated any deterrent effect on infringers. China's authorities have pursued criminal prosecutions in a relatively small number of cases, notwithstanding China's commitment to the United States to impose more criminal penalties on the range of counterfeiting and piracy activities. While the number of criminal trademark prosecutions appears to be increasing, we have reports of very few, if any, criminal copyright prosecutions. When criminal prosecutions are pursued, a lack of transparency makes it difficult to ascertain whether they resulted in convictions and, if so, what penalties were imposed.

The Supreme People's Court and Supreme People's Procuratorate (SPP) issued a new judicial interpretation (JI) in December 2004 redefining the criteria for (1) commencing prosecutions and

(2) imposing criminal convictions. The JI's key improvements and deficiencies include the following:

- Improvements – (a) lowers the criminal thresholds; (b) applies accomplice liability to importers, exporters, landlords and others who provide assistance to infringers; (c) permits goods produced in factories and/or kept in warehouses to be included in sales calculations; (d) authorizes using the number of illegally duplicated disks or advertising revenue for Internet infringements to satisfy the “for profit” requirement; and (e) expands the statutory definition of an infringing trademark.
- Deficiencies – (a) deletes special liability provisions for repeat administrative offenders (the “three strike rule”), dealers in counterfeit products that threaten public safety, and infringers of well-known trademarks; (b) determines whether criminal thresholds are met using the price of infringing goods rather than the price of legitimate goods; (c) criminalizes copyright infringements (including online piracy) only if undertaken to make a profit; (d) fails to independently criminalize the export of infringing goods; (e) fails to criminalize the unauthorized rental, translation, public performance, broadcasting, adaptation and “bootlegging” of performances, even when done “on a commercial scale;” (f) fails to address software end-user piracy; and (g) maintains thresholds three-times higher for units than for individuals.

The issuance of the JI and many of its provisions do signal top government and judicial level willingness to commit to addressing counterfeiting and piracy problems. The United States believes, however, that the JI did not go far enough to be an effective deterrent. China's efforts to draft a JI that would “increase penalties for IPR violations by subjecting a greater range of violations to criminal investigation, by applying criminal sanctions to import and export stages, storage and distribution of infringing products, and by applying criminal sanctions to online piracy,” were hampered by institutional differences and the need to accommodate competing domestic interests. Had China made drafts of the JI widely available for public comment and consulted with the United States as requested, at least some of the deficiencies noted above could have been avoided. The United States will examine closely China's implementation of the JI to determine whether its application addresses its underlying deficiencies and actually deters counterfeiting and piracy.

With regard to Internet piracy in particular, the JI provides that: “Distributing a written work, musical work, motion picture, television program or other visual work, computer software or other works to the public by information network” falls under the definition of ‘reproducing and distributing’ stipulated in Article 217 of the Criminal Law.” While this is a positive step, service providers are still not held liable for infringing material hosted on their networks and the profit motive requirement of the copyright thresholds may seriously hinder efforts to actually impose criminal liability.

### Nationwide Crackdowns and Customs Enforcement

*Crackdowns:* Although China's central Government has made largely satisfactory progress in bringing China's IPR laws and regulations into line with China's WTO commitments,

enforcement continues to be seriously inadequate. In 2004, IPR infringement continued to affect products, brands and technologies from a wide range of industries, including films, music, publishing, software, pharmaceuticals, chemicals, information technology, textile fabrics and floor coverings, consumer goods, electrical equipment, automotive parts and industrial products, among many others. Rights holders report that enforcement efforts, particularly at the local level, are hampered by poor coordination among Chinese Government ministries and agencies, local protectionism and corruption, high thresholds for initiating investigations and prosecuting cases, lack of training, and inadequate and non-transparent processes.

Articles 41 and 61 of the TRIPS Agreement require effective and deterrent IPR enforcement. Consensus exists among rights holders, however, that China's current IPR system relies too heavily on enforcement by administrative authorities and is non-deterrent. Dissatisfaction with the number and substance of investigations, prosecutions, and convictions last year by local police is widespread.

In August 2004, pursuant to China's JCCT commitments, the State Council announced a year-long national campaign to crack down on IPR infringements in sectors where trademark counterfeiting and copyright infringement are concentrated, including import and export activities, trade fairs and exhibitions, distribution and wholesale markets, brand name processing and publishing. On March 31, 2005 Vice Premier Wu Yi extended this campaign until the end of 2005. This next phase will focus on food and pharmaceutical trademark and well-known mark infringements, and target street vendors of illegal publications, audio-visual products and software.

Industry confirms that these campaigns have in fact resulted in increased seizures of infringing materials. What happens to seized product, however, is not transparent. We continue to hear reports of seized counterfeit and pirated goods being auctioned or otherwise returned to the channels of commerce. It is also clear that cases subsequently brought by the administrative authorities have resulted in extremely low fines.

The lack of deterrence from the fines is compounded by the fact that there has been a steady decline in the number of cases that administrative authorities forward to the Ministry of Public Security for criminal investigation, even for commercial-scale counterfeiting or piracy. According to Chinese Government statistics, there were 86 transfers in 2001; 59 in 2002; 45 in 2003; and only 14 in the first half of 2004. As a result, infringers are not deterred by the risk of criminal prosecution and serving jail time. They simply consider the seizures and fines to be a cost of doing business, and are usually able to resume their operations without much difficulty. Despite receiving good cooperation from some local administrative authorities, some rights holders reported a decrease in the number of seizures of infringing products in 2004 – due to smarter pirates, not decreasing levels of infringement.

A number of U.S. right holder groups have recently stepped up efforts to monitor IPR enforcement in China and its results in the Chinese market. The United States welcomes these initiatives and urges their continuation. By promoting transparency, these private sector initiatives enhance government-to-government cooperation toward achieving effective IPR enforcement.

*Customs/Administrative Enforcement:* The export of infringing products from China is of grave concern worldwide. At the U.S. border alone, counterfeit and pirated imports from China account for 67 percent of seizures by U.S. Customs and Border Protection, and the value of the products seized rose by 47 percent in 2004. Seizures by Chinese customs authorities are down, despite China's JCCT commitment to increase customs enforcement actions. Rights holders report finding infringing products of Chinese origin in most major world markets, but being unable to secure customs seizures in China. This raises serious concern.

Following China's April 2004 JCCT commitments, China's General Administration of Customs (GAC) issued new regulations and implementing rules intended to strengthen border enforcement and to make it easier for rights holders to secure effective enforcement at the border. The new regulations outline GAC's duties and provide guidance on the implementation of the customs IPR recordal mechanism, extend the term of IPR recordations from seven to ten years, and lower the cap on the security bonds required from rights holders seeking the seizure of allegedly infringing goods. In a significant step backward, however, the new rules no longer expressly authorize customs authorities to levy administrative fines on companies engaged in trading counterfeit or pirated goods and reduce the fines that Customs authorities can impose from 100 percent to 30 percent of the value of the goods. Proposed amendments to China's Foreign Trade Law also fail to address this important issue. In addition, the new measures fail to address the transfer of cases for criminal investigation and prosecution and do not authorize nationwide bonding to cover China's more than 100 customs ports of entry. Disposal of confiscated goods also remains a problem under the regulations, which allow for auction rather than mandating destruction of seized goods.

*Civil Enforcement:* In part because of the ineffectiveness of the administrative and criminal enforcement systems in China, there has been an increase in the number of civil actions seeking monetary damages or injunctive relief. Most of these actions have been brought by Chinese rights holders, although foreign rights holders are increasingly turning to the civil system for redress. While seeing some success, we continue to hear complaints of a lack of consistent, uniform and fair enforcement of China's IPR laws and regulations in the civil courts. Litigants have found that most judges lack necessary technical training, court rules regarding evidence, expert witnesses, and protection of confidential information are vague or ineffective, and the costs of investigation and bringing cases are prohibitively high. In the patent area, where civil enforcement is of particular importance, the process is inefficient and unpredictable. A single case can take four to seven years to complete.

#### Protection of Electronic Works, WIPO Treaty Accession and Government Use of Legitimate Software

Copyright infringement on the Internet is a growing phenomenon in China because of loopholes in existing regulations and implementing rules. Despite its JCCT commitment, China still has not acceded to the WIPO Internet Treaties. China's current regulations, implementing rules and judicial interpretations do increasingly address copyright issues related to the Internet. China is currently drafting additional Internet-related regulations.

Widespread use of pirated software in government offices continues. Consistent with China's April 2004 JCCT commitments, Vice Premier Wu Yi directed that by the end of 2004, all government institutions at all levels would use only legal software. While the local governments of Shanghai, Beijing, Guangzhou, Zhejiang and several other provinces and municipalities have instituted measures requiring use of only legal software, this does not satisfy China's commitment to ensure that all government agencies at all levels use only legal software.

#### Public Awareness/Education

In 2004, China launched a national public awareness campaign as part of its JCCT commitment to educate the Chinese public on IPR protection. For example, the State Intellectual Property Office (SIPO) introduced a television program, "Intellectual Fortune," which is broadcast in 20 provinces nationwide. In April 2004, SIPO began publishing an English language insert in the China Daily English-language newspaper on intellectual property. China IPR trade journals also routinely report on specific efforts targeting students and industries. In February 2005, the National Copyright Administration hosted a nationally broadcast anti-piracy concert at Beijing Capital Stadium, with a television audience that was estimated by its sponsors at 500 million. It is too early to tell what the long-term implications of this campaign will be.

#### IPR Working Group

USTR, working closely with the U.S. Patent and Trademark Office, is preparing a detailed work plan for obtaining tangible results in the specific areas noted below, and plans to hold the Working Group's first meeting in Washington in early summer 2005.

#### Patent Developments

While China's patent laws are largely compliant with the TRIPS Agreement, OCR submissions reveal that the narrow scope of patentable subject matter under Chinese law makes patents for transgenic plants and animals virtually unobtainable. A lack of clarity in laws involving generic drug patent infringement is contributing to the continued growth of counterfeit drugs. The State Food and Drug Administration has now provided in its new drug registration regulations coordination mechanisms between the health authority and patent office to prevent unauthorized registrations of patent-infringing products. However, we have no reliable data on how well these new regulations work.

In addition, OCR submissions report that China has yet to implement any meaningful data protections for pharmaceutical products, as required by Article 39.1 of the TRIPS Agreement.

#### OCR/Special 301 Determination

The United States reaffirms its appreciation for the efforts of Vice Premier Wu Yi and the progress that has been made in some areas. Nevertheless, based upon the information received during the OCR, the United States concludes that China has failed to significantly reduce IPR infringement levels, as required under the JCCT. Consequently:

- First, the Administration will use WTO instruments whenever appropriate to address our concerns regarding the unacceptable levels of counterfeiting and piracy in China. We agree with the many industries and companies that have identified lack of transparency as a serious barrier to a more complete understanding of key deficiencies in China's IPR enforcement system. Accordingly, we will invoke the transparency provisions of the WTO TRIPS Agreement to request that China provide detailed documentation on certain aspects of IPR enforcement that affect U.S. rights under the TRIPS Agreement. We will, for example, be seeking information on criminal and administrative penalties actually imposed. Statistics provided by China's central Government list numbers of cases, but often lack specificity on the legal basis for those cases and other important details. We look forward to China's complete response.
- Second, USTR is elevating China onto the Priority Watch List on the basis of serious concerns about compliance with WTO TRIPS obligations related to IPR enforcement, and the commitments China made to the United States at the April 2004 meeting of the JCCT to achieve a significant reduction in IPR infringement, and make progress in other areas. This marks the first time that China has been elevated to the Priority Watch List on the basis of WTO TRIPS or JCCT-related concerns. The United States will also maintain Section 306 monitoring of China's implementation of its 1992 and 1995 bilateral agreements with the United States (including additional commitments made in 1996).
- Third, the United States will use the JCCT and IPR Working Group to secure new, specific commitments concerning additional actions that China will take that result in significant improvements in IPR protection and enforcement, particularly over the next quarter. We will seek tangible results in areas of weakness identified in the OCR and of key concern to U.S. persons that rely upon intellectual property protection.

### Tangible Results

China must fulfill its 2004 JCCT commitments to the United States. Based upon deficiencies identified during the OCR, China must:

- Undertake additional aggressive action to significantly reduce IPR infringement levels.
- Show demonstrable results in at least the following areas:
  - Demonstrate a significant increase in the number of criminal IPR investigations, prosecutions, convictions and deterrent, proportionate sentences involving U.S./foreign rights holders, especially including but not limited to criminal copyright cases.
  - Remove the market advantages currently enjoyed by pirated and counterfeited goods resulting from market access restrictions and administrative delays so as to facilitate increased sales of the legitimate products.



- Make administrative IPR enforcement actions deterrent.
- Demonstrate a significant decline in exports of IPR infringing goods.
- Combat copyright and trademark infringing activities, including Internet piracy, through specific actions.
- Make publicly available case rulings and IPR-related statistical data, including data on government compliance with software copyright licensing, and on administrative and judicial decisions, including penalties imposed.

The United States will work through the JCCT IPR Working Group, particularly over the next quarter, to identify specific action items for China to undertake in each of these areas, and will make fulfillment of these undertakings a centerpiece of the 2005 JCCT meetings.