

Testimony of Joseph S. Papovich

Senior Vice President International

The Recording Industry Association of America

Before the

United States Senate

The Senate Finance Committee

On

U.S.-China Economic Relations Revisited

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America's song writers, performing artists and recording companies have a long history of working with the Congress and the Administration to protect and defend our uniquely successful sector of the U.S. economy. As a participant in and representative of this industry, I very much appreciate the efforts of this Committee, the rest of the Congress and the dedicated officials within the various Executive Branch agencies who have worked closely with our industry.

The importance of the U.S. recording industry, and intellectual property protection, to the U.S. economy

A critically important aspect of our nation's competitive strength lies in the creation of knowledge-intensive intellectual property-based goods and services. This is one of those economic activities that Americans do better than others. The "core" U.S. industries that rely on copyright protection account for more than six per cent of US GDP.¹ The foreign sales and exports of these industries are nearly \$90 billion, an amount greater than almost any other U.S. industry sector, including automobiles and auto parts, agriculture and aircraft.

International markets are vital to America's creative talent and record companies. Exports and other foreign sales account for over fifty percent of the revenues of the US record industry. This strong export base sustains American jobs.

In this respect, the protection of our intellectual property rights abroad is essential to promoting America's competitive advantages in world commerce. The sale of our recordings abroad makes a major contribution to America's current account balances. Each and every sale of a pirated product abroad that substitutes for the sale of a legitimate American product increases our current account deficit. As our trade deficit has soared, Congress should consider more closely the relationship between our widening trade and current account deficits and copyright piracy and to take steps to enable us to more effectively protect our intellectual property rights and to sell our products at home and abroad.

¹ These industries include recording, music, motion pictures, book and newspaper publishing, computer software (including business and entertainment software) and radio and television broadcasting.

The Effect of Music Piracy

Music is the world's universal form of communication. It touches every person of every culture on the globe to the tune of \$34 billion annually. America's record companies—small and large—create employment for thousands of people, including composers, singers, musicians, producers, sound engineers, record promoters and retail salespersons, to name only a few.

The piracy of music is almost as old as the music industry itself, but historically it was difficult for the criminal to reproduce copies with the quality of the real thing. Now with the advent of digital recordings, computers and high-speed internet access, criminals can reproduce perfect copies of any recording. There is massive manufacture and traffic of illegal CDs, both in the form of molded CDs that are produced in factories, and increasingly pirated CD-R's produced on blank optical discs by computer CD-R burners.

The illegal music trade is feeding the profits of international organized crime syndicates who are involved in drugs, money-laundering and other criminal activities. Music piracy is costing governments hundreds of millions of dollars in tax revenues.

The battle against intellectual property theft must be unrelenting. Digital technology and internet piracy have greatly exacerbated our problems. Our country must employ every tool at its disposal, including the critically important leverage provided by international trade agreements.

The Problem in China

America's creative industries are under attack, especially in China where high levels of piracy in conjunction with market access barriers plague our industry.

Last year, the record industry lost over \$200 million in China to pirate sales. Eighty-five percent of the sound recordings sold in China were pirated. This means an astounding 17 of every 20 sound recordings sold in China are sold by pirates.

Demand for American musical recordings in China is enormous, as evidenced by the massive piracy of our products across China. The result has been a colossal lost opportunity for American writers, performers and record producers to benefit from the fast growing Chinese society and economy. Here's why:

- 1. China is swamped with pirated recordings because the penalties imposed on pirates are not effective. Chinese pirates also export pirated versions of American recordings all over the world. Chinese authorities might raid one of these manufacturing facilities, a warehouse or a retail store and seize the pirate product—and they seize millions—but the resulting penalty, if any, is almost always just a small fine. Pirates are entrepreneurs who see such raids and seizures as a cost of doing business—a “slap on the wrist”—and the occasional interruptions are built into their*

business model. The penalties do not deter, punish or in any way incapacitate the thieves.

We believe there are around 90 optical disc plants in China, which operate nearly 1,400 optical disc-making lines, with a total disc capacity of a staggering 4.8 billion discs per year. Most production lines are interchangeable, switching easily between audio CD, VCD, DVD, and even CD-R or DVD-R production.

Unfortunately, a considerable amount of China's production is destined for export. In 2005, infringing product from China was found in nearly every major market in the world, including Germany, Italy, Australia, Norway, Belgium, Canada, Mexico,² the United States, Russia, the United Kingdom, the Netherlands, Israel, Paraguay, Lithuania, Singapore, Taiwan, the Philippines, Indonesia, Vietnam, Hong Kong, Malaysia, Thailand, Chile, and South Africa. Known shipments and seizures around the world are only the tip of the iceberg of the total exports of pirate optical discs from China. That China's factories have once again returned to large-scale exporting, after enforcement efforts in the late 1990s largely eradicated such pirate exports, is extremely disappointing

- 2. Internet piracy is growing rapidly in China. China has over 100 million internet users and 600,000 websites, only 8,000 of which were legally registered. Many websites offer the unauthorized downloading of music files, some for a financial charge, others for free. Certain China-based ISPs have become online "warehouses" for international pirate syndicates. Many of the legal deficiencies that enable physical piracy to flourish in China plague the on-line environment as well.*

The Internet penetration rate per capita and per household in China is still relatively small. However, the sheer numbers of broadband lines (reported to be 35 million as of September 2005), and the rapid rise of mobile applications, makes China one of the world's largest potential markets in terms of digital delivery of copyright content, and unfortunately, one of the world's largest emerging digital piracy problems. The Chinese publication "Economic Daily" reported that as of the end of 2005, 64 million Chinese accessed the Internet via broadband connections.

Hundreds of websites emanating from China now offer streams, downloads or links to unauthorized files of copyright materials (music, films, software, and books). Disturbingly, there are many Bit Torrent (BT) sites based in China now (BT is a recent P2P architecture which allows for faster file sharing due to the way users cooperate in uploading and downloading pirate content simultaneously). There are at least four "eMule/eDonkey" servers; at least seven specialized "MP3 search engines" which offer deep links to thousands of infringing song files for instant downloads or streaming; and at

² The Mexican Association of Gift Producers (AMFAR) reported that during 2005 holidays, nearly 80% of traded merchandise was imported from China through illegal means. *AMFAR: 80% of Chinese merchandise, illegal*, Corporate Mexico, January 18, 2006.

least eight China-based peer-to-peer (P2P) services (including Kuro China, whose Taiwanese affiliate has been found guilty in a criminal court in Taiwan).

The largest MP3 search engine is Baidu, the subject of two civil lawsuits in 2005; it lost one in September 2005 but has appealed.³ Baidu, as well as Yahoo!CN provide independent MP3 search functionality that produces indexes, and even deep links to, infringing files, thereby directly inducing and facilitating the misappropriation of American intellectual property. Senator Hatch has written to the Chinese Ambassador expressing his great concern that the Chinese Government would permit these activities to take place. To the best of our knowledge, he has not had a response, and this erosion of a promising digital marketplace continues.

Most of the pirate websites in China generate income through advertising, so they are profit-making ventures even though copyrighted materials are provided for free. At least three of the P2P services (including Kuro China) charge subscription fees. Unfortunately, the availability and use of these services, spurred by the rapid growth of broadband technologies in China, indicate that Internet piracy will be one of the greatest challenges industry and the Chinese Government must face.

Most unfortunately, enforcement against Internet piracy in China in 2005 was made more difficult by recent Chinese government decisions. In 2003 and 2004, thousands of “takedown” notices were sent by the recording industry to Chinese ISPs and content providers, and the takedown rate of these ISPs was relatively high.⁴ However, the April 2005 “Administrative Measures on Protecting Copyright on the Internet made such takedowns more difficult and compliance by ISPs fell precipitously in 2005.”⁵ The Administrative Measures appear not to allow e-mail notices and require that the notices include, for each infringing site, evidence of all infringements and proof of copyright ownership for each book, song or film infringed, among other things. The ISPs thus ignored notices that do not meet this unrealistically burdensome standard.⁶

As discussed below, the State Council is expected soon to issue new Internet regulations which would reportedly replace these Administrative Measures. The most recent draft would lessen the notice requirements. However, there are other concerns with the draft Regulations which need to be addressed prior to its issuance (including provisions on protection of technical protection measures, the scope of limitations on liability of ISPs, and the form of the notices to be sent to ISPs).

³ On September 16, 2005, the People's Court of Haidian District in Beijing reportedly ordered Baidu to pay RMB68,000 (US\$8,400) to mainland music company Shanghai Busheng Music Culture Media for unauthorized downloads of 46 songs. Baidu has reportedly appealed the ruling.

⁴ The recording industry achieved takedowns of three China-based servers, of at least seven international sites (Supermusic, Crazymp3, 21century-mp3, Mp3explosion, Easym3s, Realalbums, and Finestmp3s), infringing music files hosted on large Chinese portals like Wanwa, Hitmusic, Sohu, and 9sky (9sky has since become a licensed music site, as have four other sites), and 17 “eDonkey” servers based in China.

⁵ From September to November 2005, the takedown rate by ISPs was as low as 25%.

⁶ Administrative Measures on Protecting Copyright on the Internet, issued by the National Copyright Administration of China (NCAC) and the Ministry of Information Industry (MII), effective April 30, 2005.

Record Industry Takedown Rate of Suspected Infringing Websites in China			
	Number of notices	Number of sites	Takedown rate
2003	1320	2509	29%
2004	2632	7170	61%
2005	1778	4711	40%

Internet piracy in China is also infecting neighboring markets. For example, of 154 pirate websites found in Taiwan in 2002, the recording industry in Taiwan found that 102 (66%) were located in China. In 2005, the number of pirate websites in Taiwan grew to 469, of which 393 were reported to be located in China, or almost 84%.

3. *On top of the blatant piracy of our products, the record industry faces severe restrictions its ability to do business in China. Frankly speaking, it will be very difficult to ever significantly reduce piracy in China if the Chinese will not let our companies expand their ability to sell legitimate products to Chinese consumers. China must abolish these restrictions.*

The Chinese Government does not allow foreign sound recording producers, motion picture companies (for theatrical and home video, DVD, etc. distribution), or entertainment software publishers to enter the Chinese market except as a partner in a minority-share (up to 49%) joint venture with a Chinese company.

Record companies are prevented from developing talent in China and from getting legitimate product quickly to market. The fact that 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 their products makes it extraordinarily difficult for legitimate companies to participate effectively. U.S. record companies are skilled at and desirous of developing, creating, producing, distributing and promoting sound recordings worldwide.⁷ The universal experience of nations in which the international record companies do business is that local artists have expanded opportunities to have their music recorded and distributed widely. The in-country presence of U.S. companies also has brought jobs and expertise in a wide variety of areas. China should permit U.S. (and other foreign) sound recording producers to engage in:

- the integrated production, publishing and marketing of sound recordings.
- replicating, distributing, and retailing sound recordings (at present, these activities must be performed by other companies, which segments industry activity and drives up costs; even Chinese sound recording producers may not engage in these

⁷ The work of these companies encompasses a wide range of activities, including developing and investing in state of the art recording, mastering and engineering facilities; identifying and training talented singers, songwriters, composers, and musicians; promoting and advertising acts and recordings; establishing efficient and competitive distribution systems to take products from recording studio to replicator to wholesalers to retailer; and using global arrangements and distribution services to release products in markets outside the local market. U.S. record companies have long sought to bring these skills to China to develop and record Chinese artists for the Chinese market and for export.

activities, meaning all musicians, including Chinese, who record in China operate at a competitive disadvantage with those recording music outside China).

- production, publication and marketing their own recordings in China and direct importation of finished products (at present, a U.S. company must (1) license a Chinese company to produce the recordings in China or (2) import finished sound recording carriers (CDs) through the China National Publications Import and Export Control (CNPIEC)).

China should also permit foreign-owned record companies to release sound recordings in China.

The Criminal Enforcement System Remains Non-Deterrent

Despite China's promise in the JCCT to increase the number of criminal prosecutions for copyright piracy, little has yet been done. The current criminal system in China continues to operate ineffectively and without deterrence.⁸ Moreover, there are legal problems with respect to what acts constitute crimes, and what proof meets the criminal thresholds (including, *inter alia*, how to measure harm to meet the thresholds) that make it essentially impossible for copyright owners to obtain deterrent enforcement.

Further, there is not one Ministry that takes responsibility for criminal copyright enforcement, including the raid, arrest, seizure, and transfer of a case file for prosecution. Retailers, distributors, warehouse owners, and even pirate producers know that administrative raids will rarely be transferred for criminal prosecution, so they operate for the most part in the open without fear of effective enforcement action, much less effective criminal enforcement. Repeat offenders often pay insignificant administrative fines and disregard administrative orders to cease their infringing activities. Unless criminal prosecutions are brought, piracy will remain pervasive in China as mere administrative actions have long been proved to be without a deterrent effect on pirates and counterfeiters.

The U.S. copyright industry has repeatedly emphasized the importance of addressing the current absence of criminal prosecutions. While the Chinese government claims that such prosecutions have occurred, the U.S. copyright industry are aware of only a very few that have involved U.S. or other non-Chinese works. One of these cases was the infamous *Guthrie* case (involving a large DVD wholesale piracy ring run by a citizen of the United States). While this case did involve piracy of U.S. product, it is dwarfed by comparison

⁸ A fundamental issue remains that copyright piracy is still viewed by many in China as a problem to be dealt with administratively rather than in the criminal courts. Administrative enforcement of copyright has been under the auspices of the National Copyright Administration of China (NCA), which is neither properly equipped nor staffed with the resources or personnel to address the large-scale piracy problem in China. The failure to have any one agency in charge, which has the wherewithal to do the job of achieving deterrent enforcement, has led to *ad hoc* approaches to enforcement.

with the organized criminal activities conducted by Chinese citizens, who are rarely prosecuted for their crimes.⁹

China's Commitments in the US-China Joint Commission on Commerce and Trade—the "JCCT"

In meetings of the US-China Joint Commission on Commerce and Trade – the JCCT – in April 2004 and July 2005, China made a number of potentially important commitments to improve intellectual property enforcement for our industry, but so far China's implementation of these commitments has been lacking.

Perhaps most importantly, China committed in April 2004 to "significantly reduce IPR infringement levels". Under any measure, this clearly has not happened. The legitimate market, while it has improved somewhat, remains under siege. Piracy of sound recordings remains at an astounding 85%.

In addition, China agreed to

- Increase penalties for IPR violations by taking the following actions by the end of 2004:

- Subject a greater range of IPR violations to criminal investigation and criminal penalties.

- Apply criminal sanctions to the import, export, storage and distribution of pirated and counterfeited products.

- Apply criminal sanctions to on-line piracy.

- Crack down on violators by:

- Conducting nation-wide enforcement actions against piracy and counterfeiting, stopping the production, sale and trade of infringing products, and punishing violators.

- Increasing customs enforcement action against the import and export of infringing products and making it easier for rights-holders to secure effective enforcement at the border.

- Improve protection of electronic data by:

- Ratifying and implementing the World Intellectual Property Organization (WIPO) Internet Treaties as soon as possible.

- Extending an existing ban on the use of pirated software in central government and provincial agencies to include local governments.

⁹ *In re Randolph Hobson GUTHRIE III, Abram Cody THRUSH, WU Dong and WU Shibiao* (Shanghai No. 2 Intermediate Court, April 19, 2005).

Our Recommendation

China's current reliance on administrative inspections, seizures and modest fines does not work. China's criminal enforcement authorities must become actively involved in the fight against piracy in China. Unless this occurs, we foresee matters either staying the same or become even worse.

The US Government—our Executive Branch and the Congress—has been increasing pressure on China toward this end. We are extremely grateful for the help that the U.S. Government—both the Executive Branch and the Congress—is providing us. This hearing helps in this regard. The U.S. Government and U.S. industry must continue to insist that China fully implement the commitments it made in the WTO and in the JCCT over the past two years—especially to significantly reduce piracy. Our industry is working intensively with the Office of the U.S. Trade Representative to prepare the necessary elements of a possible WTO legal complaint against China, but of course we hope that the Chinese Government will quickly take steps to address the inadequacies of the current flawed system such that litigation will not be necessary.

Russia: the Next China?

As serious as problems are in China, and they are serious indeed, the challenges we face in protecting our intellectual property in Russia are even more daunting. Lawlessness, physical danger, and corruption are part of the daily challenges we face in trying to protect our rights in Russia. These types of problems are even more prevalent in Russia than in China.

Russia is one of the largest producers and exporters of pirated CDs and other copyrighted products in the world. In fact, the statistics demonstrate a dramatic increase in music theft, certainly not a crackdown.

- There are now 47 optical disc replication plants in Russia, most of which are involved in piracy. Five plants would be sufficient to meet the needs of the legitimate Russian market. As a result of that excess capacity, Russia has become the world's largest exporter of pirated music.
- At least 9 of these production plants are located on so-called "Russian State Restricted Access Regime Enterprises" in which the Russian Government itself is the owner of the premises. Local law enforcement authorities are not permitted access to these facilities.
- Russia is now home to some of the world's only Internet-based pirate *pay* download services – including a particularly notorious one known as "allofmp3.com."

The case of allofmp3.com helps illustrate the music industry's frustration. Through its online services based in Russia, allofmp3.com sells music to anyone in the world willing to pay ten cents a song. But allofmp3.com has not secured the rights to do so – and doesn't bother to pay the people who wrote and own the songs being sold. There should

be no question about the law – at the very least allofmp3.com is violating the reproduction rights afforded by Russian Copyright Law and Criminal Code, and the laws of the countries where the songs are being downloaded. But our industry's requests for legal action against allofmp3.com have been routinely denied by Russian prosecutors.

What Should Be Done?

We need to change the political calculus so that failure to control piracy has clear ramifications for the Russian Government – ramifications that outweigh the costs associated with stopping piracy. Specifically:

(1) USTR should reexamine Russia's eligibility to participate in the Generalized System of Preferences until it has satisfactorily protected intellectual property from theft. It is wrong that U.S. taxpayers should, in effect, be helping to finance Russian exports to the U.S. while the interests of U.S. intellectual property owners are being systematically undermined. The United States needs to point out how failure to address copyright piracy will impede Russia's goals, whether such goals relate to attracting foreign investment, joining the WTO, or other matters.

(2) We must learn from the China experience. Congress should insist upon demonstrated and sustainable reform before supporting Russia's accession to the WTO. By every measure, the steps taken before China was admitted to WTO have failed America's inventors and creators. The U.S. should ensure that relevant legal and enforcement measures are in place and implemented before we accept Russia into the WTO. WTO accession is not a political prize -- it represents a commitment to abide by international rules. The WTO institution and global confidence in world trade rules is quickly undermined when WTO parties openly mock trade discipline.

Let's face it – today Congress has some bilateral leverage because Russia wants to enter WTO. Once they are in, the leverage diminishes significantly, as we have seen with China. One aspect of Russia's accession to the WTO, known as granting them "Permanent Normal Trade Relations" or "PNTR" must be approved by Congress. We urge Congress to inform our Executive Branch that it will not approve PNTR unless and until Russia acts to significantly clean up its copyright piracy mess.

Conclusion

Copyright piracy in China—and in Russia—remains rampant. Much more needs to be done by each of these countries. Our industry urges the United States—and the rest of the international trading community—to bring greater pressure on China and Russia to combat much more effectively the rampant piracy in their countries. This must not be allowed to continue. It has already gone on for far too long.