

CHINA'S INTELLECTUAL PROPERTY RIGHTS AND INDIGENOUS INNOVATION POLICY

HEARING

BEFORE THE

U.S.-CHINA ECONOMIC AND SECURITY
REVIEW COMMISSION

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

—————
MAY 4, 2011
—————

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UNITED STATES-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

WASHINGTON : 2011

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

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The Commission was created on October 30, 2000 by the Floyd D. Spence National Defense Authorization Act for 2001 § 1238, Public Law No. 106-398, 114 STAT. 1654A-334 (2000) (codified at 22 U.S.C. § 7002 (2001)), as amended by the Treasury and General Government Appropriations Act for 2002 § 645 (regarding employment status of staff) & § 648 (regarding changing annual report due date from March to June), Public Law No. 107-67, 115 STAT. 514 (Nov. 12, 2001); as amended by Division P of the "Consolidated Appropriations Resolution, 2003," Pub L. No. 108-7 (Feb. 20, 2003) (regarding Commission name change, terms of Commissioners, and responsibilities of Commission); as amended by Public Law No. 109-108 (H.R. 2862) (Nov. 22, 2005) (regarding responsibilities of Commission and applicability of FACA); as amended by Division J of the "Consolidated Appropriations Act, 2008," Public Law No. 110-161 (December 26, 2007) (regarding responsibilities of the Commission, and changing the Annual Report due date from June to December).

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U.S.-CHINA ECONOMIC & SECURITY REVIEW COMMISSION

WILLIAM A. REINSCH, CHAIRMAN
DANIEL M. SLANE, VICE CHAIRMAN

June 17, 2011

The Honorable Daniel Inouye
President Pro Tempore of the Senate, Washington, D.C. 20510
The Honorable John A. Boehner
Speaker of the House of Representatives, Washington, D.C. 20515

DEAR SENATOR INOUYE AND SPEAKER BOEHNER:

We are pleased to notify you of our May 4, 2011 public hearing on "*China's Intellectual Property Rights and Indigenous Innovation Policy*." The Floyd D. Spence National Defense Authorization Act (amended by Pub. L. No. 109-108, section 635(a)) provides the basis for this hearing.

At the hearing, the Commissioners heard from the following witnesses: Senator Slade Gorton, Mr. Michael Schlesinger, Mr. Ken Wasch, Ms. Thea Lee, and Mr. Alan Wm. Wolff. The subjects covered included China's policies regarding intellectual property rights and indigenous innovation, and the implications of such policies for the United States.

We note that the full transcript of the hearing will be posted to the Commission's website when completed. The prepared statements and supporting documents submitted by the participants are now posted on the Commission's website at www.uscc.gov. Members and the staff of the Commission are available to provide more detailed briefings. We hope these materials will be helpful to the Congress as it continues its assessment of U.S.-China relations and their impact on U.S. security.

The Commission will examine in greater depth these issues, and the other issues enumerated in its statutory mandate, in its 2011 Annual Report that will be submitted to Congress in November 2011. Should you have any questions regarding this hearing or any other issue related to China, please do not hesitate to have your staff contact our Congressional Liaison, Jonathan Weston, at 202-624-1487 or jweston@uscc.gov.

Sincerely yours,

Handwritten signature of William A. Reinsch in black ink.

William A. Reinsch
Chairman

Handwritten signature of Daniel M. Slane in black ink.

Daniel M. Slane
Vice Chairman

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CHINA'S INTELLECTUAL PROPERTY RIGHTS AND INDIGENOUS INNOVATION POLICY

WEDNESDAY, MAY 4, 2011

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION
Washington, DC

The Commission met in Room 485, Russell Senate Office Building at 8:33 a.m., Chairman William A. Reinsch and Commissioners C. Richard D'Amato and Dennis C. Shea (Hearing Co-Chairs), presiding.

OPENING STATEMENT OF COMMISSIONER C. RICHARD D'AMATO HEARING CO-CHAIR

HEARING CO-CHAIR D'AMATO: Good morning and welcome. The Commission will come to order.

Today's hearing of the U.S.-China Commission focuses on two broad areas in the U.S.-China relationship: the treatment of intellectual property rights, including business software, computers, Internet streaming, recent WTO actions brought by the U.S. against China in this area; and second, the Chinese policy of indigenous innovation, so-called ININ, and its wide-ranging implications for our economic and strategic relationship.

The question is, where do we stand on these matters ten years after China's accession to the WTO and assumptions of obligations in WTO, and the U.S. granting China Permanent Most Favored Nation treatment?

We have excellent witnesses to deal with the range of issues and a number of reports have recently been released by the administration, including the USTR, the International Trade Commission, ITC, and by business groups, such as the American Chamber of Commerce, AmCham in China, which is visiting Washington this week, and the International Intellectual Property Alliance, IIPA, in which we can examine the scorecard

of progress, the promise which remains, and raise the question of how much progress we can now expect?

Do we need new tools to enforce the principles of open competition, unfettered market access, transparency, and fair dealing for our businesses in many key sectors?

Are the remedies available under the WTO adequate to help bring China into compliance with its obligations?

And is China's growth of economic, political and military power fueling a newly virulent nationalism in that country which is overwhelming the enforcement of the principles China agreed to in its accession to the WTO?

What kind of additional recommendations for legislative action or executive action to deal with China's behavior in these areas appear necessary?

We have asked today's witnesses to consider what remedies they would recommend to the Congress to address the problems which have surfaced in these two broad areas over the last few years.

The central mandate of this Commission is to make such recommendations we deem advisable to the Congress on an annual basis, and that's our reason for living.

There has recently been and will continue in the upcoming few months intense focus by the administration in bilateral meetings with the Chinese, so-called S&ED talks, by business through AmCham and other industry groups, and there have been new studies that are coming in on the quantification of the impact on the U.S. economy and our job situation, China's performance on IPR, and our competitive position.

And at this point, I would like to ask consent for the Commission to leave the hearing record open for at least six weeks to allow the inclusion of supplementary materials including, for example, ITC Report No. 2, which is not yet quite available but is very important and includes job and economic impacts of IPR violations by the Chinese, and other materials that will be associated with the bilateral S&ED talks at the highest level in a couple of weeks, and so that any additional materials or testimony that the Commission wishes to take can be included in the record of today's hearing. And I ask unanimous consent that that be included as a request.

Our hope is that a consensus will emerge to enhance U.S. competitiveness, protect and build new jobs in our industries, and help bring China into compliance with its obligations.

The Senate Majority Leader, Senator Reid, has just led what I believe was the largest U.S. Senate delegation in memory to China and had meetings at the highest level. The Chinese will be coming here in a few days in their regularly scheduled bilateral meetings.

So this hearing is very timely on these important matters, and it is our hope that the results of the hearing will help to inform and guide the debate ongoing on the U.S.-China relationship in these important areas, and I'd like to turn over the podium at this point to my co-chairman for the hearing,

Commission Dennis Shea.
[The written statement follows:]

**PREPARED STATEMENT OF C. RICHARD D'AMATO
HEARING CO-CHAIR**

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OPENING STATEMENT OF COMMISSIONER DENNIS C. SHEA HEARING CO-CHAIR

HEARING CO-CHAIR SHEA: Good morning, and thank you, everyone, for coming this morning.

A brief word about the China Commission and this hearing. This is the sixth of eight hearings we're holding this year. What we learn today will help us in the preparation of our annual report, which is published in November and usually runs about 300 pages.

A transcript will be made of today's hearing as well, and that will be published on our Web site, uscc.gov. This hearing is also available as an audio feed.

The Commission was established by Congress in 2000 to serve a watchdog role. The Commission monitors China's compliance with the promises it made in 2001 as part of its application for membership in the World Trade Organization.

It also monitors other aspects of the U.S.-China relationship, such as national security, cybersecurity, energy, the environment, and foreign relations.

In addition to intellectual property issues, we are going to take a look today at a new development in China's industrial policy, or relatively new development: its efforts to foster innovation within China's technology sector, or indigenous innovation, as it has come to be known.

That may be a laudable goal, but China seeks to accomplish this by requiring forced technology transfer from foreign companies, and by unfairly, at times, favoring domestic companies over foreign competitors in government procurement.

The U.S. business community, as well as the administration, has identified this policy or set of policies as a serious threat to our economy.

Our first speaker today is Slade Gorton. He is the former Republican Senator from Washington State. Senator Gorton served in the Senate for 18 years. He served on a number of committees, including Appropriations, Budget, Commerce, Science and Transportation, Energy and Natural Resources, I believe Banking. So I think that's the definition of well-rounded.

As someone who used to work in the Senate, I know that when Senator Gorton came to the floor to make a statement, he was always going to make a statement that was serious, thoughtful, well-reasoned, and someone you want to pay attention to because he knows what he's talking about.

That was my experience and the experience of all of us who worked at the Senate at the time. So I know you're supposed to come on, Senator Gorton, at 8:45. It's five minutes early, but you're here, so why don't we start.

We very much appreciate your being here.

[The written statement follows:]

PREPARED STATEMENT OF COMMISSIONER DENNIS C. SHEA HEARING CO-CHAIR

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PANEL I: CONGRESSIONAL PERSPECTIVES

STATEMENT OF SLADE GORTON A FORMER U.S. SENATOR FROM THE STATE OF WASHINGTON

SENATOR GORTON: Mr. Chairman and members of the Commission, a minor annoyance of having sat for 18 years on your side of the dias, including on occasion in this room, was to listen to people read a written statement, which I already had, with the implicit understanding that I was illiterate.

[Laughter.]

SENATOR GORTON: So I do not intend to insult you in that fashion. You have the written statement. You can ask any questions you wish. I will just share a few thoughts with you, one of which occurred last evening after I had completed this written statement.

I got an e-mail from Richard Ellings, who had been my Legislative Assistant for Foreign Policy in my first term in the Senate, and who thereafter founded and has headed ever since the National Bureau of Asian Research in Seattle, perhaps the premier research organization in the country for that subject.

He had just been with an unnamed but fairly high-ranking officer at Microsoft who was complaining about a new misuse of intellectual property in Microsoft software, that now there were a significant number of customers in the United States who were purchasing pirated software from Chinese companies rather than purchasing the same thing under license from Microsoft itself, something relatively new, I gather, in Microsoft's experience, but another reason for the urgency of a hearing of this nature.

When I was in the Senate, you know, more than ten years ago, and in time before that, the problem of piracy not just from China but primarily from China was a very real one. I haven't, as an amateur, discerned any particular change or improvement in those policies in the decade since that time, and so the idea that I am presenting to you has been kicking around in my own mind for some time.

I think perhaps the heart of the reason that we have been so unsuccessful is that there has been no real incentive on the part of either the government of the People's Republic of China or of its many, many private enterprises to follow appropriate rules on intellectual property of all types.

As a matter of fact, all the incentives are in the other direction. There's no real penalty for piracy, and there's a great deal of profit to be made by it.

So it does seem to me that the search for a better policy here in the United States ought to be directed at providing an incentive inside of China

itself to abide by appropriate international rules.

The rules themselves are of no great importance if they aren't followed. And the proposal that Leo Hindery, a friend of mine, first made some months ago after we had had considerable discussions on the subject is what I present to you here today.

It seems to me that if we imposed a punitive tariff or duty on all the goods coming from China in an amount considerably in excess of the value of the pirated intellectual property, whether patent infringement, copyrights, trademarks, and the like, and to a certain extent what we consider to be unfair indigenous information, my own inclination is that the piracy would decline very rapidly and that we would be successful.

The goal of such a tariff policy would not be to collect money for the Treasury, though for a time some would come in; it would be to incentivize the Chinese--and I do think this probably ought to apply to other countries in which the degree of piracy is a serious violation--the goal of the policy would be to incentivize that piracy to be dramatically lowered.

Now, it does present a number of problems, of course. The first is how do you figure out how much it is? What is the base for it? I would do it on an annual basis. I would set just arbitrarily the tariff at 150 percent of whatever that figure was. I gather just from your introductory statement that you are looking for a study at the present time that will give us better figures on exactly the nature of the problem.

Bluntly, I'd make it rather difficult for the President to waive it. We have an awful lot of presidential waivers in all of our administrations of various of our trade rules, but that's the first problem.

And the second problem, of course, is it obviously violates various international trade agreements, but as you've pointed out, the Chinese have been doing that themselves all along, and under those rules, many of those rules, it would probably allow retaliatory tariffs.

But a country with a \$200 billion plus trade surplus with the United States is never going to win a tit-to-tat exchange of tariffs or trade restrictions with us under those circumstances.

So that's it. That's the relatively simple proposal. It requires I think a degree of smoothing out, but I just get back to the fundamental proposition: we have been unsuccessful in protecting our intellectual property because we have not created any real incentives on the part of the pirating organizations and countries to stop engaging in that activity, and I think overwhelmingly we need to find a way in which it is made in their interest to do so, and this is a suggestion for that proposition.

You all have the staff, I think, and you all have the expertise, I think, to make serious recommendations, and to flesh it out to a point at which I think it could work very promptly, very successfully, and rather quickly.

[The statement follows:]

**PREPARED STATEMENT OF THOMAS SLADE GORTON
A FORMER U.S. SENATOR FROM THE STATE OF WASHINGTON
OF COUNSEL, K&L GATES, SEATTLE, WASHINGTON**

U. S. corporations consistently lose billions of dollars in intellectual property every year due to patent, copyright and trademark piracy and infringement, together with the impacts of Chinese indigenous innovation policies. All in all, not surprisingly, China is the greatest offender.

How to measure these losses presents huge challenges, but let's start with a study by the International Data Corporation. It estimates China's software piracy rate in 2009 to have been 79%, with a value of about \$7.6 billion. Another study found direct losses to copyright industries in 2005 to have been on the order of \$58 billion in lost output and accompanying lost jobs, earnings and tax revenues. A reasonable assumption might be that China accounts for about 25% of this number, or \$14 billion.

We can, of course, take for granted that these losses have been matters of great concern to several American administrations and therefore the subject of constant negotiations, the only common feature of which is a lack of success.

And it is, of course, the resulting frustration, coupled with the huge imbalance in our bilateral trade with China, that has spawned retaliatory schemes like Senator Schumer's proposal to sanction China's artificial valuation of its currency.

But while I believe that the senator's ideas stem from an appropriate concern over those trade imbalances and unfairness, I do not feel that his approach is likely to succeed.

We should recognize that the control of a nation's own currency to the maximum extent possible is in its clear vital sovereign national interest. One need only reflect on the reaction here in the United States to any Chinese attempt to order us to raise interest rates so as to strengthen the dollar to understand and even to sympathize with China's view on the same subject.

At the same time, however, the protection of our national intellectual property is clearly a vital national sovereign interest of the United States. We have the sovereign right to adjust our trade policies so as to protect that interest. Unfair trade policies should be met by trade sanctions.

Thus, our protection of that intellectual property having been so ineffectual, I submit to you once again an idea first brought to your attention several months ago by my friend, Leo Hindery.

The United States should impose on all imports from China a goods tariff designed to produce each year 150% of the losses of US intellectual property in the previous year. The GAO should determine that number, and the policy should continue for as long as that piracy exceeds an appropriate share of US exports to China, say 10%. The policy should be universal, that is to say it should apply equally to all other trading partners the piracy in which exceeds a certain level. The president should be given some, but very little, authority to waive the policy, in whole or in part, upon a determination that it is in our clear national interest to do so.

The goal, of course, is not to produce revenue for the federal treasury, but to reduce intellectual property piracy, and any degree of presidential discretion should be directed at rewarding success in that endeavor.

It will be objected that this policy violates a number of our international trade agreements, as it does, thus allowing retaliatory trade sanctions against US exports to China, though it should be pointed out that Chinese piracy is so extensive as to constitute such violations as well.

True as that right of retaliation is, and perhaps effective in the case of any trading partner with whom we have a trade surplus, it is clear that a China with a \$273 billion surplus (2010) with the United States can only lose, and lose big, by any set of tit for tat retaliatory trade sanctions with the United States.

This general proposal does not, of course, answer all relevant questions. Do we treat patent, copyright and trademark piracy and violations in the same fashion? And what about government indigenous innovation policies? To what extent do they differ from trade secret sharing in the normal course of corporate negotiations? And how do we fairly and accurately determine the losses resulting from IP piracy?

Each of these questions is food for examination by this Commission, but the time for decisive action has already passed and we should not wait on the results of future fruitless negotiations.

PANEL I: Discussion, Questions and Answers

HEARING CO-CHAIR SHEA: Well, thank you very much, Senator. Are you available for a few questions?

SENATOR GORTON: Oh, I'm here.

HEARING CO-CHAIR SHEA: We're a group that likes to ask a lot of questions.

I know as a Senator, voted in favor of Permanent Normal Trade Relations for China and for China's--

SENATOR GORTON: And it's one vote that I rather regret.

HEARING CO-CHAIR SHEA: That's what I was going to ask you. I was wondering what was your thought process when you voted for it and why do you regret it?

SENATOR GORTON: Well, I guess I have to have two reasons for having voted for it. One was it was the overwhelming desire of those of my constituents who were involved in international trade. It was a constituent-related vote. And two, I was at least willing to begin to accept the proposition that bringing China within that range of countries would have a positive impact on its behavior.

To the extent that the vote was cast on that basis, it was certainly wrongly cast because it has not done so, but I think the fundamental answer to your question is ten years have gone by, and the promised good results of that vote have not taken place.

HEARING CO-CHAIR SHEA: Thank you.

Commissioner Mulloy.

COMMISSIONER MULLOY: Thank you, Senator, for being here.

I was very happy to be on the Senate Banking Committee staff when you served on that committee. When China came into the WTO, we committed to give them permanent MFN. If China did not have MFN, the average tariff on a Chinese good into the country would be about 42 percent. With MFN, it's probably 2.5 percent.

So we've lived up to that commitment that we've given in the WTO bringing China in. That set that low tariff way. The TRIPS, the protection of intellectual property rights, is part of the WTO agreement which they pledged to follow. And as we've known and as people have testified through the years, ten years now, they are not protecting intellectual property rights. There's theft on a massive scale going on.

Now some would say that we have to bring our case in the WTO, and spend been two or three years litigating it, and maybe getting something out of it, maybe not. You seem to say forget that, find out how much this is costing us, and put the tariff on, and that will give them an incentive to comply.

How would you explain to your former Senate colleagues, why we should use that rather than to go through the WTO dispute settlement?

SENATOR GORTON: For exactly the reasons that you set out in your question. It's a long and drawn-out process. Even a successful end to that process is probably not likely to give us the ability to retaliate in an effective fashion and because we've waited a very, very long time, as I point out in this statement.

I had a great deal of sympathy with Senator Schumer's view that one unfair aspect of our trade with China was its setting of the valuation on its currency, and yet I don't think those two things are directly related, and I believe, because I believe in the United States, that there can't be a more central sovereign interest than the control of one's own currency, but on the other hand, it's in our very significant vital sovereign interest to see to it that the intellectual property of Americans is respected and paid for.

So it does seem to me that in this case, because the price is so high, because the offenses have gone on for so long, that direct action is likely to be much more effective much more quickly and much more decisively than the indirect action of following rules the Chinese have not followed and aren't going to follow unless they're given a great incentive to do so.

COMMISSIONER MULLOY: Thank you, Senator.

HEARING CO-CHAIR SHEA: Commissioner Wessel.

COMMISSIONER WESSEL: Senator, thank you for being here this morning, and I want to echo what Commissioner Shea said about your performance in the Senate when you were a member. I think that carries over to your statement this morning in terms of providing insightful comments, and, quite frankly, I'd say somewhat courageous comments in the sense that we have all been grappling, America, this Commission, policy makers on the Hill, in terms of how to deal with the intellectual property theft, counterfeits, piracy, all that goes on, which is really sapping our innovative strength, which is what we have as a nation.

Coming from the Pacific Northwest, which is known primarily politically as the heart of the free trade area, how do you square what you've said with the history of that area, what you and others from that area have done, admirably, over the time?

Are we now at a tipping point where the theory and the reality aren't mixing, and we have to, as you're pointing out, try new things?

SENATOR GORTON: Since I was a young man, two or three generations ago and just starting in my career, I have been a very firmly convinced advocate of free trade and have had no problem during my political career, both in the state and here in representing the state of Washington, in doing so.

But no principle is absolutely without exception, and following a particular rigidly and without regard to its consequences is not necessarily always to one's advantage.

I have made the suggestion in some sense because I think that its execution would lead to freer trade. I want to emphasize once again that it's not a desire to bring in some tens of billions of dollars to help deal with

a trillion-and-a-half dollar deficit.

The idea is to cause the Chinese to obey the undertakings that they've already made and to create a system of much freer trade between China and the United States than that which exists at the present time.

COMMISSIONER WESSEL: Thank you, and I agree. The reality is now coming, and is more apparent to many.

You mentioned earlier that you had talked to a Microsoft official. Boeing, Tektronix, a number of major international firms are headquartered in the Northwest. Have you talked through with them about this idea? Has their frustration, and I know they have a lot of skin in the game, so to say, but are you getting any private reactions about your idea?

SENATOR GORTON: One of the great advantages of being on this side of the table and having been in private practice for a considerable period of time is that you don't have to go through that kind of opportunity.

My guess is, and I'm sure this would have been true, say, ten years ago when I was last here, that those companies would have publicly said no, they don't think this is a very good idea because they are doing business under present rules with China, and probably sort of under the table where they'd say go ahead, go ahead with it, it would be great as long as our fingerprints aren't on it.

But, no, I'll have to say this is just simply a result of my own thinking, and this is perhaps an appropriate point at which to say I'm here on my own, I'm not here from my law firm, K&L Gates.

COMMISSIONER WESSEL: We appreciate your being here this morning, your long history of activism, knowledge on these issues, and, as you pointed out, your voting history makes your idea that much more important in the sense of looking at new ways to address problems that have been plaguing us for many, many years.

Thank you.

SENATOR GORTON: Thank you.

HEARING CO-CHAIR SHEA: Commissioner Fiedler.

COMMISSIONER FIEDLER: Let me venture into some dangerous territory--politics--in the sense that during the PNTR fight, the business community was unified; now the business community is less unified and seeking their own interests, and those interests diverge and are different from other businesses' interests, which is, in my view, politically, among other reasons, why the tariff idea that Schumer had, Senator Schumer had, on the currency issue, which is--as you rightly point out--a huge issue, combined with the intellectual property has proven to be an impractical political tool.

Nobody seems to be willing to do what is easiest, easiest in terms of implementation, but the politics of it seem to be paralytic. And so the question becomes a more judgmental one, politically less expert, and how do we get people around to this notion? We're in a major recession, hopefully coming out of one. You would have thought that that would have

driven some of the politics of that. It doesn't seem to have.

What's your political judgment on why this is not happening?

SENATOR GORTON: Well, you're entirely correct. The status quo, especially when very, very large amounts of money are available, always has those who benefit from it, and clearly the importing industries and all of the kinds of consumer goods that come from China would object very much to anything that added hugely--

COMMISSIONER FIEDLER: Price.

SENATOR GORTON: --to the price of the goods that they have to sell in the United States. The problem is that's the exact point of it. In many cases, I think a tariff of this sort would switch those importing companies away from China and to a country whose businesses could supply those goods without facing that very, very large tariff.

But I guess my answer to your question or your political question is you're absolutely right. When there are a large number of groups arrayed on one side because of their own short-term interests, they are certainly going to have their spokespeople here in the Congress and should, in a free country, and I guess I can only say that I would hope that this problem has become serious enough so that a recommendation, say, from this Commission would be given serious consideration on the basis of a national interest.

It's the same hope I have about the deficit, that maybe the Gang of Six here is going to be able to cross party lines and do something about the most serious single problem that our country is faced with. In international trade, I think this is the most serious problem with which our country is faced, and we just have to say, well, we understand what the politics are, but we think for the interests of the country, this is something we need to do.

COMMISSIONER FIEDLER: Thank you very much.

HEARING CO-CHAIR SHEA: Commissioner D'Amato.

HEARING CO-CHAIR D'AMATO: Thank you very much, Commissioner Shea.

Pursuing the line that Commissioner Fiedler is talking about in politics, what I remember from the leadership of Senator Dole was that when politics became too difficult, you invoke baseball. You talk in terms of baseball. I remember, I think it was in terms of the WTO--it may have been something else--three strikes, you're out. Three strikes, you're out. Everybody understands that one.

So we just had a WTO case we've been pursuing for several years, since 2005, I think, on audiovisual products, won the case, won the appeal, gave the Chinese 14 months to comply with it, nothing happened in terms of compliance.

I think Senator Dole would say that's one strike, and after three strikes, you go to market access. And I think what your proposal is, is that reciprocal market access is the crown jewel, because what the Chinese really

want is access to our market.

So if you have a formula that, as you expressed, where our market is hostage to their performance in terms of complying with their obligations, that's something that they'll take very seriously, and I think that would be mutual market access, reciprocal market access, however you want to call it, I think is how I would characterize what you're suggesting in terms of a tariff based on what they're doing in terms of keeping us out of their market.

SENATOR GORTON: That is correct. I think you're at the heart of the issue. It's market access. Maybe there's another way of limiting that market access. I don't know what it is.

In unfree countries, they will often do it just by tying things up at the port for six months or a year before they're released. I don't think we could possibly get away with that. The losers from it would go to court and they'd win those court things.

We in the United States can only provide for the kind of controls we need through the law, and so this obviously can only take place if the Congress of the United States makes it a law.

HEARING CO-CHAIR D'AMATO: So my suggestion is to pick up those extra votes, put it in terms of Senator Dole's baseball illustration.

SENATOR GORTON: Well, that's right. I think we're up to about six strikes now myself.

HEARING CO-CHAIR D'AMATO: Thank you.

HEARING CO-CHAIR SHEA: Commissioner Slane.

VICE CHAIRMAN SLANE: Thank you, Senator, for taking the time.

My question is whether you have received any complaints from any officials at Boeing that you could share with us?

SENATOR GORTON: I have not. We don't represent Boeing, and with all that nice comment about Boeing being headquartered in Seattle, that ceased almost ten years ago. Commercial Aircraft Division is there, and they are important part of our economy, but I have no contact with the high-ranking officials in Boeing.

VICE CHAIRMAN SLANE: Thank you.

HEARING CO-CHAIR SHEA: Chairman Reinsch.

CHAIRMAN REINSCH: Thanks. Thanks for joining us, Senator. It's good to see you again.

I noticed in your written statement, at the end, you pointed out that the general proposal that you have leaves some questions unanswered, and then you proceeded to ask the questions which I think are very good questions. Have you thought about the answers to any of them yourself?

SENATOR GORTON: Well, let me take a look so I know exactly what it is that I wrote.

CHAIRMAN REINSCH: Well, they're how you measure? Do you treat patents, copyrights and trademarks the same? What do you do about, I guess, trade secret "voluntary"--quote-unquote--"voluntary" sharing?

SENATOR GORTON: I hope maybe you'll begin to get the answer to one of those questions later on in this hearing, and that is how do China's indigenous innovation policies relate to this? Should they be a part of the formula?

I guess my answer to the question is to the first three, patent, copyright, trademark piracy and violations, I suspect you can probably use the same formula for them. You need proper estimates and the like, but those are clear violations of clear rights.

The indigenous innovation policies of China are something else again. Ordinarily--we can go back to Boeing, for example--Boeing, very frequently, in order to make large aircraft sales to state airlines overseas in Europe and elsewhere, has to agree that a certain portion of, some portions of the aircraft are built in that country. And that, generally speaking, at least with a private company, seems to me to be a legitimate competitive opportunity. They do better than Airbus, and the purchasing country gets a portion of it.

But when it's a governmental requirement in China that you go beyond that and give up all your technology, as well, a number of companies are going to feel they have to do it in order to get the short-term business, and they're more interested perhaps in short-term than they are in long-term.

And I think there are clearly elements of that indigenous information policy in China that are highly unfair and can only be reacted to on a government-to-government level. But where that line is and how that's measured, I don't know. That's a part of the question I can't answer right now.

CHAIRMAN REINSCH: Thank you.

That's helpful. As you point out, this is something that were it to get any traction would need to be fleshed out, and I think it's worthwhile thinking about how best to flesh it out.

The other question is, as you note in your comments, that this would, the action you're recommending, would violate a number of our trade obligations, which you would, I think, argue are justified under the circumstances, which is fine.

Historically, we're a country that has made a big point of sustaining the multilateral trading system and contributing a lot to that maintenance of the system even though it was often at some cost. Are there consequences for the United States above and beyond the bilateral relationship, above and beyond any retaliation questions which you address, are there consequences for us and for the system if its biggest supporter for 60 years decides that it's going to undermine rather than reinforce it?

SENATOR GORTON: That's an excellent question, and it's not one I can answer unequivocally except to say that to analogize international trade rules to domestic law, these are not criminal violations. These are civil violations of agreements. And the agreements themselves set out what the consequences are, the retaliatory action the offended-against nation can take.

I think we have to go into this recognizing that those retaliatory actions are possible on the other side, and that's why I point out that there's a distinct difference in our using this kind of policy against an otherwise fair trading partner with whom we have roughly an equal import and export relationship or one in which we have a surplus. I would certainly not advise doing it in those circumstances.

But where the imbalance is as huge as it is in China, those retaliatory actions, as legal as they are, can't possibly be effective against our re-retaliation and the like, and I think it is perfectly appropriate simply to say we understand the consequences, we'll allow them to retaliate, but if they retaliate, they will be met dollar for dollar for that, and they're going to lose out. We don't want to be engaged in this activity. As soon as you start abiding by your obligations to us, they will end.

CHAIRMAN REINSCH: Thank you.

HEARING CO-CHAIR SHEA: This has been very interesting. We're going to have a second round of questions. There are a few others who have requested the opportunity to ask a question.

I just want to take the opportunity here just to flesh out your proposal. You say that the GAO should determine the number, meaning the value, of these stolen intellectual property, and the policy of imposing a tariff should continue for as long as the piracy exceeds an appropriate share of U.S. exports to China, say ten percent.

So I believe in 2010, we had \$92 billion worth of exports to China.

SENATOR GORTON: The figure I found on Google yesterday was 67, but--

HEARING CO-CHAIR SHEA: Okay. Between 67 and 92. So ten percent of that would be between six and \$9 billion. So you would say under your proposal if the GAO calculated that the previous year's, the value of the previous year's stolen intellectual property was between six and \$9 billion, then the tariff would not apply; is that correct?

SENATOR GORTON: Yes. I must say, Commissioner, I picked that ten percent out of thin air.

HEARING CO-CHAIR SHEA: I understand.

SENATOR GORTON: And I picked it on the basis of the \$67 billion figure that I found.

HEARING CO-CHAIR SHEA: You may be right.

SENATOR GORTON: In any event, the figure should be one that darn well is going to be effective when we start, and if that required it to be five percent or it could be 15 percent, it was picked, and it should be judged, on the basis that piracy exists everywhere. There's probably not--in Nicaragua, I imagine it's going on. But in most places in the world, it's going to be de minimis, and I wouldn't mean this to be something that deals with the ordinary, ordinary losses.

You're the U.S.-China Commission, of course, and China is the center point, the centerpiece of this kind of activity, and so that percent should be

at a point that clearly gets to China and maybe to any other country that we find that even though the total amount of trade is smaller, it's still a very, very serious problem.

But it shouldn't be one that affects our normal day-to-day trading relationships with countries that are dealing pretty fairly, doing as well as we are with them. So that percentage at this point is a guess.

HEARING CO-CHAIR SHEA: Right. Understood. Thank you.

Commissioner Wessel.

COMMISSIONER WESSEL: Thank you.

Senator, I am, like the others, trying to get deeper into this and understand there's a lot of work that needs to be done, although I do want to say--and Leo Hindery is a friend--so the fact that you are reaching across the aisle, so to say, and that this has some bipartisan basis I think is great.

As you look at this and as you talk about it further, I wanted to ask you to think about a couple of things.

SENATOR GORTON: Okay.

COMMISSIONER WESSEL: One of the issues of intellectual property that has begun to be a real problem for manufacturers is not just the theft of their own intellectual property but the impact of intellectual property theft by the Chinese on their own production.

I'll give you a specific example. A tire manufacturer found that the proprietary tire-making machines, the designs of those, the Chinese were trying to steal. So if it costs them, let's say, \$50 million to produce that machine, and the Chinese are able to steal the intellectual property and produce the same machine for \$3 million, then when those tires come back to the U.S., their cost of production is much lower.

That tire manufacturer doesn't have the ability of going at the direct import because it's not imbedded in that product, but it's part of the manufacturing process. It's called downstream dumping. The textile industry has found this problem where very high-tech laser cutting machines designs have been stolen.

So as you look at this, as you work further on it, I would urge you to look not just at the highlights of movies, music, software, copyright-based products, but look deeper into patents as well as the derivative costs, because that derivative cost is becoming a much more important disadvantage for the United States now in terms of the manufacturing processes, number one.

So I'm not looking for an answer, but for you to think about these as you work on your idea.

SENATOR GORTON: I thank you for that suggestion.

One of the reasons I asked to appear here and do something is so we can think about it more seriously because this isn't an absolutely perfected suggestion at this point, and I will do that. I hope you all will do that with the staffs and abilities that you have to get the information.

I would caution only one thing. Let's not analyze this to death.

COMMISSIONER WESSEL: Agree. Agree.

SENATOR GORTON: We've waited a long, long time now, and it seems to me that it is appropriate to begin to act on it even though we don't have every "i" dotted and every "t" crossed, and to begin on it. I think the very introduction in the Congress of bills of this sort, hearings on them, passage through one house, might itself begin to have a positive impact on China.

COMMISSIONER WESSEL: I agree completely. I would only urge that as we look at the IP issue, the question is we look at it very broadly, number one.

SENATOR GORTON: I fully agree with you on that.

COMMISSIONER WESSEL: And second of all, and as you identified the question of where the harm is being done, Congress passed--I believe it was 2001--what eventually became known as the Byrd amendment, which was where tariffs are paid for illegal actions, dumping, et cetera, that those parties who had been injured would receive the tariffs if, in fact, they were reinvesting in plant equipment, et cetera, meaning that the illegal actions of our trading partners are not going to so hobble our companies and competitors here that that puts them out of business.

The WTO, in what was generally viewed here in the U.S. as illegal or overreaching, ruled that the Byrd amendment was illegal.

As you look at this, I would urge also that you think about reinstating the Byrd amendment since we're already going over the edge, if you will, in WTO strictures, so that those entities that have been harmed here would actually have funds to be able to reinvest and regain their competitiveness if that has been damaged.

SENATOR GORTON: In fact, I have thought about that, and I deliberately did not include that in my written testimony. I don't mean to say that it ought to be considered, but it seemed to me that if you reimbursed the losing companies out of this tariff, they would be less interested in the policy itself.

Again, because I'm from Washington state, I think about Microsoft. If Microsoft said, well, we were damaged to the extent of \$20 billion last year, and we gave them even 15, the urgency on their part to end the practice would be much lessened, and so I fall against the Byrd amendment theory, not because it was found to be invalid, but because I think it would be less effective in having these companies really want us to get to the seed of the problem and to end it, and to have the intellectual property theft end rather than to be reimbursed in whole or in part for their intellectual property losses.

COMMISSIONER WESSEL: So you're saying that the compensation might limit their interests in addressing it?

SENATOR GORTON: Exactly.

COMMISSIONER WESSEL: Okay.

SENATOR GORTON: At least that's the thought process I went through.

COMMISSIONER WESSEL: Okay.

SENATOR GORTON: And that's why that proposal is not in this written statement.

COMMISSIONER WESSEL: Okay. I appreciate that. Thank you.

HEARING CO-CHAIR SHEA: We're a little bit over time, but if you could take one more question, Senator, we would appreciate it.

Commissioner Mulloy.

COMMISSIONER MULLOY: Thank you, Senator.

Since China joined the WTO in 2001, about ten years ago, we've had a cumulative \$2 trillion of trade deficits with China. Now, but people want to say don't worry because we're the innovative economy, and we're going to think up new ways to produce goods and still stay ahead of China.

I'm wondering, this issue that you and Leo Hindery raise, the theft of intellectual property and the massive scale, what impact is that having on our high-tech industries to innovate? Is that having an impact that is deleterious to their ability to do that?

SENATOR GORTON: Oh, I think it clearly does. If you can't be rewarded for your innovation or if those rewards are seriously undercut, in a competitive society like that, that reduces the incentive to go ahead. The idea of don't worry, we're always going to be more innovative than they are, is irrelevant to this issue. I hope we are. I believe we are, but I think we ought to get the rewards for that innovation and not allow them to be stolen from us.

COMMISSIONER MULLOY: So you think the theft of IPR does have an impact--

SENATOR GORTON: I do.

COMMISSIONER MULLOY: --on our ability to innovate?

SENATOR GORTON: I think it hurts us.

COMMISSIONER MULLOY: That's very helpful, Senator. Thank you so much.

HEARING CO-CHAIR SHEA: Well, Senator, we want to thank you very much for forwarding your proposal, preparing the written testimony and spending some time with us this morning. I hope you enjoyed the conversation. We certainly did.

SENATOR GORTON: Oh, I did very, very much.

HEARING CO-CHAIR SHEA: Some food for thought here.

SENATOR GORTON: It was a great time and invite me back any time.

HEARING CO-CHAIR SHEA: Thank you very much.

PANEL II: BUSINESS SOFTWARE

HEARING CO-CHAIR D'AMATO: Senator, we'll be in touch with you.

We'll move right to Panel II if the panelists are here. We'd like to welcome our witnesses for Panel II, which deals with the impact of China's treatment of intellectual property rights with an emphasis on business and

copyright software.

We have two respected authorities in this field:

Michael Schlesinger, an attorney of counsel to the firm of Greenberg Traurig. He also represents the IIPA, the International Intellectual Property Alliance, which is composed of business software and a number of trade associations in the copyright industries.

Second on our panel is Mr. Kenneth Wasch, an attorney and President of the Software & Information Industry Association, in Washington, the principal trade association of the software and information industries.

According to Michael Sax, President of the Association for Competitive Technology, we have reached the position of extremis vis-a-vis China in software, and that he warns that despite the opportunities in China, the obstacles to market access are almost insurmountable.

Mr. Sax says that Chinese don't buy software; they just steal it. He says other IP intensive sectors, like telecommunications, are almost totally closed off to foreigners. I think the Chinese market is dominated by three big Chinese telecom firms, and that Internet companies, such as Google, Yahoo and Facebook, have been hurt by Chinese censorship. China has a business software piracy rate of 79 percent.

USTR in its 2010 Special 301 Report notes that the level of IPR theft in China remains unacceptable. U.S. copyright industries face severe losses due to piracy in China.

The 301 Report says that China's IPR enforcement regime remains largely ineffective and non-deterrent, and widespread IPR infringement continues to affect products, brands, and technologies from a wide range of industries, including entertainment of all kinds, apparel, many consumer goods and information technology.

The IIPA, who Mr. Schlesinger represents, issued a report this past February--I think it was written by Mr. Schlesinger--citing the woefully inadequate Chinese administrative systems as a barrier to effective enforcement.

The IIPA commended the Obama administration for securing important IPR-related commitments from China during the December 2010 trade negotiations and during the State visit of President Hu Jintao to the U.S. in January.

Whether those commitments will be effectively implemented to deal with Internet infringements remains to be seen.

I'd like to point out to my colleagues that this IIPA report that's in your packets has called for nine enforcement-related actions, nine legislation-related actions, and four market access-related actions.

These proposals are available for your review, and I ask that the paper that includes all of these proposals be included in our hearing record for our consideration because it's just along the lines that we're calling for. So take a look at the action-oriented remedies here. [The International Intellectual Property Alliance (IIPA) Report **2011 Special 301 Report on Copyright**

Protection and Enforcement follows on page 33:]

A report by the ITC, International Trade Commission, at the request of the Senate Finance Committee, last year focused on intellectual property infringement in China.

It found that enforcement of IPR laws is a serious problem: there are significant structural and institutional impediments undermining effective IPR enforcement; periodic raids on facilities are not effective; and that the distribution systems for illegal products and violations increased through digital means, and through the 240,000 Internet cafes in China, which help distribute illegal software.

Furthermore, as we'll hear from our next panel, China is implementing indigenous innovation policies which force a buy-China policy for governments and state-owned enterprises, all designed toward building strong national Chinese champions.

The ITC Report No. 2, linked below, quantifies the size and scope of the damage in lost revenues and lost jobs to the U.S. of this overall behavior.

Undoubtedly, the damage estimate by the ITC will be widely noted and may have galvanized legislative and administrative actions.

The United States International Trade Commission report on:

"China: Effects of Intellectual Property Infringement and Indigenous Innovation Policies on the U.S. Economy"
can be found at: http://www.usitc.gov/research_and_analysis/commission_publication_4226.htm

In conclusion, one could ask can the Chinese actually enforce IPR protections, eliminate piracy, and effectively protect IP?

Where there is a will in China, there seems to be a way. If you look at the crackdown on dissidents after the tumultuous events in the Middle East reportedly jarred the Chinese leadership in the last couple of months, the birth of the so-called "Jasmine Revolution" we heard about, broadcast across the Chinese Internet, was quickly stillborn with a massive crackdown on dissidents in China.

The crackdown appears to have been effective, and the Chinese brought major security resources to fix the problem as they saw it.

If the authorities were as equally serious in cracking down on Internet piracy, I would surmise that we would start seeing some substantial reversals of some of these IPR infringements.

So what I'd like to do is turn the hearing over to our witnesses, and we have only two witnesses instead of three on this panel so we're going to give you more time to make your opening remarks.

I'd like to call on Mr. Schlesinger first. Thank you very much. You may proceed.

**STATEMENT OF MR. MICHAEL SCHLESINGER
OF COUNSEL, GREENBERG TRAURIG, AND INTERNATIONAL INTELLECTUAL
PROPERTY ALLIANCE, WASHINGTON, DC**

MR. SCHLESINGER: Good morning, Chairman D'Amato, Chairman Shea, and Commissioners.

I very much appreciate the introduction. It actually allows me to move right into the substance of my talk today. Just by way of background, IIPA's seven-member associations representing the U.S. copyright industries are comprised of 1,900 companies in the business software, recorded music, filmed entertainment, book publishing, and entertainment software industries, making up the large proportion of the creative industries in the United States.

These industries themselves contribute mightily to the U.S. economy, comprising nearly 6.5 percent of the total U.S. gross domestic product, employing more than 5.5 million workers, providing high-paying jobs, and contributing more than \$125 billion in foreign sales and exports.

Yet, these industries continue to suffer harm due to high copyright piracy levels in China, from pervasive use of unlicensed software by businesses and pre-installation of unlicensed software at the distribution level, to widespread online piracy of music, films, television programming, videogames and other copyright materials, and piracy of hard goods.

China's many notorious online piracy sites and services, its failure to effectively lower enterprise end-user software piracy or legalize government and state-owned enterprise use of software or publications, and its market access failures are effectively shutting U.S. content industries out of one of the world's largest and fastest growing markets.

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

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

Let me highlight the scope of the problem. According to market research firm IDC, 79 percent, or, put another way, nearly eight out of every ten copies of software deployed on personal computers in 2009 was unlicensed.

The commercial value of this unlicensed software was a staggering \$7.6 billion. This represents an enormous lost market opportunity for U.S. and other software firms.

China has made commitments in bilateral negotiations with the U.S., dating back to 2004, to curtail software piracy, yet the value of unlicensed

software use in China still more than doubled from \$3.6 billion in 2004 to 7.6 billion in 2009.

Software piracy in China harms more than just U.S. software firms. Software is a critical input in production for business in many sectors. The unlicensed use of software by business in China across a wide array of sectors results in products from these firms competing unfairly against products made by U.S. firms--firms that pay for the software they use.

Just as the market for software sales in China is significantly undercut by piracy, there are also a growing number of policies being rolled out by the Chinese government that can severely restrict access to the legal market in China for foreign software companies.

These so-called "indigenous innovation" policies seek to use government procurement, standard-setting and other levers to bolster domestic technology companies by shutting out foreign competitors and compelling transfers of technology to them.

The mechanisms available in China to address this massive problem have proven to be insufficient. Criminal enforcement against businesses that pirate software is not available. While China has an administrative enforcement system, penalties issued against businesses pirating software are low and do not serve as an effective deterrent.

There has been some progress in using civil actions, but not nearly enough to send the signal that software piracy is unacceptable and carries significant risks.

In short, IP infringement and market access restrictions are stifling the ability of the U.S. software industry to see sales and exports in China in line with the dynamic growth of this market.

At the same time, products made with unlicensed software in China compete unfairly against the goods of other U.S. sectors. This has broad and increasingly harmful impacts on the U.S. economy.

I will now highlight some recent developments or commitments which hopefully shine a path forward for the Commission for addressing the four key issues discussed in the written submission.

First, a significant hurdle to effectively dealing with enterprise end-user piracy in China is a lack of availability of criminal enforcement. The Supreme People's Court indicated in a 2007 judicial interpretation that under Article 217 of the criminal law, unauthorized reproduction or distribution of a computer program qualifies as a crime.

Yet, authorities will not bring criminal end-user cases on the grounds that they do not meet the "for-profit" requirement in Article 217.

The 2011 Criminal IPR Opinions could be helpful in this regard since they define in Article 10(4) of the criteria of "for profit" as including "other situations to make profits by using third-parties' works." The Chinese government should make a clear commitment to criminalize end-user piracy.

Second, there remains a need for the Chinese government to ensure that government agencies at all levels use only legal software. At the

December 2010 Joint Commission on Commerce and Trade and in the summit between President Obama and President Hu in January 2011, the Chinese government made several significant commitments on software legalization for government agencies and “state-owned enterprises” (SOEs).

These included: treating software as property and establishing software asset management systems for government agencies; allocating current and future government budgets for legal software purchases and upgrades; implementing a software legalization pilot program for 30 major SOEs; and conducting audits to ensure that government agencies at all levels use legal software and publish the results.

These commitments must now be implemented in a meaningful and sustainable manner that results in a significant increase in legal software procurements.

The Chinese government must also follow through on its commitment in prior years to ensure that all computers produced or imported into China have legal operating systems.

Third, the business software industry remains concerned that Chinese government efforts to legalize software use in the government and enterprises will be accompanied by preferences favoring the acquisition of Chinese software over non-Chinese software.

China committed in its WTO working party report that the government would not influence directly or indirectly commercial decisions on the part of state-owned or state-invested enterprises, including the quantity, value, or country of origin of any goods purchased or sold, and made a commitment in the JCCT that software purchases by all Chinese private and state-owned enterprises will be based solely on market terms without government direction. The Chinese government must meet its commitments in this area.

China has also repeatedly committed to join the WTO's Government Procurement Agreement, yet has been slow to move this process along. Its most recent offer to join the GPA contains significant shortcomings that must be remedied, and we urge the U.S. government to raise these concerns with China and press the Chinese government to develop an improved GPA offer on an expedited basis.

Finally, we remain concerned that China's indigenous innovation policies are discriminating against foreign companies and compelling transfers of technology. In particular, some policies condition market access on local ownership or development of a service or product's intellectual property or aim to compel transfers of foreign intellectual property and research and development to China.

A broad array of U.S. and international industry groups have raised serious concerns about these policies, and it is noteworthy that following the summit between President Obama and President Hu, the joint statement issued in January 2011 indicated that China will not link its innovation policies to the provision of government procurement preferences, and the

accompanying U.S. fact sheet issued the same day indicated a number of commitments that were made in that area.

These are all welcomed commitments that should be communicated to all levels of the Chinese government and effectively enforced to avoid discriminating against U.S. products.

I have two industry sectors to talk about today so that is the reason that my remarks are a little bit longer. The second industry sector I will touch on briefly is recorded music. Unfortunately, the story is that the combination of online music piracy and market access concerns has stifled the development of a legitimate online marketplace for music in China.

The development of online and mobile connectivity in China is truly staggering. China's Internet population stands at 457 million Internet users, almost all with broadband connections and with two-thirds of them using mobile phones to surf the Web.

Chinese government statistics indicate that nearly 80 percent of all Internet users use it for web music. This statistic speaks volumes since for the music sector, legitimate content is not made available in significant quantities online in China due to the prevalence of piracy, market access restrictions, and other discriminatory measures which effectively keep legitimate content out.

Simply put, the music market in China for U.S. companies is in crisis. Internet piracy of music is estimated at 99 percent and fueled primarily by businesses like Baidu, a Nasdaq-traded company, that directs users to infringing content and is supported financially by advertising.

The harm caused by Internet piracy of music can perhaps best be understood in numbers by comparing the values of China's legitimate market with that of other countries. The value of total legitimate digital sales in 2009 in China was \$94 million. The total legal revenue, both physical and digital, was a mere \$124 million.

This compares to \$7.9 billion legitimate sales in the United States, \$285 million in South Korea, and \$142 million in Thailand, a country with less than five percent of China's population, and with roughly the equivalent per capita GDP.

If Chinese sales were equivalent to Thailand's, on a per capita basis, music sales would be \$2.8 billion. It is fair to say that China's lack of enforcement against music piracy, particularly on the Internet, amounts to more than \$2 billion in subsidies to Chinese Internet companies who can provide their users with access to music without negotiating licenses therefor.

There is a lot on the serious infringement problems with sites like Baidu, Sohu, Sogou, Xunlei's Gougou, and others in my written testimony. To summarize, there are myriad Internet piracy problems in China, including pre-release of albums that haven't yet been released commercially that have been shared by postings at forums in China, which have registered hundreds of thousands of users, decimating the markets for those recordings.

Other big problems include P2P filesharing forums, cyberlockers used for infringing purposes.

We note one service in the written testimony called Xunlei which has announced its intention to hold a U.S.-based IPO and we would call upon the Commission to consider providing its views to the SEC on this.

While significant challenges remain, there are at least some signs that the Chinese government is becoming more active in dealing with online infringements. The outcome of the recent JCCT plenary session and the subsequent meeting between President Obama and President Hu contain important commitments aimed at addressing the massive online piracy problem in China.

Specifically, China committed in the JCCT "to obtain the early completion of a judicial interpretation that will make clear that those who facilitate online infringement will be equally liable for such infringement."

Just days before President Hu's visit to the United States, the Chinese government issued new Supreme People's Court opinions on handling criminal cases which hopefully can lead to stronger and clearer criteria for criminal liability for Internet-based infringements.

I have two minutes left, and I would be remiss if I didn't talk about the market access situation in China. So I will skip to that but ask you to take a look at my written submission on online piracy.

I would like to talk about market access as related to the recording music industry. There is a direct relationship between the fight against infringement and the need for liberalized market access to supply legitimate product, both foreign and local, to Chinese consumers.

Unfortunately, there are a range of restrictions affecting the recorded music industry which stifle the ability of U.S. rights holders to do business effectively in China.

The single-most damaging barrier is the application of onerous and discriminatory censorship provisions. Foreign recordings must go through a very cumbersome censorship process before they can be released to the online market. Local content by contrast can be self-censored.

This cumbersome process for U.S. music to receive government clearance results in long delays for release during which time infringing versions are broadly available, completely undermining the legitimate market.

China's discriminatory regime is both unfair and highly suspect under WTO rules. I would only state that the Circular has made the situation worse, significantly hampering the development of the healthy legitimate digital market in China, while making it easier for pirates to continue their opportunities.

The Circular denies bargained-for market access and discriminates against foreign-invested enterprises (FIEs), thereby violating China's national treatment obligations, China's accession commitments under GATS and GATT, and China's Accession Protocol. China must revoke or modify the

Circular to fix these problems.

Record companies are also prevented from establishing meaningful commercial presence that would permit them to develop talent in China and from getting legitimate product quickly to market.

My time is up. In conclusion, the continued overall lack of deterrence against piracy, market closures or barriers for creative content, some of which have been found to violate China's WTO commitments, and the imposition or specter of discriminatory policies toward foreign content suggests a conscious policy seeking to drive Chinese competitiveness while permitting free access to foreign content through unapproved pirate channels.

Engagement with China to improve the situation must be multifaceted, including through Special 301, as well as discussions at the SED, JCCT, and through seeking meaningful results-oriented solutions, it is hoped that tangible results, increasing overall sales and exports to China by the creative industries, can be achieved.

Thank you very much for the opportunity to share the copyright industry's experience in China, and I am pleased to answer any questions you have.

[The prepared statement follows:]

**PREPARED STATEMENT OF MR. MICHAEL SCHLESINGER
OF COUNSEL, GREENBERG TRAURIG, AND INTERNATIONAL INTELLECTUAL
PROPERTY ALLIANCE, WASHINGTON, DC**

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

At the outset, we note that the IIPA's seven member associations, comprised of 1,900 companies in the business software, recorded music, filmed entertainment, book publishing, and entertainment software industries, make up the large proportion of the creative industries in the United States. These industries in turn contribute mightily to the U.S. economy, contributing nearly 6.5% of the total U.S. gross domestic product (GDP), employing more than 5.5 million workers, providing good, high-paying jobs outpacing other industries, and contributing more than \$125 billion in foreign sales and exports, based on the latest figures. Yet, these industries continue to suffer harm due to high copyright piracy levels in China, from pervasive use of unlicensed software by businesses and pre-installation of unlicensed software (hard disk loading piracy) at the distribution level, to widespread online piracy of music, films, television programming, videogames,¹ and other copyright materials, and piracy of hard goods. China's many notorious online piracy sites and services, its failure to effectively lower enterprise end-user software piracy or legalize government and state-owned enterprise (SOE) use of software or publications, and its market access barriers are effectively shutting U.S. content industries out of one of the world's largest and fastest growing

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

markets.

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

Business Software Industry Concerns

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

Let me highlight the scope of the problem:

- According to market research firm IDC, 79%, or nearly 8 out of every 10 copies of software deployed on personal computers in 2009 was unlicensed. The commercial value of this unlicensed software was a staggering \$7.6 billion. This represents an enormous lost market opportunity for US and other software firms.
- China has made commitments in bilateral negotiations with the US dating back to 2004 to curtail software piracy; yet the value of unlicensed software use in China more than doubled from \$3.6 billion in 2004 to \$7.6 billion in 2009.
- Software piracy in China harms more than just US software firms. Software is a critical input in production for business in many sectors. The unlicensed use of software by business in China across a wide array of sectors results in products from these firms competing unfairly against products made by US firms that pay for the software they use.
- While the market for software sales in China is significantly undercut by piracy, there are a growing number of policies being rolled out by the Chinese government that can severely restrict access to the legal market in China for foreign software companies. These so-called "indigenous innovation" policies seek to use government procurement, standard-setting and other levers to bolster domestic technology companies by shutting out foreign competitors and compelling transfers of technology to them.

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

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

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

End-User Piracy Concerns

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

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

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

Government Legalization of Business Software and Related Issues

Another important issue for the software industry is the need for the Chinese Government to ensure that government agencies at all levels use only legal software. At the December 2010 JCCT and in the joint statement from the summit between President Obama and President Hu in January 2011, the Chinese Government made several significant commitments on software legalization for government agencies and SOEs. These included: 1) treating software as property and establishing software asset management systems for government agencies, 2) allocating current and future government budgets for legal software purchases and upgrades, 3) implementing a software legalization pilot program for 30 major SOEs and 4) conducting audits to ensure that government agencies at all levels use legal software and publish the results. These bilateral commitments have been followed by a number of directives from the Chinese Government implementing processes for software legalization in the government and SOEs. While these commitments and directives are welcome, it remains unclear whether they will be implemented in a meaningful and sustainable manner that results in a significant increase in legal software procurements. Using accounting firms and other credible third parties to conduct software audits of what software is actually running on government and SOE systems and implementation of internationally recognized software asset management (SAM) practices can help achieve this result. The Chinese Government must also follow through on its commitment in prior years to ensure that all computers produced or imported into China have legal operating systems. Implementation in recent years has been spotty.

Procurement Preferences

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

In addition, fair and non-discriminatory access to China's vast government procurement market is a

critical issue for the IIPA. China has repeatedly committed to join the WTO's Government Procurement Agreement (GPA) yet has been slow to move this process along. This past July, China released a Revised Offer to join the GPA that, while improving somewhat on prior offers, has significant shortcomings that will not make it an effective agreement for ensuring meaningful market access for our members and many other U.S. industries. The deficiencies include: (1) the lack of express coverage for software and related services; (2) monetary thresholds that would be too high to reach a significant share of procurements; (3) an unacceptably long transition period for full commitments to take effect (*i.e.*, a five year stand-still followed by a five-year transition period); (4) limitations on coverage of central government agencies and an absence of coverage for "sub-central" agencies; (5) lack of clarity regarding coverage of state-owned enterprises; (6) a broad, undefined exception for "national policy objectives," and (6) the ability to require domestic content, offset procurement and transfers of technology. We also believe that China's GPA offer should include a provision reaffirming its commitment to ensure that government agencies use legal software and that government contractors use only legal software as well. We urge the U.S. government to raise these concerns with China and press the Chinese government to develop an improved GPA offer on an expedited basis.

Indigenous Innovation

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

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

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

Recorded Music Industry Concerns

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

As backdrop for the discussion, it should be noted that development of online and mobile connectivity in China is truly staggering. According to the China Internet Network Information Center (CNNIC) (which "takes

orders from MII” – the Chinese Government – according to its website), China’s Internet population stands at 457 million Internet users as of December 2010, with over 66% of them using mobile phones to surf the web, by far the largest number in the world. More spectacular is the percentage of those users with high-speed broadband interconnections, at an estimated 450 million users. Of mobile users, 303 million now have mobile Internet access, and there is growing evidence that piracy is taking place directly on mobile devices over wireless broadband networks (3G), and the pre-loading of infringing files on mobile devices is a problem for copyright industries. Of all Internet users, according to CNNIC, 79.2 % use the Internet for “Web music,” 66.5 % use the Internet for “Web game,” 62.1% use the Internet for “Web video” and 42.6% use the Internet for “Network literature.” These statistics speak volumes, since for most of the copyright sectors, legitimate content is not made available in significant quantities online in China due to the prevalence of piracy, market access restrictions, or other discriminatory measures which effectively keep legitimate content out.

Internet Piracy of Music

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

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

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

While significant challenges remain, there are at least some signs that the Chinese Government is becoming more active in dealing with online infringements. The outcomes of the recent JCCT plenary session (December 15, 2010) and the subsequent summit meeting between President Obama and President Hu (January 19, 2011) contain important commitments aimed at addressing massive online piracy in China. Specifically, China committed in the JCCT “to obtain the early completion of a Judicial Interpretation that will make clear that those who facilitate online infringement will be equally liable for such infringement.” On January 19, 2011, the U.S. “welcomed China’s agreement to hold accountable violators of intellectual property on the Internet, including those who facilitate the counterfeiting and piracy of others.” Just days before President Hu’s visit to the United States (January 11, 2011) the Chinese Government issued new “Supreme People’s Court, Supreme People’s Procuratorate and Ministry of Public Security Promulgated Opinions on

Certain Issues Concerning the Application of Laws for Handling Criminal Cases of Infringement of Intellectual Property Rights,” hopefully leading to stronger and clearer criteria for criminal liability for Internet-based infringements.

These high-level commitments resulted in some progress by the Chinese Government against Internet piracy in 2010, both in terms of administrative measures and seeking criminal prosecutions against infringing sites and services supporting and benefiting from infringement. For example, the Ministry of Culture on December 15, 2010 announced a Notice by which illegal websites not acquiring approval from or registering at provincial cultural departments, would be shut down. The list included 237 music websites, including yysky.com and cococ.com. As of 2009, 89 of these sites had closed. The websites were given a deadline of January 10, 2011 to delete illegal music. While the recording industry welcomes these enforcement actions, the industry hopes that moving forward the Chinese Government takes meaningful action against Baidu and others for their role in promoting and facilitating the distribution of infringing materials rather than basing enforcement actions on the basis of censorship. Regarding case law developments, meanwhile, a couple of cases in recent years suggests that progress can be made against music download and streaming sites (7t7t and Qishi) through criminal prosecutions. There has also been some evidence of increased referrals by the administrative authorities. Yet, the largest services like Baidu (an estimated 50% of all illegal music downloads in China takes place through Baidu) continue to be shielded even from civil liability for their involvement in music piracy. The recent complaints against Baidu’s library filesharing service and Baidu’s takedown of unlicensed publications notwithstanding, Baidu’s “mp3” search functionality for illegal music files remains intact.

Market Access Concerns, Including Discriminatory “Content Review” (Censorship)

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

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

China’s discriminatory regime is both unfair and highly suspect under WTO rules. China further complicated an already unsatisfactory situation by issuing the September 2009 *Circular on Strengthening and Improving Online Music Content Examination*. This Circular puts into place a censorship review process premised on an architecture already determined to violate China’s GATS commitments—by allowing only wholly-owned Chinese digital distribution enterprises to submit recordings for required censorship approval. Especially because of the large number of titles involved, this imposes virtually impossible delays on these foreign businesses and the right holders who license their product to them. The *Circular* significantly hampers the development of a healthy legitimate digital music business in China, while making it easier for those who infringe to thrive, since they would never comply with these rules.

When China joined the WTO, it agreed to allow foreign investment in all music distribution ventures on a non-discriminatory basis. That includes online music distribution. By excluding foreign-invested enterprises (FIEs) from submitting imported music for censorship review, the Circular denies bargained-for market access and discriminates against FIEs thereby violating China’s national treatment obligations. It violates China’s accession commitments under the General Agreement on Trade in Services (GATS) and the General Agreement on Tariffs and

Trade 1994 (GATT); it also violates China's Accession Protocol commitment to authorize trade in goods by any entity or individual. China must revoke or modify the Circular to fix these problems relating to the rights of FIEs to distribute music online, and to remove the discriminatory censorship processes for treatment of foreign as opposed to local content.

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

- * the integrated production, publishing and marketing of sound recordings;
- * production, publication and marketing their own recordings in China;
- * the signing and management of domestic artistes;
- * the distribution of sound recordings via digital platforms and in physical formats;
- * the operation of online music delivery services; and
- * the importation of finished products of their own sound recordings.

Conclusion – Thoughts on Ways Forward

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

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

However, as has been the case with past commitments to improve copyright protection and market access made by the Chinese Government, it remains to be seen whether the Chinese will implement them in a sustainable and meaningful way, at the central and provincial levels, to ensure that copyright piracy in all its forms is curbed and to provide a fairer and more open market for U.S. creative content. It is particularly critical that the leaders group (led by the State Council) which has been a key driver in the latest Special Enforcement Campaign,

be made a permanent part of the enforcement structure, since such high-level involvement has resulted in greater success during this Campaign, and that China take steps in new judicial interpretations to clarify that those who as a business model facilitate infringements online will be held liable.

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

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

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

INTERNATIONAL INTELLECTUAL PROPERTY ALLIANCE (IIPA) 2011 SPECIAL 301 REPORT ON COPYRIGHT PROTECTION AND ENFORCEMENT, PEOPLE'S REPUBLIC OF CHINA

Special 301 Recommendation: IIPA recommends that USTR maintain China on the Priority Watch List in 2011.²

Executive Summary: High copyright piracy levels persist in China, from pervasive use of unlicensed software by businesses and pre-installation of unlicensed software (hard disk loading piracy) at the distribution level, to widespread online piracy of music, films, television programming and other copyright materials, and piracy of hard goods. The continued overall lack of deterrence against piracy, market closures or barriers for creative content (some of which have been found to violate China's WTO commitments), and the imposition or spectre of discriminatory policies toward foreign content, suggest a conscious policy seeking to drive Chinese competitiveness while permitting free access to foreign content through unapproved pirate channels. China's principal reliance on its woefully underresourced administrative system to deal with IPR infringements rather than through criminal enforcement presents a significant hurdle to effective enforcement.³

At the same time, with the launch of a new Special Campaign on IP enforcement, and through commitments made in recent bilateral forums, the Chinese Government has indicated measures it will take to achieve higher levels of copyright protection. Specifically, the recent meeting of the Joint Commission on Commerce and Trade (JCCT) in December 2010 and the summit between President Obama and President Hu in January 2011 resulted in a number of important commitments by the Chinese to ensure legal use of software in the

² For more details on China's Special 301 history, see IIPA's "History" Appendix to this filing at <http://www.iipa.com/pdf/2011SPEC301HISTORICALSUMMARY.pdf>, as well as the previous years' country reports, at <http://www.iipa.com/countryreports.html>.

³ In November 2010, the Chinese Government announced a "special campaign on fighting against infringing IP and manufacturing and selling counterfeiting and shoddy commodities," to last from October 2010 to March 2011. While the industries support sustained enforcement campaigns, this campaign has mostly focused on physical piracy and lacks the permanence to significantly reduce piracy.

government and state-owned enterprises (SOEs), seek effective measures to deal with Internet infringements (including intermediary liability), deal with digital library infringements, and ensure that China's "indigenous innovation" policies do not effectively limit market access for U.S. intellectual property owners, compel transfers of intellectual property to access the Chinese procurement market, or create conditions on the use of or licensing of U.S. intellectual property.⁴ New Opinions on handling criminal copyright infringement cases contain helpful provisions which could foster an effective criminal remedy against online piracy activities. IIPA commends the efforts of the U.S. Government to secure these important commitments. However, as has been the case with past commitments to improve copyright protection and market access made by the Chinese Government, it remains to be seen whether the Chinese will implement them in a sustainable and meaningful way, at the central and provincial levels, to ensure that copyright piracy in all its forms is curbed and to provide a fairer and more open market for U.S. creative content.

Priority Actions Requested in 2011:

Enforcement

- Increase the number and effectiveness of criminal prosecutions, including against online piracy and those services that facilitate piracy, such as Baidu; bring criminal cases against corporate end-user software piracy; allow specialized IPR judges to hear criminal cases; and move more criminal IPR cases to the intermediate courts.
- Follow through on China's commitments at the recent JCCT and Obama-Hu summit to ensure legal use of software by the government and SOEs by 1) treating software as property and establishing software asset management systems for government agencies, 2) allocating current and future government budgets for legal software purchases and upgrades, 3) implementing software legalization pilot programs for 30 major SOEs, and 4) conducting audits to ensure that government agencies at all levels use legal software and publish the results.
- Increase actions by SARFT, GAPP, MOC, and the Ministry of Industry and Information Technology (MIIT) to revoke business licenses and halt online services that deal in/provide access to infringing materials, and shut down websites that operate without government-issued licenses.
- Enhance "pre-release" administrative enforcement for motion pictures, sound recordings, and other works.
- Crack down on web-based enterprises' piracy of library academic journals as promised in the 2010 JCCT outcomes, and otherwise take steps to legalize usage of books and journals at universities and by government.
- Combat piracy occurring on mobile networks, such as unauthorized WAP sites, and unauthorized downloading and streaming of infringing music to smart phones.
- Expand resources at National Copyright Administration of China (NCAC), local Copyright Administrations, and Law and Cultural Enforcement Administrations (LCEAs), commensurate with the scale of the piracy problem, for more effective enforcement actions against all forms of piracy.
- Impose deterrent fines in administrative enforcement actions.
- Allow foreign rights holder associations to increase staff and conduct anti-piracy investigations.

Legislation and Related Matters

- Follow through on JCCT and bilateral commitments to hold accountable violators of intellectual property on the Internet (including growing hard goods sales on e-commerce sites), including those who facilitate the infringement of others, through appropriate amendments and regulations.
- Confirm that corporate end-user software piracy and hard disk loading of unlicensed software are criminal offenses, including issuing a Judicial Interpretation and amending the Criminal Code and Copyright Law and case referral rules as needed; and remove the "public harm" requirement as a hurdle to administrative enforcement.⁵

⁴ See The White House, Office of the Press Secretary, FACT SHEET: U.S.-China Economic Issues, January 19, 2011, at <http://www.whitehouse.gov/the-pressoffice/2011/01/19/fact-sheet-us-china-economic-issues> and United States Trade Representative, 21st U.S.-China Joint Commission on Commerce and Trade: Fact Sheet, December 15, 2010, at <http://www.ustr.gov/about-us/press-office/fact-sheets/2010/21st-us-china-joint-commission-commerce-and-trade>.

⁵ The Business Software Alliance reports that administrative officials are often unwilling to act against enterprises engaged in use of unlicensed software due to the vague "public harm" requirement, notwithstanding China's 2005 declaration that

- Amend the Copyright Law and subordinate legislation/regulations to ensure full compliance with Berne, TRIPS, and the WIPO Copyright Treaty (WCT) and the WIPO Performances and Phonograms Treaty (WPPT).
- Increase damages against copyright infringers in civil cases to deter piracy and adequately compensate the copyright holders.
- Significantly increase maximum statutory damages of RMB500,000 (US\$75,850) in the Copyright Law and related laws to ensure deterrence in the new technological environment.
- Review and amend the 2006 Internet Regulations to provide for a mandatory “notice and takedown” procedure for hosted content and penalties for non-compliance of right holders’ notices; ensure their effectiveness and implement them with more aggressive administrative and criminal enforcement.
- Amend the Copyright Law to clarify ISPs’ liabilities and introduce measures designed to ensure that there are incentives for active cooperation between Internet service providers and content holders in addressing the use of networks for the transmission of infringing materials in the non-hosted environment, e.g., infringements occurring using peer-to-peer (P2P) filesharing services, web bulletin boards, torrent sites, link sites and cyberlockers.
- Amend the Copyright Law to grant full communication to the public rights for related rights.
- Extend term of protection for sound recordings to at least 70 years from publication, and preferably to match the U.S. term of 95 years from publication, or 120 years from fixation.

Market Access

- Bring laws into compliance with WTO panel decision on market access for published materials, audiovisual materials, and recorded music.
- Refrain from implementing “indigenous innovation” policies that discriminate against foreign products or condition market access based on whether a product’s intellectual property is owned or developed in China.
- Ease the many market access restrictions noted in this filing, including the duopoly for theatrical film distribution and the ban on game consoles.
- Withdraw or significantly modify the Ministry of Culture Circular on Strengthening and Improving Online Music_Content Examination which imposes burdensome procedures for online distribution of sound recordings, new discriminatory censorship procedures for foreign sound recordings, and WTO-inconsistent restrictions on the ability of foreign-invested enterprises to engage in the importation and distribution of online music.

PIRACY AND ENFORCEMENT CHALLENGES AND UPDATES IN CHINA

Previous IIPA submissions, including those made to USTR in the Special 301 process, those related to China’s WTO compliance,⁶ those describing “notorious markets,”⁷ and the recent submission before the USITC on identification and quantification of piracy in China,⁸ have described in detail the many forms of copyright piracy and enforcement challenges in China faced by IIPA members. The following highlights key piracy and enforcement challenges and updates.

software end-user piracy is considered to constitute “harm to the public interest” and as such is subject to administrative penalties nationwide.

⁶ International Intellectual Property Alliance, China’s WTO Compliance: (1) Request to Testify at October 6, 2010 Hearing and (2) Notice of Testimony Regarding China’s Compliance with its WTO Commitments, 75 Fed. Reg. 45693 (August 3, 2010), September 22, 2010, at

<http://www.iipa.com/pdf/ChinaWTOrequesttotestifyandtestimonytoTPSCFinal092210.pdf>.

⁷ International Intellectual Property Alliance, 2010 Special 301 Out of Cycle Review of Notorious Markets: Request for Public Comment, 75 Fed. Reg. 60854 (October 1, 2010), Docket No. USTR-2010-0029, November 5, 2010, at

<http://www.iipa.com/pdf/IIPAOCRNotoriousMarketstoUSTRFINAL110510.pdf>.

⁸ International Intellectual Property Alliance, China: Intellectual Property Infringement, Indigenous Innovation Policies, and Frameworks for Measuring the Effects on the U.S. Economy, Written Submission, Investigation No. 332-514, 75 Fed. Reg. 25883 (May 10, 2010), July 9, 2010, at <http://www.iipa.com/pdf/IIPACHINAITCWrittenSubmission070910.pdf>.

Internet Piracy: According to the China Internet Network Information Center (CNNIC), China's Internet population stands at 457 million Internet users as of December 2010, with over 66% of them using mobile phones to surf the web, by far the largest in the world.⁹ More spectacular is the percentage of those users with high-speed broadband interconnections, at an estimated 450 million users. Of mobile users, 303 million now have mobile Internet access,¹⁰ and there is growing evidence that piracy is taking place directly on mobile devices over wireless broadband networks (3G), and the pre-loading of infringing files on mobile devices is a problem for copyright industries.¹¹ Of all Internet users, according to CNNIC, 79.2 % use the Internet for "Web music," 66.5 % use the Internet for "Web game," 62.1% use the Internet for "Web video" and 42.6% use the Internet for "Network literature."¹²

These statistics speak volumes, since for most of the copyright sectors, legitimate content is not made available in significant quantities online in China due to the prevalence of piracy, market access restrictions, or other discriminatory measures which effectively keep legitimate content out. Internet piracy of music is an illustrative example, estimated at 99% piracy and fueled primarily by businesses like NASDAQ-traded Baidu, that direct users to infringing content and are supported by advertising.¹³ The harm caused by Internet piracy of music can perhaps be best understood in numbers by comparing the values of China's legitimate market with that of other countries. The value of total legitimate digital sales in 2009 in China was US\$94 million, and total revenue (both physical and digital) was a mere US\$124 million. This compares to \$7.9 billion in the U.S., \$285 million in South Korea and \$142 million in Thailand — a country with less than 5% of China's population and with a roughly equivalent per capita GDP. If Chinese sales were equivalent to Thailand's on a per capita basis, present music sales would be US\$2.8 billion, and even that would represent under-performance and reflect significant losses to piracy.

⁹ China Internet Network Information Center (CNNIC), Statistics Report on the Development of Internet in China, January 2011, at <http://research.cnnic.cn/img/h000/h12/attach201101211728520.pdf>.

¹⁰ The latest Internet numbers represent significant increases over previous years, especially in the areas of increase in access to the Internet via mobile devices and laptops: 66.2% of all Internet users in China employed mobile Internet as of December 2010, up from 60.8% in December 2009; and 45.7% of all Internet users in China employed laptops for Internet as of December 2010, up from 30.7% in December 2009. Meanwhile, 78.4% of Internet users in China used desktops as of December 2010, still representing a majority of Internet users.

¹¹ For example, the total value of recorded music sales and licensing in China last year was US\$124 million. Of this, only \$30 million was physical sales. More than 80% of the remaining \$94 million was due to revenue generated through mobile platforms, the greatest single contributor being ringback tones. Given the extremely high piracy rates, it is evident that significant losses accrue due to mobile piracy of copyright materials. Mobile broadband provides instant access to infringing copyrighted material, not only music, but also video, books, software and videogames. The record industry notes that a wide range of unauthorized WAP sites and mobile applications, "Apps" (Apple), and Android and other domestic mobile platforms offer infringing song files for streaming and download. Chinese made mobile phones, e.g., Malata Group, now have built-in features linking the phone to infringing WAP sites such as 3g.cn, aitmp3.com, 3Gwawa.net, wap.kxting.cn, wap.soso.com, to allow mobile phone users to gain access to thousands of infringing song files hosted at remote servers.

¹² See supra note 8 above at 31. All these percentages amount to huge spikes in actual numbers of users since the number of overall users went up so significantly. For example, the number of Internet users accessing "Web music" in December 2010 was 12.9% higher than in December 2009. Of the so-called "web entertainment" applications, the greatest increase in the sheer numbers of users was for "Network literature," which saw an increase of 19.8%.

¹³ It is estimated that almost 50% of all illegal music downloads in China take place through Baidu. Baidu frequently creates "top 100" charts and indexes inducing users to find and then download or stream infringing music without permission or payment. On January 20, 2010, the Beijing No. 1 Intermediate People's Court found that Baidu's MP3 deeplinking service did not infringe the rights of Chinese and international record companies. The court determined that Baidu did not have "reason to know" that the tracks to which it was linking were infringing under Article 23 of the Internet regulations, despite the fact that Baidu's operators actively provided full indexes of popular songs, and knew that the sites being linked to were not those of the legitimate licensees of the plaintiffs. In a companion case, the Court held that Sohu/Sogou were not generally liable for its linking service. The Court only held that Sohu/Sogou infringed several tracks that were part of a "notice & takedown" request made by the plaintiffs, although the damages awarded were only RMB1000 (US\$152) per track. There remains evidence of Baidu's contributions to, and profiting from, the infringing activities over its services. Baidu's deeplinking service also continues to direct users in Hong Kong, Taiwan, Singapore, Malaysia, and elsewhere to infringing music files. Perhaps emboldened by the Baidu decision, there are now thousands of websites that offer streams, downloads, or links to unauthorized music files as well as other specialized deeplinking or "MP3 music search engines" such as Sogou, Gougou offering access to thousands of infringing music files for unlimited streaming and download without consent, while generating income from advertising and other services. It is hoped that the 2011 Criminal IPR Opinions will effectively address these services.

It is fair to say that China's lack of enforcement against music piracy—particularly on the Internet, amounts to more than US\$2 billion in subsidies to Chinese Internet companies who can provide their users with access to music without negotiating licenses therefor. In addition to serious infringement problems with sites like Baidu, Sogou, and Xunlei's Gougou, there are many other websites such as 1ting.com, sogua.com, qq163.com, haoting.com, 520music.com and cyberlocker sites such as Rayfile, Namipan, and 91files which have been implicated in music piracy activities in China. A wide range of recordings have been found on web "forums", such as pt80.com and in-corner.com. These forums direct users to download or stream unauthorized sound recordings stored in Chinese cyberlockers. An increasing number of prerelease albums have been shared by postings at forums which have registered users in the hundreds of thousands – decimating the market for those recordings. Although cease and desist notices have been sent to the administrators of the forums and cyberlockers identified, immediate takedowns of such "URLs" and/or postings are rare. Illegal P2P filesharing remains prevalent in China. Many Chinese-based P2P services, such as Xunlei, VeryCD,¹⁴ etc., assist in large scale illegal file-sharing activities that have caused serious damage to the recording industry. Most of these illegal services offer songs for free, generating income from advertising and other services.

The entertainment software industry continues to report steadily growing Internet piracy of videogames in China. P2P downloads of infringing video game files is fast becoming the predominant form of piracy along with websites that offer infringing video game product that can be accessed from home PCs and from Internet cafés. The Entertainment Software Association (ESA) reports that during 2010, ESA vendors detected 16.7 million connections by peers participating in unauthorized file sharing of select member titles on P2P networks through ISPs located in China, placing China second in overall volume of detections in the world.¹⁵ This comprises 11.57% of the total number of such connections globally during this period. In addition to P2P piracy, China is home to a growing number of online auction and e-commerce sites that serve as platforms for the commercial distribution of pirated game products and circumvention devices. Sites such as Alibaba.com, Aliexpress.com, GlobalSources.com, Made-in-China.com, DHgate.com, Taobao.com, and Tradetang.com are among the top online marketplaces selling videogame circumvention devices, as well as being cited by industry as offering other copyright infringing products to consumers and businesses, including scanned copies of commercial bestsellers (trade books) and academic textbooks. Unfortunately, most of these sites are unresponsive to rights holder takedown requests. Alibaba should, however, be commended for their cooperation with videogame right holders in the removal of infringing items. The Business Software Alliance (BSA) also reports that online distribution of pirated business software including both downloading/linking/P2P sharing as well as online sales is a significant and growing problem.

For the motion picture industry, the Internet in China presents a monumental opportunity for growth of legitimate online video,¹⁶ but poses equally monumental challenges.¹⁷ The motion picture industry remains

¹⁴ Although VeryCD closed its music and movie sections on January 21, 2011, it is unknown whether this is only temporary under the pressure of the special campaign. Also, links to download books and articles are still available.

¹⁵ These figures do not account for downloads that occur directly from hosted content, such as infringing games found on "one-click" hosting sites, which appear to account each year for progressively greater volumes of infringing downloads.

¹⁶ China's "Three Network Convergence" trial presents content owners with new business opportunities, for example, video content transmitted from the Internet to TV sets (IPTV/Internet TV), as well as challenges as broadband speed increases. In the absence of legitimate business opportunities (DVD/BD, PPV, cable TV) due to rampant hard goods and online piracy, China presents real business potential for movie products in the online video space. Arguably, China's Internet video business is better positioned for the development of pay/subscription-based business models if the problem of piracy can be resolved/contained. Currently, several websites in China are adopting ad-supported online video business models with legitimately acquired content. Many are planning to roll out pay business models (subscription-based, PPV) in 2011.

¹⁷ Online video sites, especially video search engines (e.g., Xunlei) and P2P sites (e.g., UUsee, PPLive) are inspired to enter this new frontier by directly providing OEMs/TV manufacturers with content they "aggregate" from the Internet. Although SARFT has made it clear that all video content transmitted from the Internet to TV sets will need to go through the five "authorized broadcast control platforms," companies such as Xunlei are likely to find ways to bypass the regulations to work with OEMs and attract customers with the offer of "free content." The independent segment of the film and television industry (IFTA) reports that Internet-based piracy in China prevents the establishment of legitimate online distribution platforms and services for consumers, which independent producers may use to finance future productions. For independent producers who license content country-by-country, online piracy exports troubled marketplaces and high piracy rates to other markets instantly. The independent production sector is limited in its ability to shift to technology-enabled new business practices that might limit piracy. For example, independents, whose national distributors release on their own schedule, cannot use piracy-averting techniques like "day-and-date" release of their films.

particularly concerned about infringements on sites like Youku and Tudou which are “User-Generated Content” (UGC) sites where users upload/make available illegal copies of their favorite feature films or TV programs in China, which then become accessible to anyone in the world. Linking sites to these UGC sites or to other sites multiply the accessibility to the unauthorized content and thereby significantly increase the harm to the copyright companies. The Motion Picture Association of America continues to report that close to half of the illegal content available on the world’s “topsites” is sourced from UGC sites in China. PPLive and PPStream are examples of unauthorized IPTV webcasting channels out of China, which webcast all kinds of television content without authorization. Such pirated IPTV webcasts damage right holders both in their ability to legitimately license pay television and Internet streaming rights and their ability to foster the deployment of legitimate IPTV distribution platforms.

Other problems include illegal P2P streaming sites, illegal P2P filesharing, online sales of pirated hard goods which in 2010 spread at an alarming speed and scale along with the rapid development of e-commerce in China, and a recent phenomenon of “subtitling/translation” sites engaged in piracy. TVAnts is an example of a Chinese P2P software model which results in real-time illegal streaming of television content and live sporting event telecasts. These sites unfortunately provide an efficient environment for infringing activities online with respect to broadcast content to occur. Streaming sites allow, with or without the downloading client software, the viewing or listening to illegal content directly without making a permanent copy as occurs in a download. Other P2P sites in China, including Xunlei, are P2P filesharing sites by which users download and install the P2P client application, enabling them to search for illegal files on each other’s computers and illegally download the infringing files they want. Several of China’s top e-commerce sites now allow online shop owners to sell pirated DVD/Blu-ray discs without requesting those operating the online shops to provide government-issued AV business licenses. Finally, some “noncommercial” piracy websites (e.g., movie/TV subtitling/translation groups, software/client developers) are increasingly becoming a source of pirated content and activities. Due to the fact that these sites are operated by “volunteers” and are constantly changing IP addresses/servers inside (and outside) China, they pose a serious challenge for right holders.

The publishing industry faces unique challenges on the Internet, involving the commercial distribution of electronic copies of academic, scientific, technical and medical journals by unlicensed commercial entities operating with licensed libraries acting in violation of their licenses. This distribution is not only in violation of the terms of the license but also contravenes Chinese Copyright Law and international norms. The commercial enterprises sell subscription access to the electronic distribution service in direct competition with the legitimate publishers. In 2006, publishers became aware of the then-named “Kangjian Shixun,” now operating as “KJ Med,” which was providing electronic files of millions of medical and scientific journal articles on a subscription basis to customers in libraries and hospitals throughout China, without the permission of or payment to right holders. This matter was first raised with government authorities in early 2007 but KJ Med continues to operate unimpeded. Many of the articles illegally distributed continue to be provided by a well-known, powerful state-run medical library. Given the lack of action against the site over the past several years, there is heightened concern that copy-cat sites are following the KJ Med model.¹⁸ The issue was again a key agenda item in the 2010 JCCT dialogue and has been followed by positive engagement from NCAC in early 2011; the publishers are hopeful that this engagement will result in meaningful video business is better positioned for the development of pay/subscription-based business models if the problem of piracy can be resolved/contained. Currently, several websites in China are adopting ad-supported online video business models with legitimately acquired content. Many are planning to roll out pay business models (subscription-based , PPV) in 2011. action on this matter. On October 28, 2009, Chinese agencies issued a Notice on Enhancing Library Protection of Copyright notifying libraries of their obligations under the Copyright Law. The Notice calls for regular random inspections by NCAC and the local copyright administrations, and as appropriate, the imposition of administrative sanctions upon libraries found to have been engaged in unauthorized copying and dissemination of copyrighted works. Unfortunately it is unclear whether the obligations outlined in this Notice have been carried out, including whether random inspections of library institutions have been conducted. A number of publishers have been working with Taobao to address the rampant copyright infringement occurring on the site. In December 2010, a ten day campaign was launched by Taobao to

¹⁸ In 2008, the publishing industry discovered and conducted an investigation into another Internet operation that facilitated access to online journals in a manner similar to the entity Kangjian Shixun. In mid-2009, the industry initiated an administrative complaint with the NCAC against the entity, which was providing unauthorized access to over 17,000 online journal articles published by foreign publishers to universities and other organizations. The case remains pending.

specifically target online book and journal piracy. This collaborative initiative is welcomed by the publishing industry and it is hoped that this will progress to sustained action by Taobao, which has been cooperating with publishers in this regard.

While home (broadband or not) and mobile Internet usage has become the predominant way Chinese access content online, piracy in Internet cafés remains a major concern, as they make available unauthorized videos and music for viewing, listening or copying by customers onto discs or mobile devices. The recording industry notes that syndicated services have even emerged, which supply website templates, software, and databases containing infringing song files for individuals or Internet cafés to set up infringing music websites with ease.

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

These high-level commitments resulted in some progress by the Chinese Government against Internet piracy in 2010, both in terms of administrative measures and seeking criminal prosecutions against infringing sites and services supporting and benefiting from infringement. For example, the Ministry of Culture on December 15, 2010 announced a Notice by which illegal websites not acquiring approval from or registering at provincial cultural departments, would be shut down. The list included 237 music websites, including yysky.com and cococ.com. As of 2009, 89 of these sites had closed. The websites were given a deadline of January 10, 2011 to delete illegal music.¹⁹ While the recording industry welcomes these enforcement actions, the industry is distressed that the Chinese Government also appears to be using censorship as justification for closing websites. As has been established, foreign recordings, in contrast to domestic recordings, must go through a very cumbersome censorship process before they can be released to the online market. Therefore, the prohibition on making available foreign recordings without censorship clearance should not be the basis for acting against licensed music site operators. In fact, many licensed music site operators have already used their best endeavors to satisfy the censorship application requirement. Other developments include the recent arrest of OpenV.com executives and several other criminal investigations that are underway. The recording industry reports that local copyright bureaus recently have come to them requesting support for criminal prosecutions against website operators. As a result, law enforcement agencies appear to have stepped up actions taken against copyright infringers in 2010, especially in combating Internet piracy, in regards to administrative measures as well as criminal prosecution. This increased action has gotten the attention of ISPs who in turn have become more cooperative in their response to rights holders’ requests for takedown of infringing content/goods on their sites. Finally, on January 24, 2011, VeryCD.com reportedly suspended all links to movie and music content on the site. Some news sources reported that many file-sharing sites similar to VeryCD, including subpig.net and uubird.com, would shortly follow suit, but these sites were as of early February 2011 still in operation. IIPA has consistently included VeryCD as being among the worst copyright infringers on the Internet. This development, if permanent, will represent a significant step forward for IPR in China. We will continue to monitor the situation closely and report any further developments.

Continuing hurdles to more effective enforcement include non-deterrent administrative fine structures (e.g., there is no daily fine for continuing to infringe); inadequate staffing and resources within local administrative

¹⁹ Qiu Bo, Sites Offering Songs Told to Obey the Law or Face the Music, China Daily, December 17, 2010, at http://usa.chinadaily.com.cn/2010-12/17/content_11718277.htm. Prior to this Circular, in April 2010, MOC announced that it would “request” 117 sites to apply for an MOC Online Cultural Operating Permit. About 30 of the sites had been shut down as of December 10, although some had reemerged.

agencies responsible for copyright to deal with the task of curbing infringements (including online infringements),²⁰ and lack of cooperation at the provincial levels generally;²¹ unwillingness of authorities or service providers to assist in identifying infringers' locations and identities;²² lack of a willingness to administer fines against ISPs which do not comply with takedown requests;²³ unwillingness among authorities generally to enforce against Internet cafés (notwithstanding some attempt by NCAC to regulate the use of motion pictures in such premises); and the lack of an effective criminal remedy for online infringement.

Internet Infringement Case Results Mixed: The recording industry reports that on August 20, 2010, the operator of an infringing website (7t7t.com) making available infringing sound recordings for streaming and downloading was found guilty by the People's Court in Changshu in Jiangsu Province.²⁴ The operator was sentenced to a jail term of 6 months, suspended for 1 year, and fined RMB15,000 (US\$2,275). In addition, his earned commission of RMB12,837 (US\$1,950) was confiscated. In January 2011, three operators of another infringing site, Qishi.com, were convicted by the criminal court in Chuzhou in Anhui Province of copyright infringement. One of these operators was sentenced to 5 years imprisonment and was fined RMB1.5 million (US\$227,500). The remaining two were sentenced to jail terms of 3 years and 6 months, and 3 years and 3 months, respectively, and both were subject to a fine of RMB200,000 (US\$30,350). These cases represent a welcome sign in the direction of strengthened judicial results against online piracy. Administrative authorities also appear to be acting more aggressively in coordinating with local public security bureaus to transfer cases for criminal investigation against music streaming websites. For example, the Administration of Culture in Jiangsu Province (JSAOC) transferred a case against 51wma.com to the PSB in Suzhou, Jiangsu Province; the Jin Men PSB in Hubei Province arrested the operator of music98.net; and the PSB in Sichuan province commenced a criminal investigation against 6621.com that led to the arrest of the site operator. These cases are still under investigation and it is unknown whether these actions and deterrent sentences will be meted out after the special campaign. Cooperative arrangements among PSBs in certain localities also seem to be helping create a more coordinated approach to dealing with online infringements.²⁵ These positive outcomes are in contrast to the unfortunate result in the civil litigation against Baidu.²⁶

Enterprise End-User Piracy: The business software industry continues to face unlicensed software use by enterprises – including private businesses, state-owned enterprises and government agencies – on a massive scale. For 2010, market research firm IDC preliminarily estimates the PC software piracy rate in China to be 79 percent –

²⁰ In addition, some government agencies simply do not employ their authorities, for example, the Communication Bureau has the ability to halt Internet access to any infringing websites which does not have an ICP record number, but the authorities seldom exercise this power.

²¹ Local protectionism (e.g., Shanghai, Shenzhen) is an issue that prevents effective measures from being taken against pirate Internet sites. The industries report that coordination among enforcement authorities and industry regulators is lacking. Local telecom bureaus are not always cooperative in helping NCAC find evidence and shut down infringing sites. MIIT, SARFT, Ministry of Culture, and GAPP have not provided clear guidance that serious infringements or repeated infringement should result in revocation of the relevant business licenses. As a result, large sites that have been fined several times by NCAC or even found infringing in the civil courts for infringements can still legally operate in China.

²² For example, 1) the MIIT website and domain name registration process allows for fake IDs to register, making it difficult for right holders to identify infringers, 2) there is no identification authorization process which, coupled with lack of cooperation from ISPs, makes it difficult to find uploaders, 3) authorities that do take enforcement actions are reluctant to share evidence they have collected with right holders to facilitate private remedies like civil lawsuits, and 4) courts are not equipped at present to provide quick and effective evidence preservation proceedings. The implementation of "genuine name/ID" registration (IP address) will have a positive impact on fighting Internet piracy, including video streaming, e-commerce platforms, music sites and others.

²³ The recording industry notes that takedown rates of complaints filed with administrative authorities like MOC, NCAC and SARFT worsened in 2010.

²⁴ IFPI working with the local Jiangsu PSB conducted criminal investigations into targeted infringing music websites, with copyright holder provision of a large quantity of proof to fulfill the criminal threshold.

²⁵ On December 7, 2010, Xinhua News reported on the signing ceremony of the agreement on cooperation against online crime by public security bureaus in Hainan Province. The cooperative system involved PSBs in the 11 signatory cities in the Pearl River Delta agreeing to assist one another in conducting investigations to increase efficiency, remove obstacles in evidence collection and reduce cost. A similar cooperative system established in June 2009 led to more than 7,000 leads being handled through the system, resulting in the arrest of 460 suspects in 432 online criminal cases.

²⁶ See supra note 12.

nearly 8 out of every 10 copies of software deployed last year. This rate is flat from 2009 and has only dropped 3 points since 2006. The preliminary estimated commercial value of pirated PC software in China from U.S. vendors last year was nearly \$3.7 billion.²⁷ Piracy of U.S. business software in China not only diminishes sales and exports for U.S. software companies, but gives an unfair competitive advantage to Chinese firms that use this unlicensed software without paying for it to produce products that come into the U.S. market and unfairly compete against U.S.-made goods produced using legal software.

A significant hurdle to effectively dealing with enterprise end-user piracy in China is the lack of availability of criminal enforcement against end-user piracy. While the Supreme People's Court (SPC) indicated in a 2007 JI that under Article 217 of the criminal law, unauthorized reproduction or distribution of a computer program qualifies as a crime, authorities remain unwilling to take criminal end-user cases for fear of failing to meet the "for-profit" requirement in Article 217. The Chinese Government should make a clear commitment to criminalize enterprise end user piracy, providing details on the timing, framework and approach, including issuance of a Judicial Interpretation by the Supreme People's Court (SPC) and the Supreme People's Procuratorate (SPP) and corresponding amendments to the Criminal Code and Copyright Law and case referral rules for the Ministry of Public Security and SPP as needed. The 2011 Criminal IPR Opinions could be helpful in this regard, since they define in Article 10(4) the criteria of "for profit" as including "other situations to make profit by using third parties' works." Since the unlicensed use of software in enterprises involves reproduction and/or distribution, and since use of unlicensed software lowers costs and allows enterprises to "make profit," the Opinions appear to support criminalization of enterprise end-user piracy. Another key hurdle is meeting the applicable thresholds, i.e. calculation of illegal revenue or illegal profit, even if determined to be "for profit." In the meantime, the only avenue for seeking redress over the years have been the administrative and civil systems, which are under-funded and under-resourced, and which generally result in nondeterrent penalties. For example, in 2010, BSA lodged 36 complaints against end-users, including 13 with the local authorities and 23 with the National Copyright Administration for Special Campaign.²⁸ Unfortunately, in 2010, software end-user complaints shifted jurisdiction from the local Copyright Administrations to the LCEAs; as a result, only ten administrative raids were conducted in 2010. BSA brought nine newly filed civil cases in 2010, five against enterprise end-users, and one involving Internet piracy.²⁹ There is similarly a need to clarify criminal liability for hard disk loading (HDL) of unlicensed software. There have been a few such cases and at least one is in the preliminary investigation phase by a local PSB. Clarification will be helpful to building a pilot case and developing best practices.

Government Legalization of Business Software and Related Issues: Another important issue for the software industry is the need for the Chinese Government to ensure that government agencies at all levels use only legal software. At the December 2010 JCCT and in the joint statement from the summit between President Obama and President Hu in January 2011, the Chinese Government made several significant commitments on software legalization in the government and SOEs. These included: 1) treating software as property and establishing

²⁷ BSA's 2010 statistics are preliminary, representing U.S. software publishers' share of commercial value of pirated software in China. They follow the methodology compiled in the Seventh Annual BSA and IDC Global Software Piracy Study (May 2010), <http://portal.bsa.org/globalpiracy2009/index.html>. These figures cover packaged PC software, including operating systems, business applications, and consumer applications such as PC gaming, personal finance, and reference software – including freeware and open source software. They do not cover software that runs on servers or mainframes, or routine device drivers and free downloadable utilities such as screen savers. The methodology used to calculate this and other piracy numbers are described in IIPA's 2011 Special 301 submission at <http://www.iipa.com/pdf/2011spec301methodology.pdf>. BSA's final piracy figures will be released in mid-May, and the updated U.S. software publishers' share of commercial value of pirated software will be available at <http://www.iipa.com>.

²⁸ In 2009, based on BSA complaints, 19 end-user raids were undertaken by the local copyright administrations, 13 of which led to settlements, and only 3 of which resulted in administrative fines. The maximum fine was RMB20,000 (US\$3,033). In many of these cases, there was no seizure of the unlicensed software and computers employing it. This lack of a seizure remedy spills over into civil cases, as civil courts often refuse to authorize evidence preservation against an infringer unless the application is preceded by an administrative action establishing illegal software use or a right holder has obtained especially strong evidence.

²⁹ BSA filed three civil actions in 2009, and of those and previous cases, six settled. In 2009, major software companies won several civil judgments against those engaged in corporate end-user piracy, including the Dare Information Industry Ltd. Co. case; the Guangdong Huaxing Glass Co., Ltd. in Fuoshan, resulting in the defendant paying RMB500,000 (US\$75,840) in compensation and RMB1,000,000 (US\$151,680) for software legalization, and the July 2010 CRS Electronic Co. case. In which the court granted an evidence preservation order for the first time in an end-user software piracy case and the defendant paid RMB780,000 (US\$118,300) in compensation.

software asset management systems for government agencies, 2) allocating current and future government budgets for legal software purchases and upgrades,³⁰ 3) implementing a software legalization pilot program for 30 major SOEs and 4) conducting audits to ensure that government agencies at all levels use legal software and publish the results.³¹ These bilateral commitments have been followed by a number of directives from the Chinese Government implementing processes for software legalization in the government and SOEs. While these commitments and directives are welcome, it remains unclear whether they will be implemented in a meaningful and sustainable manner that results in a significant increase in legal software procurements. Using accounting firms and other credible third parties to conduct software audits and implementation of internationally recognized software asset management (SAM) practices can help achieve this result. The Chinese Government must also follow through on its commitment in prior years to ensure that all computers produced or imported into China have legal operating systems. Implementation in recent years has been spotty.

Physical Book and Journal Piracy: In addition to the Internet issues described above, the U.S. publishing industry continues to suffer from physical piracy including illegal printing of academic books and commercial bestsellers, and unauthorized commercial-scale photocopying.³² Well-known university presses suffer from trademark infringement as well, with university names and seals reproduced on content bearing no relation to the university and sold at mainstream bookstores. The industry continues to monitor textbook centers and libraries at universities but there appears to be continued improvement in this regard as the presence of pirated books at these venues has markedly decreased. Where pirated textbooks have been found on library shelves, they are out of date editions and thus do not pose a threat to publishers' current legitimate market. The partnership of the Ministry of Education (MOE) with GAPP, NCAC and local authorities remains essential to tackling the ongoing on-campus infringement issues, especially given the large number and wide geographic spread of universities engaged in these practices.

Areas for possible improvement include transparency with respect to inspections, raids and formulation of administrative decisions. In October 2010, publishers worked with the Beijing Cultural Enforcement Department (CED) to conduct a raid against several targets that appeared to be the suppliers and distributors of pirated trade books being sold by itinerant vendors at several high traffic areas in Beijing. Unfortunately, despite good information about the targets, only one target's wholesale premises was actually raided as CED lacked the manpower and resources to conduct simultaneous raids. Despite the presence of Public Security Bureau (PSB) officials, CED refused to raid a storage facility previously identified as associated with the target as it was not open at the time of raid on the target. Though the raid resulted in the seizure of over 300 pirated books, it was disappointing as earlier surveillance had indicated that the combined targets were housing a large volume of apparently pirated books at their various locations. A subsequent raid was executed against the second (of three targets) at which over 1,000 books were seized, although only about 100 were English language titles. There have been no further developments regarding proceedings against the first target, and further action by the authorities against the second target is unlikely. Enforcement efforts such as these continue to be hampered by a general lack of resources leaving the authorities simply unable to handle enforcement against distribution networks or other multiple targets. Similarly the authorities are unable to respond to timely intelligence, a fact which, combined with the authorities' inability or unwillingness to enter unmanned premises, makes evasion by pirates simple and enforcement efforts severely limited in effect.

Illegal Camcording:³³ The Motion Picture Association of America reports that the number of forensic matches from illegal camcords traced to China increased to 14 in 2010. MPAA also reports that camcording piracy has become a source of pirate films on Chinese UGC sites and as masters for pirate DVDs. SARFT should

³⁰ In implementing government legalization, IIPA notes that proper budget allocations should be made not only for the central government agencies but for provincial and sub-provincial levels.

³¹ It is our understanding that the government software audit agreed to by the Chinese Government in the summit joint statement involves an audit of agency budgets and spending on software rather than an audit of whether government agencies are using properly licensed software.

³² Copy shops continued to harm publishers by condoning, or providing as a service, illegal photocopying. Furthermore, English language teaching programs often use the prospect of high-quality, color materials to lure students to their after-school programs, but then make and distribute unauthorized photocopies of those materials instead of the originals.

³³ Among the harms of illegal camcording in China is that it fuels rampant online piracy negatively impacting worldwide distribution and prevents the establishment of legitimate online distribution platforms. Camcording also threatens the continued growth of the Chinese theatrical box-office marketplace.

immediately implement watermarking in theatrical prints and ensure that China Film Group/exhibitors step up efforts to deter illegal camcording. The government should consider a standalone law/regulations (such as that in the United States and several other countries to date). There is evidence that such a statute may be needed in China, as the first camcording case in China (in November 2008), involving a Chinese film, resulted in the three suspects being released by the police.

Other Hard Goods Piracy: Physical piracy remains rampant in China,³⁴ including the manufacture and distribution of factory optical discs (ODs);³⁵ the burning of recordable discs either retail or industrial copying using disc drives or towers; “hard disk loading” of software without a license onto computers for sale; production and/or sale of pirate videogames and circumvention devices; the production in China (generally for export) of high-quality counterfeit software packages; and the loading of pirate music on karaoke machines. The piracy levels for video, audio and entertainment software in physical formats continue to range between 90% and 95% of the market. China remains a source country for high quality manufactured counterfeit optical discs, many of which are found throughout the region, in Australia and in European markets such as Italy, Switzerland, Turkey, Poland and the United Kingdom.³⁶ In 2010, enforcement raids and seizures at the retail, wholesale, warehouse, or other distribution level continued to result in seizures of massive quantities of pirate product. Unfortunately, these “campaigns” do not result in significant improvements in the market for legitimate product.³⁷ In recent years, the civil courts, particularly the IPR divisions of the courts, have rendered more favorable decisions in copyright infringement cases, including some significant civil remedy awards in cases involving physical piracy.³⁸

³⁴ Physical piracy harms the legitimate markets for all IIPA members but in different ways. The recording industry estimated value of physical pirate product was US\$425 million in 2010, with a 95% physical piracy level; this is not an estimate of U.S. losses which greatly exceed this amount. For the independent film producers, physical piracy of DVDs remains a significant export constraint for independent producers and distributors, the majority of which are small- to medium sized businesses. Independent producers partner with local authorized distributors to finance and distribute film and television programming. These authorized distributors find it nearly impossible to compete with pirates and report that both physical and Internet-based piracy have significantly contributed to the demise of what was left of the home video market in China. Producers and distributors confirm that DVD sales have been particularly impacted since pirated digital copies are offered for free online and with a similar quality viewing experience that a DVD can provide. Unable to compete with free, legitimate distributors often cannot to commit to distribution agreements or they offer drastically reduced license fees which are inadequate to assist in financing of independent productions. Piracy undermines and may permanently damage legitimate distribution networks essential to reaching consumers and leaves little confidence for investment in intellectual property in China. On a positive note, IFTA also reports continued success with its certification program that is operated in conjunction with the Copyright Protection Center of China, an institution directly under the NCAC. This certification program provides an administrative method of preventing false registrations in China. To date, IFTA has issued over 2,950 unique certifications that demonstrate legitimate distribution rights to IFTA member product distributed in mainland China.

³⁵ Previous IIPA submissions have described in greater detail the number of factories, production over-capacity, interchangeable production methods (e.g., from music CD to DVD), and fraudulent practices (such as false marking of VCDs or DVDs as “Blu-ray”).

³⁶ An increasing number of pirate products found or seized around the world have “mould codes” allocated to optical disc plants located in China. Due to the lack of forensic results provided by the “PRC Police Bureau for Disc Production Source Identification Center” to overseas copyright owners, however, insufficient evidence is available to support further actions against these suspected plants. This is due to Chinese Customs adopting a recordation/registration system for the protection of intellectual property rights, rather than a system of random inspections.

³⁷ For example, IIPA members tracked the impact of the 2006 “100 Day Campaign,” directed primarily at retail piracy, on the availability of pirate product in the marketplace. While seizure statistics were very high, those studies concluded that pirate product remained available in virtually the same quantities as before the campaign commenced, just in a more clandestine manner; piracy activities also tended to return to normal when the campaign concluded.

³⁸ Several successful civil judgments against those engaged in “hard disk loading” have been obtained in the past couple of years.

- In July 2009, Microsoft won a civil judgment against Beijing Strongwell Technology & Development, one of the larger custom PC dealers in Beijing.
- In a case against Shanghai HISAP Department Store, the court awarded a total of RMB700,000 (US\$106,175) in damages and costs. Compensation in this case reportedly followed the SPC’s July 2009 announcement requesting civil judges to award damages on the “full compensation” principle. See <http://www.chinaipr.gov.cn/news/government/283006.shtml>.

IIPA members have voiced frustration with thresholds that make criminal enforcement rare. The entertainment software industry in particular registers its frustration in failure of the Chinese Government to bring criminal actions against manufacturers and distributors of pirated entertainment software and circumvention devices. Unfortunately, the methodology used by the Price Evaluation Bureau (PEB) fails to adequately account for the economic impact caused by pirated software and circumvention devices, and as a result, raids that result in the seizure of major quantities of pirated games or circumvention devices are rarely referred to the PSB unless counterfeit hardware is also involved. For instance, a factory was raided in Baiyun, Guangzhou in June 2010, where over 8,000 game copiers (circumvention devices) were seized; a similar raid in Liwan, Guangzhou in March 2010 resulted in the seizure of more than 19,000 pirated game discs. Neither of these raids were transferred for criminal action despite the enormous economic impact that would have ensued had these products made it to the market. PEB should make adjustments to the methodology it uses for assessing the value of seized goods in order to facilitate criminal prosecutions in appropriate cases.

Public Performance Piracy: Another abiding problem in China involves the unauthorized public performance of U.S. motion pictures, music videos, and increasingly, music, which occurs mostly unchecked (and unpaid for) in hotels, bars (including “Karaoke” bars),³⁹ clubs, mini-theaters (like KTV rooms), and karaoke establishments. In addition, there are instances of unauthorized broadcast by cable and/or satellite of the same.

China has long been in violation of its TRIPS/Berne Convention obligation to compensate copyright owners for the broadcast of musical compositions.⁴⁰ Finally, on November 10, 2009, the State Council publicly announced that commencing January 1, 2010, China’s broadcasters must begin making payments to copyright owners of musical compositions (songwriters and music publishers, through performing rights societies). The Measures on the Payment of Remuneration to the Copyright Owners of Audio Products would correct this longstanding TRIPS/Berne Convention violation to compensate copyright owners for the broadcast of musical composition. However, such payments are wholly inadequate and the tariff would result in one of the lowest payment rates in the world. Broadcasters could either choose to pay rights holders based on very low percentage of a station’s advertising revenue or pay RMB0.3 (US\$0.05) per minute for music played on the radio or RMB1.5 (US\$0.23) for TV. Advertising revenue for Chinese broadcasting was reported to be US\$10.16 billion in 2008.⁴¹ Since music performing rights payments in most countries are calculated as a percentage of such revenue, and it is estimated that 15% of music heard on Chinese broadcasting is U.S. music, the payment scheme is clearly tens of millions of dollars below what would be a fair rate. IIPA has urged that the new tariff be retroactive, at least to the date of China’s joining the WTO, but the new tariff is prospective only.

Pay TV Piracy: There were a few incidents of unauthorized use of copyright content during 2010 by broadcast and pay-TV networks in China. While SARFT is normally cooperative in assisting rights owners in responding to complaints filed, more stringent copyright compliance checks should be conducted by SARFT on a regular basis in 2011.

COPYRIGHT LAW, REGULATIONS UPDATES

The 2001 Copyright Law of the People’s Republic of China,⁴² subordinate regulations, judicial interpretations, or “opinions,” provide a sound basis for effective copyright protection on paper. Some of the laws

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- In a case against Beijing Sichuangweilai Technology & Development, one of the larger custom PC dealers in Beijing, RMB460,000 (US\$69,775) was awarded in damages.

In addition, in a case involving infringement of the Graduate Management Admission Test (GMAT), the Beijing No. 1 Intermediate People’s Court found that Beijing Passion Consultancy Ltd. infringed copyright and awarded the plaintiff RMB520,000 (US\$78,875) in damages.

³⁹ In November 2010, the China Audio-Video Copyright Association brought more than 100 karaoke bar operators in Beijing to court, claiming they supplied unauthorized music to customers.

⁴⁰ The recording also notes the desirability of a workable remuneration system for the public performance or other communication/broadcast of their recordings. With the increase in playing of recorded music in commercial premises as a primary form of commercial exploitation of music, public performance, communication to the public and broadcasting income is becoming a major potential source of revenue for record producers.

⁴¹ On Screen Asia, China in Focus, April 1, 2009, at <http://www.onscreenasia.com/article-4897-chinainfocus-onscreenasia.html>.

⁴² Previous IIPA Special 301 reports have gone through the legislative landscape in China in detail. This report is intended only to provide a summary of the key legislative and regulatory deficiencies and an update on new developments.

still require clarification or changes to fully meet China's treaty obligations.⁴³ With the adoption of the Internet Regulations in July 2006 and the entry into force of the WCT and WPPT on June 9, 2007, the legal infrastructure for effective protection of content online was significantly enhanced. One area of weakness has always been the Criminal Law, including Articles 217 and 218 of the Criminal Law of the People's Republic of China (1997) and accompanying Judicial Interpretations.⁴⁴

New Criminal IPR Opinions: On January 11, 2011, the "Supreme People's Court, Supreme People's Procuratorate and Ministry of Public Security Promulgated Opinions on Certain Issues Concerning the Application of Laws for Handling Criminal Cases of Infringement of Intellectual Property Rights" were issued.⁴⁵ These Opinions set out some important elements for Internet and related criminal cases and may help clarify and address other ongoing issues related to criminal liability in China. Salient features of the Opinions include:

- Article 10 of the Opinions reportedly provides that in addition to sale, "for the purpose of making profits" includes any of the following circumstances,
 - Directly or indirectly charging fees through such means as publishing non-free advertisements in a work or bundling third parties' works;⁴⁶
 - Directly or indirectly charging fees for transmitting⁴⁷ third parties' works via an information network or providing services such as publishing non-free advertisements on the site using infringing works uploaded by third parties;
 - Charging membership registration fees or other fees for transmitting⁴⁸ others' works via an information network to members; and
 - Other circumstances that make profits by taking advantage of others' works.⁴⁹
- Article 15 expands the scope of criminal liability by including as subject to accomplice liability "providing such services as Internet access, server co-location, network storage space, [and] communication and transmit channels..."⁵⁰
- The Opinions provide specificity on the thresholds for criminal liability in the online environment. Specifically, Article 13 provides that "[d]issemination of third parties' written works, music, movies, art, photographs, videos, audio visual products, computer software and other works without copyright owners' permission for profit, in the presence of any one of the following conditions, shall be regarded as "other serious circumstances" under Article 217 of the Criminal Law:"
 - illegal operation costs amount to over RMB50,000 (US7,585);
 - disseminating over 500 copies of third parties' works;⁵¹

⁴³ It is worth noting that a Chinese official has acknowledged that further amendments to the Copyright Law are needed. Interview with NCAC Vice Minister Yan Xiaohong, June 13, 2007, BBC (republishing and translation of original Xinhua text), June 9, 2007. This view has also been expressed by Chinese experts at a number of recent seminars held in China on protection of copyrights on the Internet.

⁴⁴ Among other things, the laws contained thresholds that are too high (in the case of illegal income) or unclear (in the case of the copy threshold), require proof that the infringement is carried out "for the purpose of making profits" which was left undefined, fail to cover all piracy on a commercial scale as required by TRIPS Article 61, fail to take into account the WCT and WPPT, only provide accomplice liability as to the criminalization of imports and exports (penalties available are much lower and generally non-deterrent), and leave uncertain the penalties for repeat offenders (the 1998 JIs included repeat infringers but were inadvertently not included in the 2004 JIs).

⁴⁵ IIPA does not at present possess a full English translation of the Opinions, but we have received summaries and refer to these herein. In addition to internal summaries, we draw points from Richard Wigley, New Guidelines for Criminal Prosecutions of Online Copyright Infringement Provide Aid in Fight against Online Piracy, China Law Insight, January 19, 2011, at <http://www.chinalawinsight.com/2011/01/articles/intellectual-property/new-guidelines-for-criminal-prosecutions-of-online-copyright-infringement-provide-aid-in-fight-against-online-piracy/>.

⁴⁶ This last phrase has been alternatively translated as "binding a third party's works with other person's works." See id.

⁴⁷ This has been alternatively translated as "disseminating."

⁴⁸ This has been alternatively translated as "disseminating."

⁴⁹ This has been alternatively translated as "Other circumstances that make profits by taking advantage of other's works."

⁵⁰ See Wigley, supra note 44.

⁵¹ This has been alternatively translated as "aggregate quantity of others' works being transmitted is more than 500 pieces." See id. The recording industry notes that differing interpretations have emerged over time and in different provinces with respect to the "500 copy" threshold. It is hoped that the Opinions will confirm that 500 different tracks or clips (or 500 copies of the same track or clip, or a combination) will suffice.

- disseminating third parties' works with the actual number of clicks amounting to over 50,000;⁵²
- disseminating third parties' works in a membership system with the number of members amounting to over 1,000;
- if the amount or quantities listed in 1 to 4 categories above are not met, but more than half of the amount or quantities in two of the above categories are met;
- in case of other serious circumstances.
- The Opinions reportedly also clarify that the crime of IPR infringement takes places where 1) the infringing product is produced, stored, transported and sold, 2) the place where the server of the website which distributes and sells the infringing product is located, 3) the place of Internet access, 4) the place where the founder or manager of the website is located, 5) the place where the uploader of infringing works is located and 6) the place where the rightful owner actually suffered from the crime. This reported listing provides extremely helpful guidance to the courts, as it would include the point of transmission, the point of receipt, the location of the server, the location of the key defendants, and any place where onward infringement causes harm to the right holder.⁵³

Importantly, the Opinions appear to confirm criminal liability against a web service which does not directly receive revenues from the dissemination of copyright material, but which charges fees indirectly through “non-free advertisements.” This clearer understanding of “for the purpose of making profits” in the Criminal Law is welcome. What remains to be seen is how various hosted or non-hosted piracy situations will be regarded under Article 10 or 15 of the Opinions. For example, the second prong of Article 10 seems clearly aimed at infringements over user generated content sites on which there is paid advertising. Article 15 would appear to reach cyberlockers over which infringement takes place (“network storage space”), infringing streaming sites (“communication and transmit channels”), web-hosting services, ISPs and payment processing companies. It is hoped the Opinions will also address IPR violations on auction websites dealing in hard goods piracy targeted toward foreign markets and services providing access to infringing content through deeplinks, and that they will assist in addressing repeat infringers. To the extent they do not, coverage of such should be confirmed in other laws or regulations. It also remains to be seen how Article 10 (“Other circumstances that make profits by taking advantage of others’ works”) will be interpreted. It is important to note that the Opinions are not limited to the online environment (dealing with other IPR crimes), and it is hoped that, for example, enterprise end-user piracy of software, which is clearly a circumstance which results in increased profits for an enterprise by taking advantage of others’ works, may be regarded as a crime under these Opinions. In the very least, the language lays the groundwork for such liability.

The Opinions also set out important clarifications with regard to thresholds for criminal liability. While it is yet to be seen how these new thresholds will be interpreted in practice, they appear to provide some flexibility and it is hoped they will ease the evidentiary burden to prove criminal liability in the online space. For example, whereas the previous numerical threshold was “500 copies” it now appears possible to prove a combination of elements, e.g., proof of “250 copies” combined with proof that there were 25,000 downloads appears to be sufficient under the Opinions, or as another example, in the case of a membership site, proof of 500 members combined with proof that “250 copies” were disseminated should now suffice for criminal liability. Moreover, it is hoped that the decision as to whether the threshold is met will be vested with the Procuratorate rather than the MPS or PSB. This is because the MPS or PSB, as they have in the past, may claim that the evidence provided by the right holders does not meet the criminal threshold such that they refuse to accept the case at the outset. In fact, it is necessary to require the MPS/PSB to conduct further investigation, e.g. the advertising revenue, membership detail, etc. as part of determining whether the threshold requirement is met.

Copyright Law – Some Remaining Issues: The following name just a few remaining issues in need of reconsideration, with mention of any relevant international treaties:

- **Temporary Copies (WCT and WPPT):** Copyright protection in China should extend to reproductions regardless of their duration (e.g., as long as they can be further reproduced, communicated, or perceived).

⁵² This has been alternatively translated as “[w]here others' works being transmitted has been actually clicked for more than 50,000 times.”

⁵³ See Supreme People's Court, Supreme People's Procuratorate and Ministry of Public Security Promulgated Opinions on Certain Issues Concerning the Application of Laws for Handling Criminal Cases of Infringement of Intellectual Property Rights, Watson & Band, January 13, 2011, at http://www.watsonband.com.cn/news/detail?id=182&language=en_US.

Neither the Copyright Law nor subordinate laws or regulations (e.g., the July 2006 Information Networks Regulations) confirms such coverage.

- **Scope of Coverage of July 2006 Regulations:** Although SCLAO's Director General Zhang has taken the position that all rights (and not just "communication to the public") are covered directly by Article 47 of the Copyright Law, and therefore the July 2006 Regulations), language to remove ambiguity would be helpful.
- **Service Provider Liability Under the July 2006 Regulations:** While the July 2006 Regulations provide for notice and takedown, preserve injunctive relief, and preserve liability in the case of knowledge or constructive knowledge, there are some issues that need to be clarified, especially in light of recent court decisions.⁵⁴ For example, under Article 23 of the July 2006 Regulations, it appears clear that ISPs are liable for linking to infringing materials, and Article 23 has been interpreted as such by the Court in the Yahoo!CN decision. But the Baidu decision casts doubt on whether Article 23 applies to deeplinking in the absence of actual knowledge. It is also important to clarify 1) the adequacy of electronic mail notices, and 2) the requirement that takedowns must occur within 24 hours subject to penalties imposed for non-compliance of right holders' notices⁵⁵ and the proviso that ISPs failing to take down sites following compliant notices will be deemed infringers and subject to administrative fines.⁵⁶ In addition, the current law does not, but should, provide a fair and effective mechanism to address repeat infringers.
- **Compulsory License Under the 2006 Regulations (Berne/TRIPS):** Article 9 of the 2006 Regulations sets forth a statutory license, which Director General Zhang has confirmed applies to foreign works which are owned by a Chinese legal entity. Unfortunately, such a compulsory or statutory license would appear to be inconsistent with China's Berne Convention and TRIPS obligations.
- **Other Exceptions and Limitations in the 2006 Regulations (Berne/TRIPS):** IIPA remains concerned about: (a) potentially overbroad exception as to teachers, researchers and government organs in Article 6; (b) the reference in Article 7 to "similar institutions" which leaves open who may avail themselves of the exception, and the failure to limit Article 7 to "non-profit" entities; and (c) lack of express exclusion of Article 8 to foreign works.⁵⁷
- **Communication to the Public for Related Rights (WPPT):** The Chinese Government should confirm a full communication to the public right, including public performance, broadcast, simulcast and cable transmission rights for sound recordings as well as works.
- **Civil Pre-Established Damages, and Maximum Administrative Fines:** Statutory damages under the Copyright Law (Article 48) should be increased to RMB1 million (US\$151,680, as in the patent law), made per work, and permitted at the election of the copyright owner. In addition, maximum administrative fines should be increased and assessed for each day an infringement persists in order to foster deterrence.
- **Protection for Live Sporting Events:** The law should be amended to ensure that live sporting events are protected either as works or under neighboring rights (i.e., such that unauthorized retransmission of copyright broadcasts is clearly forbidden).
- **Presumptions of Subsistence and Ownership:** The Law should be amended to establish clear presumptions of copyright subsistence and ownership.

⁵⁴ IIPA notes that a new China Tort Liability Law was enacted and passed by the Standing Committee of the National People's Congress of PRC on December 26, 2009. It came into effect on July 1, 2010. Under Article 36 of the Law, Network Users and Network Service Providers will be held jointly liable for an act of infringement if the Network Service Provider "knows" that a network user is using the network service to infringe others' civil rights but has not taken any necessary measures with respect to such practices. However, a Judicial Interpretation is needed to clarify that the word "knows" under Article 36 of the Tort Liability Law should mean "knows or ought to know" so that it becomes consistent with Article 23 of the Regulation on the Protection of the Right to Disseminate via Information Network.

⁵⁵ The January 20, 2010 Declaration on Content Protection contains the principle that takedowns should be accomplished within 24 hours.

⁵⁶ The NCAC should clarify and reform the evidentiary requirements necessary to provide a compliant notice. Unfortunately, Article 14 of the Internet Regulations arguably appears to require detailed evidence, including detailed copyright verification reports, and, if so, that Article should be amended.

⁵⁷ Director General Zhang also confirmed that Article 8, which affects publishers, would not apply to foreign works but this should be confirmed in writing and a notice made widely available.

- **Term of Protection:** China should take the opportunity while modernizing its law to extend the term of protection to life plus 70 years for works, and to 95 years for sound recordings and other subject matter where the term is calculated other than on the life of the author. Extending term will ensure China is following the international trend and that it will receive the benefit of reciprocal protection in other countries which provide longer term of protection.

Other Regulations – Administrative-Criminal Transfer Regulations: The amended Criminal Transfer Regulations leave unclear whether transfers are required upon “reasonable suspicion” that the criminal thresholds had been met, and thus, some enforcement authorities believe “reasonable suspicion” is insufficient to result in a transfer, requiring proof of illegal proceeds; yet, administrative authorities do not employ investigative powers to ascertain such proof. The “reasonable suspicion” rule should be expressly included in amended transfer regulations.

MARKET ACCESS AND RELATED ISSUES

IIPA has consistently stressed the direct relationship between the fight against infringement and the need for liberalized market access to supply legitimate product (both foreign and local) to Chinese consumers. Unfortunately, there are a range of restrictions, affecting most of the copyright industries. Some of these must be eliminated as a result of a recent successful WTO case brought by the United States against China (as discussed below). All of them stifle the ability of U.S. rights holders to do business effectively in China.

Chinese market access restrictions include ownership and investment restrictions,⁵⁸ a discriminatory and lengthy censorship system (which further opens the door to illegal content), restrictions on the ability to fully engage in the development, creation, production, distribution, and promotion of music and sound recordings,⁵⁹ and the continued inability to engage in the import and export, distribution, publishing, and marketing online of published materials in China. They also include the maintenance of a quota of 20 foreign films for which revenue sharing of the box office receipts between the producers and the importer and distributor is possible,⁶⁰ the inability to import and distribute films except through the two main Chinese film companies (the duopoly), a screen-time quota for foreign theatrical distribution and foreign satellite and television programming, blackout periods for films, local print requirements, and onerous import duties, all of which close off the market for U.S. produced films and programming.

An onerous ban on the manufacture, sale and importation of videogame consoles remains a major barrier.⁶¹ Entertainment software companies also continue to face lengthy delays in the censorship approval process, wiping out the very short viable window for legitimate distribution of entertainment software products. The recently concluded WTO case will hopefully help address some, but not all, and in many cases, not the fundamental issues with respect to access to the Chinese market for U.S. music, movies, and books, and leave untouched many issues for the other industries. IIPA also notes a range of policies that China has developed under

⁵⁸ For example, Hong Kong and foreign companies may not invest in any publishing or importing businesses for audio-visual products in mainland China.

⁵⁹ For example, the recording industry notes that the MOC Circular dealing with online music contains a restriction on “exclusive licenses” of online music services. Currently, there are less than 20 licensed services in China providing repertoire from non-local record companies. There should not be any problem for MOC to regulate these services and conduct anti-piracy actions against other infringing sites. Record companies should be free to choose their licensees.

⁶⁰ The impact of the “quota system” in China on the independent segment of the film and television industry is particularly damaging because most often the independents do not have access to legitimate distribution in China. For example, the recent WTO decision on intellectual property rights said that China could not solely extend copyright protection to works that are approved for distribution in China (i.e., pass censorship) as this inherently damages rights holders who cannot access “approved” distribution in China and whose works are simply not protectable under current Chinese Copyright Law. Similarly, the nontransparent censorship process in China and its multiple levels poses a significant market access barrier to the independents. Local distributors have reported the inability to obtain an official notice of denial from the censorship authorities.

⁶¹ The current ban on the manufacture, sale and importation of electronic gaming devices (i.e., video game consoles), in effect since a 2000 Opinion on the Special Administration of Electronic Gaming Operating Venues, stymies the growth of the entertainment software sector in China. The ban even extends to development kits used in the creations and development of video games. The ban impacts not only foreign game publishers, but also domestic Chinese developers, who are unable to obtain such kits given the prohibition on their importation.

the banner of promoting “indigenous innovation” that have the effect of discriminating against foreign products or compelling transfers of technology and intellectual property to China in order to access the market. These policies limit market access for software and other IIPA member products and undermine the IP development of U.S. and other foreign copyright industries.

Previous IIPA filings, including that to the United States International Trade Commission in July 2010, raised the litany of market access issues of concern to the copyright industries.⁶² The following provides an update on several significant issues.

WTO Case Implementation Update: On December 21, 2009, the WTO Appellate Body issued its decision on the appeal by China of the WTO Panel’s report on certain Chinese market access barriers to the motion picture, recording and publishing industries.⁶³ This landmark WTO case will require China to open up its market for these industries in significant ways and hopefully begin the process of undoing the vast web of restrictions which hamper these industries not only from doing business in China, but in engaging effectively in the fight against infringement there. Specifically, the Appellate Body affirmed the Panel’s ruling that requires China to:

- **allow U.S. companies to import freely into China** (without going through the government monopoly) films for theatrical release, DVDs, sound recordings, and books, newspapers, and periodicals. This is a significant market opening result.
- **provide market access to, and not discriminate against, foreign companies wishing to distribute their products in China.**⁶⁴
- **discard discriminatory commercial hurdles** for imported reading materials, sound recordings intended for electronic distribution, and films for theatrical release.⁶⁵

Related to this last point, the WTO Panel and Appellate Body, in a technical finding, concluded that they lacked sufficient information to determine whether China’s discriminatory censorship regime for online music violated China’s WTO commitments. However, this was not a “green light” for the Chinese to continue their discriminatory censorship practices. China’s discriminatory regime is both unfair and highly suspect under WTO rules. China further complicated an already unsatisfactory situation by issuing the September 2009 Circular on Strengthening and Improving Online Music Content Examination (issued while the WTO case was being adjudicated and therefore not the direct subject of any Panel ruling). This Circular puts into place a censorship review process premised on an architecture already determined to violate China’s GATS commitments—by allowing only wholly-owned Chinese digital distribution enterprises to submit recordings for required censorship approval. When China joined the WTO, it agreed to allow foreign investment in all music distribution ventures on a non-discriminatory basis. That includes online music distribution. By excluding foreign-invested enterprises (FIEs) from submitting imported music for censorship review, the Circular denies bargained-for market access and discriminates against FIEs thereby violating China’s national treatment obligations. It violates China’s accession commitments under the General Agreement on Trade in Services (GATS) and the General Agreement on Tariffs and Trade 1994 (GATT); it also violates China’s Accession Protocol commitment to authorize trade in goods by any entity or individual. China must revoke or modify the Circular to fix these problems relating to the rights of FIE’s to distribute music online, and the discriminatory censorship processes for treating foreign as opposed to local content.

⁶² See supra note 7.

⁶³ China – Measures Affecting Trading Rights And Distribution Services For Certain Publications And Audiovisual Entertainment Products, WT/DS363/AB/R, December 21, 2009, at <http://www.wto.int>. The U.S. Government requested consultations in this case on April 10, 2007, supported by the China Copyright Alliance (a coalition consisting of MPA, IFTA, RIAA, IFPI and AAP).

⁶⁴ Specifically, China must fix its measures in ways which will: open its market to wholesale, master distribution (exclusive sale) of books and periodicals, as well as electronic publications, by foreign-invested companies including U.S. companies; permit sound recording distribution services, including electronic distribution, by Chinese-foreign contractual joint ventures, including majority foreign-owned joint ventures; allow the participation of foreign capital in a contractual joint venture engaged in the distribution of reading materials or audiovisual home entertainment products; ease commercial presence requirements for the distribution of DVDs; and do away with China’s 15-year operating term limitation on foreign joint ventures.

⁶⁵ For example, China must not improperly and discriminatorily limit distribution for imported newspapers and periodicals to “subscriptions,” and must not limit such materials and other reading materials to Chinese wholly state-owned enterprises, and may not limit the distributor of such reading materials to a State-owned publication import entity particularly designated by a government agency. Finally, China may not prohibit foreign-invested enterprises from engaging in the distribution of imported reading materials.

While the U.S. had also alleged that certain Chinese measures indicated that imported films for theatrical release can only be distributed by two state-controlled enterprises (China Film and Huaxia), whereas domestic films for theatrical release can be distributed by other distributors in China, the WTO Panel (upheld by the Appellate Body) concluded that the duopoly did not constitute a “measure,” and cited the lack of any evidence that a third distributor had been denied upon an application from operating in the Chinese market. Were there to be a de facto duopoly as to foreign films only that was enforceable by a measure, the Panel and AB reports confirm that China would be in violation of its WTO obligations. The industries view this decision as confirming that, to be consistent with what the Panel and AB reports have said, China must approve applications for other theatrical film distributors in China, a step which would significantly open up this market to competition, and additionally, would open up to competition and negotiation the underlying agreements upon which foreign films are now distributed in China.

The Appellate Body report was adopted by the Dispute Settlement Body on January 19, 2010, and the parties in consultation came to an agreement of 14 months for implementation of the report, so the expiration date for China to implement the market access decision is March 19, 2011. IIPA views it as critical for the U.S. Government to take an active approach to pressing the Chinese Government to implement its commitments arising from the market access case, and to address the two very important issues noted above related to discrimination of foreigners in the distribution of music online and breaking the duopoly for foreign theatrical film distribution in China. Intensive engagement with the Chinese Government is essential to achieving meaningful implementation of the WTO ruling, and thereby make possible broad gains in bringing U.S. creative industries’ products to market in China.

Indigenous Innovation: Over the past several years, China has been rolling out a series of policies aimed at promoting “indigenous innovation.” The apparent goal of many of these policies is to develop national champions by discriminating against foreign companies and compelling transfers of technology. Of particular concern are policies that condition market access (including the provision of government procurement preferences) based on local ownership or development of a service or product’s intellectual property or aim to compel transfers of foreign intellectual property and research and development to China. A broad array of U.S. and international industry groups have raised serious concerns that these policies will effectively shut them out of the rapidly growing Chinese market and are out of step with international best practices for promoting innovation. IIPA has shared its concerns as well and strongly believes that the best ways for China to further enhance its innovative capacity are to: further open its markets to foreign investment; provide incentives to innovate by ensuring full respect for intellectual property rights including patents, copyrights and trademarks; avoid policies which establish preferences based on nationality of the owners of the intellectual property rights; and act forcefully and promptly to prevent misappropriation of such rights.

In this regard, it is noteworthy that following the summit between President Obama and President Hu, the joint statement issued on January 19, 2011 indicated that “China will not link its innovation policies to the provision of government procurement preferences.” The accompanying the White House “Fact Sheet” on “U.S.-China Economic Issues” issued the same day indicated that:

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

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

TRAINING AND PUBLIC AWARENESS

MPA, IFPI and BSA undertook a number of training and awareness programs throughout China in 2010. The trainings have involved police, prosecutors, judges, customs officials, and administrative agency enforcement personnel. For example, BSA provided Software Asset Management (SAM) training for over 300 enterprises in Beijing, Nanjing, Kunshan, and Guangzhou, facilitated SAM Training for 100 central SOEs and 80 financial

companies in Shanghai, and provided SAM tools for a free trial in Shanghai for 10 financial companies. The recording industry group, IFPI, through its Asian Regional Office and its Beijing Representative Office, conducted 14 Internet Training Workshops for NAPP, NCAC, MOC, PSB officials and for Judges between September 2009 and December 2010.

Throughout 2010, MPA continued to engage the local government in trainings and seminars in hopes of raising awareness of piracy and its harm toward developing the creative industry. These efforts included participation in: a seminar in early 2010 for officials from Beijing, Tianjin and Shanghai specifically to promote awareness of the Criminal Law, and discuss the 500 copy threshold;⁶⁶ other seminars for government law enforcement officials to highlight the need for judicial protection in China's copyright protection regime; trainings for theater owners to raise the awareness of illegal camcording and consequent harm to the film industry; judges' trainings to highlight Internet piracy issues and share experiences from overseas markets; various industry events (e.g., China Digital TV Summit, China Telecom Business Value Chain Seminar, Beijing Cultural and Creative Industry Expo, and film festivals) to leverage platforms for building anti-piracy alliances and to seek support from relevant parties; copyright verification and online piracy investigation technical trainings for local law enforcement officials; various industry trade shows/film festival forums and the annual copyright expo to highlight the need for copyright protection as necessary in developing the value chain for China's creative industry.

HEARING CO-CHAIR D'AMATO: Well, thank you very much, Mr. Schlesinger, for a very strong and interesting statement.

I know there will be a number of questions. If you do not mind, Mr. Wasch, we will interrupt this panel for a moment to accommodate Congressman Sherman. It will take awhile, Congressman. We're going to be here for another hour so if you wouldn't mind switching with Congressman Sherman, we'll be right back with you for some questions.

PANEL I (CONTINUED)

The Commission is very pleased to have Congressman Brad Sherman with us from the 27th District of California, and he's serving his eighth term in the Congress.

He's the top Democrat in the House Foreign Affairs Subcommittee on International Terrorism, Nonproliferation and Trade, as well as a senior member of the Financial Services Committee.

He's been a leader in the fight against unfair trade practices that negatively affect American workers. In the 111th Congress, Congressman Sherman sponsored H.S. 6071, the Emergency China Trade Act of 2010, which would have withdrawn most favored nation status for Chinese products and required the President to negotiate a balanced trade relationship between the United States and China.

In his position as Ranking Member of the Subcommittee on International Terrorism and Trade, the Congressman recently has had a hearing examining China's Indigenous Innovation Program, which the Commission is reviewing today and is a concern of American business and labor interests alike.

The Congressman has been a vocal critic of language in the U.S.-Korea

⁶⁶ MPA reports that only Beijing (Chaoyang District) and Shenzhen have implemented the threshold in practice.

Free Trade Agreement that would allow goods that were made mostly in China to be imported to the United States through Korea.

Congressman, we very much appreciate your hard work on these important issues and coming to the Commission today. And we're open to any comments you wish to make.

**STATEMENT OF BRAD SHERMAN
A U.S. REPRESENTATIVE FROM THE STATE OF CALIFORNIA**

MR. SHERMAN: Thank you.

I know this Commission focuses on the national security aspects and foreign policy aspects of our trade relationship, but since Admiral Mullen has commented that the greatest national security threat we face is the U.S. budget deficit, it seems clear that the economic health of our country and our national security are so intertwined that to say, well, you're not concerned about the economic aspects, just the national security aspects, would be a non sequitur.

Second, as just a matter of economic theory, we're running a huge trade deficit, and there are only two explanations. One is that the American workforce is underskilled, overpaid and lazy; the other is that the American government and Wall Street and the talking classes of the United States have acted in their own interests and betrayed the American middle class. I'll leave it to you which of those two explanations better explains our situation.

We are going to need radical change, and I'll describe my bill at the end and its purposes. And finally I'd like to commend many on the Commission for standing up to the condescension that is one of the chief tools of those who benefit from the present system, as if those of us who think there is something the matter with our trade relationship didn't take Economics 101.

We did, and all the economic theory would say that the trade deficit that we have with China is impossible. So those who benefit from that or want to defend it simply say "it's such a beautiful theory; you just have to ignore the facts." And that is what we do every time we point to an enormous and growing trade deficit, and we're told "but it's such a beautiful theory."

The reason the theory breaks down is because the theory assumes that every other country is just like us. What is America? What is our economic system? It is a system of private actors acting in their own self-interests, constrained only by published laws and regulations. If you eliminate the textile quota from a particular country, more textiles come in from that country. Why? Because private actors find it in their own interests, and private actors are not constrained except by written laws and regulations.

Culture does not constrain them; making a buck whether it be by importing, exporting, whatever, is the American way. And so we assume

that Adam Smith lives by the billions in China. This is not true. So we negotiate a change in our written laws and regulations in return for at most a change in their written laws and regulations, as if well-written laws and regulations are the only constraint in private actors in the United States, so that must be true in China as well.

Put yourself in the following position: let's say I believe in American jobs, and I call the local Toyota dealer in my district, and I say, Jack, stop selling those Toyotas; don't even--start--open up--start selling Fords, and don't even sell the Fords that are made abroad, just the ones here, the only question would be whether he would laugh at me or hold a press conference saying, "idiot congressman tries to influence private sector enterprise."

Now imagine I'm not a Congressman, I'm a commissar in Shanghai, and I call a business, and I say, look, I know we have to import these goods, but you should buy the German goods, not the American goods, because the Germans insist that we have a balanced trade relationship with them. So we got to buy some of their stuff if we're going to sell to Germany, and the Americans are, well, idiots.

And you make that call as a commissar. Do you think that the response is but the American goods are better or cheaper? The conversation might go something like this: Mr. Wen--if that's his name--we're sure you'd make the right decision because I see your resume here, and you're very well educated; I'd hate to think you need reeducation.

Now, the fact is such pressure isn't really necessary because the major economic actors in China are partially owned or controlled by the Chinese government anyway. And so when an American airline buys planes, they'll buy from the United States, they'll buy from Europe, but no American airline has said, well, we'll buy the Airbus only if you build a factory in Alabama. Yet, what happens when Boeing tries to sell to China?

It's not an independent actor making a decision as to what is in the economic interest of a private airline. It is a national planning apparatus, and so if we enter the world in which our only shield is written laws and regulations, and we enter into treaties to change them, and we play against a society in which government control of private enterprise, the ability to intimidate, a culture of governmental control, are all available, in addition to written laws and regulations, we should not be surprised at the result unless it's "but nothing prevents a man from understanding something like that his livelihood depends on not understanding it."

I forget who said that, but they were quite wise. And so we are constantly, constantly repeated "the old economic theory," and the economic theory is based on, you know, everybody being Adam Smith and every society being one in which they're free economic actors.

As to some of the current issues that are before us and how we got here, we made a blunder in giving most favored nation status to China. We changed our written laws and regulations in return for them perhaps changing theirs--that was H.R. 4444. In the Chinese tradition, 4444

connotes extreme bad luck. Chinese are telling us something. Maybe we're telling ourselves something.

Our trade deficit exploded from 84 billion to 273 billion. During the recession, it dropped a little bit, and every time we run a trade deficit with China, the response is, oh, our trade deals are just wonderful. It's because America is running a budget surplus or a budget deficit. Well, last year, we had the biggest budget deficit in our history. Just a decade or so ago, we ran a very large budget surplus and the trade deficit grows and grows and grows. It grows in the sunshine; it grows in the shade.

But every effort is made to blame America for what is Chinese mercantilist policies, and you should blame America because we're getting away with it. They're doing a good job of protecting their people; they have done an outstanding job of taking a very poor population and raising its standard of living.

Now, as to the size of our exports, they only equal 1.6 percent of China's GDP, and this is actually shrinking. So there is no overall Chinese effort to reduce the trade deficit. They are importing less from us as a percentage of GDP than they did before. Economic Policy Institute study on unfair China trade estimates that between 2001 and 2008, 2.4 million American jobs were lost or displaced.

We are told that our exports are growing more quickly than our imports, which just shows that the devil has a calculator. The fact is, no, as a percentage, our imports are growing less quickly than our exports, but in dollar amounts. So usually if something--one thing grows by 50 billion, something else grows by 100 billion, the 100 billion is usually thought to be the larger number.

[Laughter.]

MR. SHERMAN: It's like saying that I increased my follicle count more than anyone else in the room. Yes, but from what base? And, of course, individual American companies are even if they resent the situation, they quickly adjust to it. They're not public policy actors.

They say, well, in a fair world, we'd export \$10 billion worth of goods to China, and we'd make them in the United States, but it's an unfair world, so we're only going to sell \$4 billion worth of goods to China, and we're going to have to enter a co-production agreement to do it, but that's \$4 billion that we wouldn't have otherwise.

So American businesses, if anything, send their lobbyists here to Washington to show the Chinese how much they deserve not to be completely screwed when they go to China because they're here on the Hill lobbying for the present system.

The latest outrage is the indigenous innovation policy, and here the direction has gone out from Beijing: buy Chinese goods, especially for state and local governments, but also for other companies as well.

Now, the Chinese are being urged to un-ring the bell. Send out a memo saying, well, we didn't really, the Americans have asked us to tell you

that we really don't think you should not buy your goods. You can't un-ring the bell. The fact is the word is out: discriminate against imports, particularly American imports, in all state and local or provincial and local government purchases.

Now, obviously we should do something about the currency manipulation. The one other comment I'd want to make here is that the current system is not just insanity for the United States; it is insanity for China, a developing country with a U.S. bond fetish.

Every year they make a lot of stuff, and what do they get for it? More U.S. bonds. This is a country where people aren't getting enough protein if they're getting enough food. Do they import American chickens? No, they import American bonds.

There is a codependency here that is bad for both countries. You would think that China would import 100 million chickens every week from us on the theory that if the government wants to be popular, there is a proven political slogan, "a chicken in every pot." But, instead, they just buy another \$100 million worth of our bonds.

Developing poor countries investing their capital in America rather than using that money to raise the standard of living, using that money to import goods so as to control inflation in China, it is a perverse relationship from both sides although I can't say that my bill is done to correct the perversity and the harmful effects of it on China.

Yes, we need to deal with the currency manipulation. Yes, we need to deal with the indigenous innovation. Yes, we need to deal with the copyright infringement and the piracy. But ultimately these are just nibbling around the edges. We need a balanced trade relationship with China. And you cannot get a balanced trade relationship with a country that has a managed economy just by using Adam Smith advice for how to deal with countries that have free economies.

What you need instead is an agreement to have balanced trade. My bill would cut off MFN for China six months after enactment, not for the purpose of cutting off, of ending all trade or taking it back to a few billion dollars a year in each direction, but rather for the purpose of causing a crisis and entering into an agreement with China that is guaranteed to reach balanced trade within four years.

One way to do that is Warren Buffett's long ago put-forward policy, and it's similar to cap and trade, and I don't want to get involved in that argument because it has nothing to do with carbon atoms or higher energy costs or alleged higher energy costs for Americans.

What it is, is you export something to China, you get a chit; you want to import something from China, you need a chit. You do that, you can have, you can determine how large the trade deficit will be. You could say you export to China, you get 1.2 chits, and you import a dollar's worth of goods from China, you only need one chit, and then you're going to have it being unbalanced to the ratio of 1 to 1.2. Well, that might be good for a

year or two, and then you can work your way to 1.1. Economic theory would say that we should eventually repay our debt to China.

Another point I want to make is that there are those who think that America should cower in fear because China is our banker. These are people who start with their own experience. If the bank has a mortgage on your home, and you don't pay them, then the sheriff will come throw you out of your home, and so you ought to fear your banker.

Putting aside our invasion of Haiti in roughly 1905 and seizing their customs houses in order to make sure they paid their debts, since about then, sovereign countries are operating as if there is no sheriff. Your bank would have to be nice to you to get you to pay your mortgage payment if we had a rule that they could never foreclose against your house.

In international affairs, it is the debtor, not the borrower, who has the ultimate power. So I've gone on long enough. I look forward to whatever questions you might have, and I thank you for your work on this important issue.

Panel I: Discussion, Questions and Answers

HEARING CO-CHAIR D'AMATO: Thank you very much, Congressman Sherman, for that tour de force, and if 4444 is extremely bad luck, we hope 6071 will be extremely good luck, and I know you have to get back for a committee meeting, but I know there are a couple of quick questions that some of the Commissioners have for you if that's okay with you.

Commissioner Wessel.

COMMISSIONER WESSEL: Actually not a question, but a comment, and thank you, number one, for being here today and for your leadership on this issue.

Also, as you may know, this Commission has a broad charge of not only economic but other security issues. Your work on the Kaesong issue to try and ensure that our sanctions regime is faithfully reflected and enforced so that further resources aren't going to the North Korean regime is appreciated and well-noted. So thank you for that.

MR. SHERMAN: If I can use that just as an excuse to talk about the Korea Free Trade Agreement, two things. First, it is a unilateral free trade agreement with China to the tune of 65 percent. That is to say goods can be made 65 percent in China, 35 percent completed in South Korea, perhaps by Chinese guest workers, come into the United States duty-free, not most favored nation, but duty free. And yet, of course, we don't get any concession at all as far as getting our goods into China.

The second thing is that we will be between a rock and a hard place if we sign the Korea Free Trade Agreement because, on the one hand, our national security laws say don't let goods partially made in North Korea into the United States.

The agreement--and all the proponents of the agreement have refused

to remedy this--seems to say that if we block any goods that are partially made in North Korea but partially made in South Korea--for auto parts or electronics, that would be the 65 percent North, 35 percent South, or 50-50, or anything less than 65 North--having a right to enter the United States, but our laws will block the entry of those goods; therefore, we're in violation of the agreement.

South Korea can then either push us to change our national security laws, which the administration refuses to have codified so they're free to change them, or some subsequent administration change them at any time.

Or, alternatively, face sanctions from South Korea where they can then use our national security laws vis-a-vis North Korea to take back any concession they made in the negotiations that they aren't real happy with.

So for us to enter into this agreement without an explicit binding, I don't just mean a press release from South Korea saying we know that America has a policy of not admitting North Korean goods, but an agreement from South Korea that we are not in violation of the agreement by barring North Korean or partially North Korean-made goods, we won't get that because I don't have a megaphone loud enough to make this an issue nationally although this one, this megaphone, is working pretty good. So maybe we can.

Thank you for that question.

COMMISSIONER WESSEL: You are being heard by some, and we hope that you'll be heard by a broader range of actors.

Thank you.

HEARING CO-CHAIR D'AMATO: Thank you.

Commissioner Mulloy.

COMMISSIONER MULLOY: Congressman, thank you for being here.

I follow very closely when you speak on the floor. We get that from our staff, and I read everything you're saying. You've got it as far as I can see, exactly what's going on here. Now you talk about, we send the dollars to China for the goods that we import, and then they're buying our Treasurys.

I was at a meeting yesterday where a high administration official said we're now encouraging Chinese investment into the country, not just to buy Treasurys.

This concerned me. Traditionally we have not wanted our own government owning large chunks of the American economy. Now, the Chinese investment, which is all by state-owned enterprises or state-owned investment funds, is going to end up owning chunks of our economy.

So the only solution to this is to balance trade as quickly as we can so they stop accumulating all those dollars and future claims on the American economy. Do you see it that way, and is this a concern that members of Congress are now looking at?

MR. SHERMAN: Look, if somebody, anybody, wants to build a factory in my district, it's going to be very hard for me not to be there to cut the

ribbon. We need jobs in the San Fernando Valley, and every member of Congress would tell you that. And so the solution, of course, is to end the trade deficit. It does worry me that Chinese investment will give China even more power. They already have power in Washington because so many people, highly-placed in the United States, make so much money importing stuff from China.

You make it for pennies, you sell it for dollars, what better use of an MBA? So it does worry me that they'll have the power, and you see this all the time. When somebody says, hey, there are a thousand jobs in my district; I voted that way for that reason, but ending the trade deficit is a solution.

COMMISSIONER MULLOY: Thank you, Congressman.

HEARING CO-CHAIR D'AMATO: Thank you, Congressman, Mr. Chairman, for coming.

Let me ask you one quick question. You mentioned ININ, indigenous innovation--you had a hearing on it. Is there any one specific remedy that you have thought about that would be something that we could recommend to Congress, that we could approach in terms of trying to roll this back?

MR. SHERMAN: Well, first, we can insist that the Chinese do more to roll it back. Then if we feel that the bell cannot be unring, we would demand that, if anything, they have targets or goals for more buying from the United States and specific targets for their state, or provincial and local governments.

And then finally, since we're not likely to get anything but flimflam from China, we've got to look at American laws preventing the acquisition of Chinese goods by state and local governments. If they can't unring their bell or won't, we ought to ring our bell.

HEARING CO-CHAIR D'AMATO: Well, thank you very much again for your comments, Congressman, and I know you have got to get back. We appreciate it, and we'll be back in touch, and thank you very much.

MR. SHERMAN: Thank the Commission for its work.

HEARING CO-CHAIR D'AMATO: Let's get our panelists and resume our panel. And I think we're at the point where Mr. Wasch is going to give his presentation, and then we'll go to questions.

Panel II (resumes)

STATEMENT OF MR. KEN WASCH PRESIDENT, SOFTWARE & INFORMATION INDUSTRY ASSOCIATION WASHINGTON, DC

MR. WASCH: Thank you, Commissioner Shea and Commissioner D'Amato.

I'm going to take Senator Slade Gorton's suggestion and not read from my testimony. I'll speak directly to you.

Michael Schlesinger, who preceded me, discussed many of the issues that are of concern to the software industry. I'm going to just concentrate on sort of the nature of software piracy in China.

First, I'll just tell you, the Software and Information Industry Association, the organization that I represent, we're a trade association of 500 members that represents most of the major players of the business software community. Our members include just about everybody except Microsoft, and that's for good reason, I might add.

Some people question that at times. It just has to do with--I don't know--11 years ago, we got involved in the antitrust case on the other side of Microsoft, and, well, that's continued to the present day --but the issues that Microsoft is concerned about in China that we're absolutely on board and agree with them completely. There is no daylight between Microsoft and the rest of the industry when it comes to software piracy.

We are allies on that issue. But the nature of the software industry is changing dramatically, and first I want to indicate how the software industry is changing. Up until four or five years ago, software was an enterprise purchase where people--well, maybe a little more than five years ago, you bought disks. You bought disks. The purchaser would then install them or the IT shop of that enterprise would install them.

We're now moving to an on-demand model, much more effectively, and so that you've got companies that are born Web-native, companies like Salesforce and SuccessFactors, Workday, a number of companies where the only installation is actually the use of a browser. When you use a company's software product like Salesforce, it's just licensed on a metered basis when individuals have a license. How many employees are going to be using Salesforce, and you'd buy a number of licenses relative to that number.

I will report that the level of piracy of those kinds of on-demand software products is actually relatively low because there's a close relationship between the user and the company providing the service, and I wouldn't want us, for instance, Michael is sitting next to me, if he had a license for Salesforce, I wouldn't want to pirate his user account because the application and the data are intertwined.

In other words, if I were to get his password, I'd get his data. Unless our businesses, unless our functions were exactly the same, I don't want his data; I want my data. So that the level of piracy of on-demand products is actually a lot lower than it is with respect to enterprise products that are sold on disks.

Now, there aren't many major companies that sell enterprise products that are significantly hurt in China. And I want to just outline for a second--there are three important ways that software piracy occurs in China.

The first is the duplication and use of pirated software within China, and Michael talked a little while ago about the state-owned enterprises and the ministries using pirated software. This is something we have discussed with the Chinese for over 15 years. It's absolutely inexcusable for the

Chinese government to continue to run the ministries on pirated software. Whether it's pirated domestic software or it's Microsoft or Adobe or Symantec or others, it's absolutely inexcusable that they are continuing to run their operations on pirated software.

Now the commitments that were made in the State visit in January and previous show some promise to us, but again, as Michael's testimony indicated, they're supposed to do a demonstration project with 30 state-owned enterprises. We're waiting to see how that develops.

But this also occurs in private businesses. U.S. businesses operating in China of all kinds are at a disadvantage. If you're a business, if you're an American business operating in China, and you're using pirated software, you're not afraid of the Chinese court system; you're afraid of the American court system.

Just taking a company like, let's say Pfizer, great American company, Pfizer operating in China is going to use legal software because if they aren't, the vendor of that software is going to sue them not in China, but in the United States.

Now, if Pfizer is competing against other pharmaceutical companies in China, what's the remedy? Well, is Microsoft or Adobe or Symantec going to sue the Chinese pharmaceutical company in China? And the answer to that is it's a lot harder. The legal system is not developed enough to provide the kind of remedies that are available to those same companies suing in the United States.

So the first kind of piracy is duplication and use of pirated software in China.

The second is the unlawful duplication of software in China for distribution to the rest of the world. In other words, you go to a card table on 15th and K and see somebody selling illegal movies, music or software, there's a very substantial likelihood that those illegal products are manufactured in China.

So we have an importation problem of importing illegally duplicated disks. This cuts across all forms of intellectual property--music, motion pictures, and software, and this is true all over the world. If you were to go on the streets of Buenos Aires and find out what's the software that's being sold or the music that's being sold, frequently it's developed, frequently it is duplicated in China.

But the third area of piracy is one that hasn't gotten sufficient attention, but I think Senator Gorton mentioned it in his earlier remarks, and that is where software is being distributed from Web sites in China.

Keep in mind that bits know no boundaries. And that when you are seeking pirated products, using your computer here in Washington, you don't know where the servers are located. The servers can be located in Belarus. They can be located in China. They can be located in Russia or anywhere else. And so if you are seeking a pirated copy, let's say, of Adobe Photoshop, you have no idea where that server is located.

But if that server is located in the United States, we have a legal system, and a process where we can identify where that illegal software is being sold from by IP address, et cetera.

We don't have that ability with respect to China. We don't have that ability with respect to other countries as well. What we're finding increasingly is that China is becoming the primary source for illegal intellectual property goods of all kinds being distributed through the Chinese servers.

So there are three different kinds of piracy problems that we have dealing with China today, and it involves what Michael had previously described as a major commitment on the part of the Chinese government to curb them. We can't solve that problem for them.

Before I conclude my remarks, let me just tell you how we fight piracy in the United States. Corporate piracy is one where the industry has come together to fight that piracy. We do not rely upon the federal government to do so. In other words, we have a piracy outline. We've had one in our office for 20 years.

The phone doesn't ring as much as it used to. Our reports come in from the Internet, but in tough economic times, and even in good times, we get a lot of phone calls, a lot of Internet reports that say I work at such and such company here in Wichita, Kansas, and they bought three copies of Norton utilities, and they've loaded it on a hundred machines, go after them.

It's classic whistle blowing, and we, our organization, brings over 150 cases in the United States a year. Now, let's change those circumstances so that now you're in southern China and you're an accounting office in Southern China, and you have a whistleblower. Well, who's he going to call? And who's going to take any action?

The deterrence of the private sector to go after companies for their under licensed software is greatly diminished from what it is in the United States or other Western countries. What I've just described to you as how we operate in the United States is the same thing that happens in Canada, in France, in Germany and the UK.

But if you're a private enterprise in China and you're using pirated software, the gamble that you will make that no one is likely to find out and no one is likely to come after you is probably a reasonable one. That has to change as well.

So to fight piracy in China, we're reliant on stepped up government enforcement, but we also need to facilitate the ability of the industry to come together and get before the Chinese legal system so that the gamble that the private enterprises and state-owned enterprises makes that no one is going to catch us, and if they do catch us, there will be no penalty, that is something that obviously has to change.

Thank you.

[The statement follows:]

**PREPARED STATEMENT OF MR. KEN WASCH
PRESIDENT, SOFTWARE & INFORMATION INDUSTRY ASSOCIATION
WASHINGTON, DC**

The Software & Information Industry Association (SIIA) appreciates the opportunity to speak today on two issues of significant concern to the U.S. technology industry: the protection of intellectual property rights in China, and what has been referred to as China's Indigenous Innovation Policy. My testimony will focus solely on the intellectual property issues, but this written statement is intended to address both issues.

Intellectual Property Issues

On December 29, 2010, SIIA, along with our partner trade associations that are part of the United States Information Technology Office (USITO) met with MIIT's Deputy Director General Chen Ying to discuss the importance of intellectual property protection in China, especially to curb the rampant piracy of computer software. In that meeting, Deputy Director Chen agreed that software piracy is an important issue for American companies and for the entire U.S. – China trade relationship. Following the meeting, we outlined several concrete steps that China should take to curb piracy. :

SIIA supports the Chinese government's efforts to fight software piracy through sound policies and effective enforcement. SIIA advocates sustainable, long-term policies that support anti-piracy efforts. We support the current special anti-piracy campaign, but we also believe copyright enforcement must be strengthened and sustained to bring about the change in copyright culture necessary to foster innovation in China. Short-term initiatives can, by definition, only have limited impact.

We also observe that anti-piracy and software legalization programs, policies, and enforcement measures cannot be effective in the absence of greater enforcement resources, stiff penalties, and, for the government's own software use, sufficient software budget and implementation of effective software asset management systems to break the cycle of piracy. We therefore support the Chinese government increasing enforcement and imposing tougher penalties against software piracy in sales and distribution channels. This is consistent with the objectives set out in the State Council's October 2010 IP Initiative to promote software legalization and "strengthen enforcement," including by imposing "severe scrutiny and severe punishments" on companies that make or sell illegal copies of software.

Software piracy in China is a problem in three important ways. First is the duplication and use of pirated software within China. Second is the unlawful duplication of software in China for distribution to the rest of the world. Third is the distribution of illegal software from Chinese-based online sellers. Keep in mind bits know no boundaries, and computer users in the U.S. who are seeking applications for a fraction of their lawful cost, can often find those applications sold from Chinese websites.

In China, even though PCs are often pre-loaded with free operating systems, they are routinely reconfigured with pirated versions of commercial operating systems. We therefore support MIIT's consideration of operating system pre-installation policies designed to curb such illegal activity. We further recognize the complexity of balancing market demand with effective regulation to protect intellectual property and support continued innovation.

Software piracy is an issue of great concern, not only to the software but also to the computer hardware industries and semiconductor industry. As such, ongoing efforts to combat software piracy require close coordination between government and all different segments of the ICT industry

Indigenous Innovation Issues

China's indigenous innovation policies have been instituted by the Central Government and carried out by local government to help support local companies through government procurement. SIIA is very concerned that these government procurement practices, despite President Hu Jintao's verbal commitment to de-link government procurement from innovation policies, discriminate against foreign companies. Currently, China has yet to release its official national indigenous innovation policy law from 2010, and no official statements about the law have been made thus far in 2011. We strongly urge China to implement a formal regulation supporting President Hu Jintao's verbal commitment in January 2011.

Specifically, SIIA believes there are alternatives to the Indigenous Innovation Policies that are being pursued by the Chinese Government. Among suggested alternatives are:

Adopt Alternative Innovation Policies. US industry respectfully discourages the Chinese Government from continuing to promote an indigenous innovation policy by publishing product catalogues. We urge China to adopt global approaches to successful innovation policies, and encourage the Chinese government to advance its science and technology goals and promote innovation through fair, transparent, and technology-neutral processes that reflect international best practices. SIIA and its members want to underscore that tax incentives on R&D investments and other similar incentives are more universally beneficial, transparent forms of innovation policy.

Avoid National Indigenous Innovation Catalogues. SIIA and its members strongly believe that an Indigenous Innovation Catalogue will not serve its purpose of accelerating innovation. An annually published catalogue will not keep pace with ICT industry product development and fail to maximize the innovative capability of this sector. The catalogue might satisfy China's stated need to regulate government procurement practices but it will have a deeply adverse effect on innovative ICT companies. In order to foster a thriving and innovative ICT industry, China should consider other means besides product catalogues which, by nature, limit innovation instead of promoting it.

Avoid Local Indigenous Innovation Catalogues. At a meeting on November 19, 2010, ICT industry members and Chinese ministry representatives each acknowledged the existence of a number of local indigenous innovation catalogues. Such catalogues block foreign technology products from entering the Chinese market; they also hinder makers of local brands from conducting business in different regions of China which might create an adversarial inter-industry environment. For example, local regulations requiring local registration, local production, local IPR, or local brand ownership are vague and subject to arbitrary local interpretation, and should thus be abandoned. Despite MOST's and MOF's claims that they lack jurisdiction over local catalogues, we believe the ministries should work together and use their influence over local governments to enact policies that encourage innovation, not hinder it.

Ensure Transparency and Fairness in Innovation Evaluation. SIIA and its members remain concerned about the transparency and fairness of China's national innovation policies. First, we are interested in how an indigenous innovation accreditation specialist team would be selected to ensure non-discrimination between domestic and non-domestic product innovation evaluation. Second, we cannot identify any mechanism for companies to submit comments or complaints about innovation evaluation decisions (for example, resolving potential confusion and confirming that foreign companies adopting OEM production models are qualified applicants). Third, there is no mechanism for resolving disputes between companies and/or government evaluators when products fail to be listed in a catalogue.

- To do so most effectively, we respectfully urge the Chinese government not to publish any indigenous innovation product list and not carry forward this program or any other program which unfairly promotes certain products over others based on origin of IP.
- We also encourage China to continue ongoing dialogue with U.S. and other industry stakeholders on best policies, and practices that promote innovation; and avoid creating market access barriers for foreign companies to

complete fairly in the Chinese market.

- In that regard, as an essential first step, the Chinese government should undertake an immediate review of all indigenous innovation policies to ensure they do not discriminate between foreign and domestic suppliers.

In summary, SIIA supports Chinese government efforts to implement effective policy measures in a transparent and fair manner, and seeks more opportunity for direct communication to share perspectives and expertise to ensure promulgation of anti-piracy regulations and innovation policies that reflect global best practices and create fair and transparent opportunities for collaboration with the US ICT industry.

PANEL II: Discussion, Questions and Answers

HEARING CO-CHAIR D'AMATO: Thank you very much, Mr. Wasch.

I want to open up the floor. Commissioner Shea.

HEARING CO-CHAIR SHEA: Yes. Thank you both for your very interesting testimony, and I appreciate the time you've put into preparing it.

I just want to go into this issue of business software legalization and both of you have mentioned it in your testimonies. As I understand it, and I'm actually reading your testimony, Mr. Schlesinger, the Chinese made four commitments with respect to business software legalization at the JCCT in December of 2010, and subsequently affirmed by President Hu in the summit in January.

First, that they would treat software as property and establishing software asset management systems for government agencies. Have you seen any evidence that that has occurred?

MR. SCHLESINGER: Well, we've certainly had a lot of discussions with the Chinese government and also the U.S. has had many bilateral discussions with the Chinese.

HEARING CO-CHAIR SHEA: But you've had discussions. Have you seen any evidence of these asset management systems for government agencies?

MR. SCHLESINGER: Well, what I can state to you is that the lead negotiator on the Chinese side has indicated that there are two facets to the problem of implementing software asset management tools.

The first one is understanding the kind of tools that can be deployed. The second is actually deploying them throughout the state-owned enterprises, private enterprises, and indeed in government.

My understanding is that they are at the beginning phases of that second part of the process, of implementing SAM. The industry is working with them closely to do that. It's going to take a little bit of time, I think, for them to get that implemented, but it's absolutely essential that they do so.

HEARING CO-CHAIR SHEA: Okay. What about the second commitment, that they were going to allocate current and future government budgets for legal software purchases and upgrades. Have you seen any evidence that they've allocated current government budgets for legal software purchases?

MR. SCHLESINGER: Yes, I think that also this folds into the third

aspect of the commitments, which is that they've started a pilot program of naming specific SOEs, naming specific companies.

Now, the SOEs that are in the pilot program are not necessarily the ones that we would ultimately like to see. What we have heard from the Chinese government side is that there are literally thousands of companies that now have been placed on notice that they will be subject to a legalization process, and that they must take steps to begin implementing software asset management and to begin procuring legitimate software.

Unfortunately, what we've seen in the past is that in many instances, these companies will end up adopting legitimate operating systems, and sometimes legitimate Chinese software packages, but they'll continue to run illegal U.S. software packages on top of the legalization. So that's the big concern that we have and what we have to watch over the coming year.

HEARING CO-CHAIR SHEA: Okay. And then the other commitment, the final commitment, was conducting audits to ensure that government agencies at all levels use legal software and publish the results. Have you seen any evidence of an audit actually being conducted?

MR. SCHLESINGER: No. This is an absolutely essential part of the process. We need to make sure that accounting firms, credible third-parties, are conducting software audits, making sure that what's actually running on, whether it's government systems or whether it's state-owned enterprise systems, and the implementation of internationally recognized software asset management. This is an essential part of the process, and it has not happened yet.

HEARING CO-CHAIR SHEA: So as I understand what you're saying, just to summarize, they've taken some steps. Following the verbal commitments, you've seen some evidence that they're moving to fulfill their commitments, but they have a long way to go. Is that fair to say?

MR. SCHLESINGER: That is definitely fair to say.

HEARING CO-CHAIR SHEA: Okay. Thank you.

HEARING CO-CHAIR D'AMATO: All right. Commissioner Wessel.

COMMISSIONER WESSEL: Thank you, gentlemen, for being here.

Mr. Schlesinger, you talked about commitments in 2004. I've been doing this issue a long time. I remember commitments back in 1994. I believe we had four separate MOUs, each of which was not adhered to. So we get ticked off enough; the Chinese are concerned enough so we have another nice dialogue, new commitments, and things sort of solve themselves or quiet down for a little while, and then we're back at it.

It sort of reminds me of the old Charlie Brown Peanuts situation where Lucy is holding the football, and time after time Charlie Brown goes to kick the ball, she takes it out, and yet he comes back a couple of weeks later and does it again.

The question is, is the industry going to at some point recognize that the current dialogue situation is not working or is only resulting in marginally improved situations as the overall numbers worsen?

I'd like to ask you, though, a question of both the witnesses, because I do believe we have tools here that could be used to address this, and I wanted to get your thoughts as to whether you think there's any viability to that.

As I recall, there are 12 state-owned firms, Chinese state-owned firms, that are listed on the New York Stock Exchange. There are many, many more Chinese firms that are listed on other U.S. or international exchanges. The theft of intellectual property, if one believes or reads the Chinese law, now have some increased sanctions against them.

And, therefore, as a matter of materiality, failure to abide by those legal restrictions increased the risk to the shareholders of those companies. That's a material event, depending on what your definition of net income is, et cetera.

I would argue to you that we have the tool at the SEC with those publicly-traded firms that we could bring suits against the board of directors and the management right now here in U.S. courts for their failure to abide by Chinese law because it is exposing U.S. shareholders to those material risks.

Would you be willing to work with the SEC to have them rather than the companies, and for the fear of retribution, et cetera, U.S. companies, begin to go to the SEC and say you have the existing tools to go after China for this vast theft. It is risking shareholder returns, and ultimately if the directors and the management think that they are personally liable for this, we may get pretty quick resolution.

Can both of you give your thoughts about whether that might be an appropriate enforcement tool?

MR. SCHLESINGER: Sure. I'd be happy to start. In my written submission, you'll have seen I think two companies mentioned specifically where this potential novel approach could be considered.

One of them is Baidu.

COMMISSIONER WESSEL: Right.

MR. SCHLESINGER: Now understanding and looking at Baidu as a business model, it's not unlike other business models that have emerged in other countries. Indeed, we have one that is somewhat similar in terms of its functionality in the United States as a search engine. But the difference with Baidu, and what we've seen, that while they've licensed some of their content, video content being an example of that, they also provide a dedicated service to lead people to deep link to infringing music, their so-called "mp3" service.

Indeed, in the written submission, I also mentioned Baidu, which recently fielded complaints over Baidu's provision of publications, massive numbers of publications, including Chinese publications, without authorization.

COMMISSIONER WESSEL: And I appreciate that. Because time is short, I reviewed your testimony. It's clear from what you've said and others--

MR. SCHLESINGER: I'll cut to the chase.

COMMISSIONER WESSEL: --that there are violations that are definable. Those I would argue create material risks if, in fact, the laws are enforced and those are not being identified in their public filings. So the SEC has power.

MR. SCHLESINGER: The answer is yes to the extent that Baidu is fostering infringement of, massive infringement of copyright materials, in this case, music, and Xunlei, which has announced that it is about to undertake an IPO. This is something which certainly should be considered.

COMMISSIONER WESSEL: Okay.

MR. WASCH: I would agree with Michael, it's something that ought to be considered. We ought to consider a couple other issues in connection with that.

The United States is in a competition for a listings of public companies, and the good news in this is that, first of all, companies are willing to, by listing with NASDAQ or the New York Stock Exchange and being subject to the SEC, they're adopting what are becoming the international standards for public financial disclosure.

And that's all good news. If we start to add additional requirements that are viewed by foreign companies as being too burdensome we negate those incentives, and I think we have to be a little cautious about that. I'm just thinking about if Baidu or somebody else, we want them to be listed here, and it is true that if they're pirating software--I'm not thinking about music--if they are pirating software, our companies, companies that are members of my organization, have an opportunity to seek redress in U.S. courts, which is good news.

Getting the SEC involved in piracy enforcement, it's worth considering, and it's a very good thought and something that both Michael and I are reacting to in a manner of seconds, but there may be some external impacts that we have to consider about this listings issue.

COMMISSIONER WESSEL: I would argue--and thank you for that, and I realize you've been hit with this quickly and urge you to think about it--but there are derivative rights. We have your question about the primacy of U.S. markets and them going to the German exchange or somewhere else. There are ADRs. There are any number of tools through derivative, whether it's Fidelity and them buying foreign or whatever, I think our reach is quite broad. I don't believe that we're going to face that kind of competitive inequality--

MR. WASCH: Hope not.

COMMISSIONER WESSEL: --if we design a program right. So I would urge you to think about it.

MR. WASCH: Good.

COMMISSIONER WESSEL: --and if you could get back to us with some of your thoughts.

MR. WASCH: Thank you. Yes.

COMMISSIONER WESSEL: Thank you.

HEARING CO-CHAIR D'AMATO: Thank you very much. This is a very interesting area that we elected to pursue with both of you.

So Commissioner Fiedler.

COMMISSIONER FIEDLER: A couple of questions and then later some comments. Could I ask you, Mr. Schlesinger, I think, or, but you can answer as well, your member companies in your associations, how many people do they employ in China producing software or performing research and development roughly?

MR. SCHLESINGER: Well, I don't know the answer to that question.

COMMISSIONER FIEDLER: Take a big one. Take Microsoft. Microsoft is a major company.

MR. WASCH: All the major companies. That's a good point. I don't think either Michael or I know or have a precise number, but if it's not already over a million employees, it's probably getting close already.

COMMISSIONER FIEDLER: So you're producing intellectual property in China that they're stealing?

MR. WASCH: That is correct.

COMMISSIONER FIEDLER: No, beyond being correct, it may be stupid; right? You're sitting before us complaining about how they steal from you, yet you take the jobs of developing those products, you take them to China, and then they steal them again. And now you're crying about it.

MR. WASCH: As I say, there's no international company on the face of the earth that can afford not to be in China. Everybody recognizes that.

COMMISSIONER FIEDLER: So what you're doing is hedging. Okay. You're hedging. The politics of this were for the first five, six, seven, eight years, you didn't really want too much enforcement going on by the U.S. government because--or you didn't care that they were stealing because it wasn't enough theft. That's what Bill Gates said early on.

Said, yes, they're not stealing enough; we're getting market share. Then he changed his tune. Because you didn't do anything about the stealing when it first started. You're asking, you're asking a number of people, I'll give you an example of Baidu. You're hung up on Baidu.

We did a hearing partially on Baidu after the Google debacle. Baidu was started with American money. Walton family money, Madrone Capital. Rob Walton, chairman of Wal-Mart. Gregg Penner, who is still on the board of Baidu--just checked--lives in Silicon Valley. Have you boys talked to him lately about their theft of your music? You don't have to go to Beijing to reach Mr. Penner.

MR. SCHLESINGER: Well, I appreciate your comments very much. I think that in the Internet space, we are facing a new challenge between the development of business models and the protection of intellectual property rights.

I think that in some cases, these are in conflict. Even in our own country, we have court cases right now that are weighing the contours and

trying to find the contours and the balance between the development of a new business model and the protection of intellectual property rights. In some cases, these business models such as those that were found to be in violation of law by the Supreme Court, Grokster, are found to be facilitating infringement.

There's the recent case involving YouTube, and the question still is out there as to what, to what extent a company can legally use as a business model built on--

COMMISSIONER FIEDLER: Being in both places.

MR. SCHLESINGER: --the use of infringing materials. The same is true in China.

COMMISSIONER FIEDLER: Let me ask you a quick technical question. Is pirated software more vulnerable to hacking?

MR. WASCH: No, I don't think so.

COMMISSIONER FIEDLER: You mean a hacked copy, a pirated copy of Microsoft operating system operating, do they have the ability to update and get security updates for that?

MR. SCHLESINGER: Well, they shouldn't.

MR. WASCH: Shouldn't.

COMMISSIONER FIEDLER: They shouldn't.

MR. SCHLESINGER: They shouldn't and certainly the use of an authentication tool--

COMMISSIONER FIEDLER: Right.

MR. SCHLESINGER: --without authorization from the company is a violation of U.S. law, and it's a violation of Chinese law today.

COMMISSIONER FIEDLER: But as a practical matter, do they have problems updating their security? We have enough problems maintaining security on Microsoft's operating system with authorized copies.

MR. SCHLESINGER: There's no doubt that there are myriad problems associated with the use of unlicensed software in China.

COMMISSIONER FIEDLER: So from a national security point of view, why do I really want the Chinese ministries to buy a better software if the United States intelligence community can get into it more easily without it?

MR. SCHLESINGER: Well, look, at the end of the day, what we're trying to foster is mutual respect for intellectual property rights. The fact is that there are entertainment sectors such as music, the making of movies, the making of entertainment software. I would note that there is a ban on the sale of game consoles.

But you have millions of Chinese Internet users who are making use of those games. What you want to see over time is the mutual development of creative industries that allow for mutual economic development in the U.S. and in China.

COMMISSIONER FIEDLER: I don't think the basis of the relationship has anything to do with mutual respect. I think that we have offered our hand, and it's been bitten for the last 15, 20 years, and that Senator Gorton

was talking this morning about coercion, if you will, a tariff, in order to engender mutual respect.

MR. WASCH: Yes, there is one other element that Senator Gorton described at the beginning of today's hearing, is that the companies themselves are reluctant to speak out publicly for fear of--

COMMISSIONER FIEDLER: They won't come here.

MR. WASCH: For fear of retribution. I'm sure it's been well reported, of the theft of one of General Motors' designs by Cherry Motors. And apparently they were given a quiet reprimand that says you've got a multi-billion dollar business in China; do you really want to pursue this intellectual property case against Cherry Motors because it will, quote, "harm your relationships here in China."

COMMISSIONER FIEDLER: Yes.

MR. WASCH: And General Motors ultimately dropped it.

COMMISSIONER FIEDLER: There are not many Chinese companies that are hesitant to criticize Americans, but all the American companies are hesitant to criticize Chinese. I would argue that they're more effective in retaliation than we are.

MR. WASCH: I think that's true, and that's why I think to some extent Michael and I are here on the dais instead of individual companies.

COMMISSIONER FIEDLER: I know because they refuse to testify. We've invited them all repeatedly.

MR. WASCH: Because they'd rather hide behind their trade associations, and that's nothing new.

MR. SCHLESINGER: If I might, I know that you're over time here--

COMMISSIONER FIEDLER: Yes, I'm sorry.

MR. SCHLESINGER: --but just to make one comment about the record industry, the record industry at this stage I think has very little to lose. They received commitments at the WTO that are not being honored. Their market has been decimated by piracy for years, and what they're looking for is similar gains that have been gotten by other industries to allow them to enter and exploit the Chinese market.

COMMISSIONER FIEDLER: Yes. My aggression was to get you to be more aggressive.

Thank you.

HEARING CO-CHAIR D'AMATO: Thank you, Commissioner Fiedler.
Commissioner Mulloy.

COMMISSIONER MULLOY: Thank you, Mr. Chairman.

I have a couple of quick questions for Kevin, and then one for Mr. Schlesinger. On page one of your testimony, you talk about three things of software piracy in China. First is the duplication and use of pirated software within China. Now, let me make sure I understand that.

If it's within China, our laws don't apply in China. So the TRIPS Agreement requires China to put its law in place and to enforce them.

MR. WASCH: Correct. Correct.

COMMISSIONER MULLOY: I understand that. Now, second is the unlawful duplication of software in China for distribution to the rest of the world, meaning including the United States.

Now, if that pirated software comes into the United States, I think there is Section 337 of U.S. trade law that permits us to bring actions to stop any of that being distributed and even have penalties on the companies that are doing it.

MR. WASCH: I think that's true. But we've got to detect it. This is a borders issue. It's a trade issue. Inspection of cargoes coming into the United States.

COMMISSIONER MULLOY: No, but my understanding of use of that provision of law, you could get a general order preventing any of that stuff from coming into the country.

HEARING CO-CHAIR D'AMATO: An exclusion order.

COMMISSIONER MULLOY: Is that correct or?

HEARING CO-CHAIR D'AMATO: Yes.

HEARING CO-CHAIR SHEA: Section 337.

COMMISSIONER MULLOY: 337.

HEARING CO-CHAIR D'AMATO: Yes, that's right.

MR. SCHLESINGER: Certainly if there's been a patent infringement, you can seek a remedy under 337.

COMMISSIONER MULLOY: Well, doesn't that also apply to copyright infringement?

MR. SCHLESINGER: The 337 has not been used traditionally in the copyright sphere.

HEARING CO-CHAIR D'AMATO: It could be used though.

COMMISSIONER MULLOY: Could you guys, could you find out--

MR. WASCH: We'll get back on it.

COMMISSIONER MULLOY: --can that be used and why isn't it being used because I think that's a very important provision of law--

MR. WASCH: Good question.

COMMISSIONER MULLOY: --that I don't think is being properly--or we could use it where we're not.

MR. WASCH: Right.

MR. SCHLESINGER: I think the general answer to why copyright has not generally been used to seek exclusion orders is because you would be going product by product so for the recording industry, for example, you would be going literally song by song in excluding the export.

COMMISSIONER MULLOY: No, I'm worried more in the software. The software is the--

MR. SCHLESINGER: Yes.

COMMISSIONER MULLOY: Software I understand is subject to copyright, not patent.

MR. SCHLESINGER: Right. Well, to both, but on the software side, it would be the same thing. You would be excluding on a product-by-product

basis. The question is the efficiencies of that, I think, but more directly also to your question, certainly the TRIPS Agreement prohibits the unauthorized importation of that product.

And to some extent, there have been increased protections against exports in countries as well, and China has undertaken some steps to strengthen its protection there on the books.

COMMISSIONER MULLOY: Okay. So if you could help me understand 337.

MR. WASCH: Sure, sure.

COMMISSIONER MULLOY: And then--

MR. WASCH: But I will point out to you that the piracy problem in the business software community stemming from the illegal duplication and shipment of disks into the United States is something that's been in existence, it's something that's occurred for 20 years, and if you're rank ordering our piracy problems, that's probably the smallest because more and more people get access to their software online. There's no reason to distribute disks when you can just download it.

COMMISSIONER MULLOY: Could you use 337 to stop the distribution online?

MR. WASCH: That's a good question. We'll get back to you on that.

COMMISSIONER MULLOY: The second question for you, Mr. Schlesinger, my understanding is that the TRIPS Agreement requires countries to have criminal prosecution of commercial type violations of intellectual property rights. From what I read in your testimony, you're saying that the Chinese Supreme Court has knocked out their criminal enforcement. That doesn't free them from their international obligation to have criminal enforcement; is that correct?

MR. SCHLESINGER: No, absolutely not, and, in fact, we would argue that the unlicensed use of software in a business setting is, is when distributed throughout a company, for example, an example of commercial scale piracy, which is required to be criminalized under the WTO TRIPS regime, and therefore China, in our view, is required to criminalize, and we're certainly strongly calling for that.

COMMISSIONER MULLOY: Do you agree with that, Kevin?

MR. WASCH: Yes, I agree.

COMMISSIONER MULLOY: And is that, their interpretation where they've knocked out the criminal, are we now aggressively pushing to get that fixed?

MR. WASCH: We have been. Sure.

MR. SCHLESINGER: There is no doubt that the United States continues to raise the issue of end-user software piracy and the criminalization of such as a key trade issue in its bilateral discussions with the Chinese.

COMMISSIONER MULLOY: Thank you. Thank you, both.

HEARING CO-CHAIR D'AMATO: Thank you, Commissioner Mulloy.
Commissioner Bartholomew.

COMMISSIONER BARTHOLOMEW: Thanks very much and thank you, gentlemen.

It's awkward. I think I have to stand up to see you guys.

[Laughter.]

COMMISSIONER BARTHOLOMEW: A couple things reflecting some of what Commissioner Fiedler raised though I suspect I would be a little bit less blunt in the way he raised it.

[Laughter.]

COMMISSIONER BARTHOLOMEW: But also reflecting, I've been working with Commissioner Wessel for 20 years on these issues, and there's a frustration obviously. There's a frustration with the lack of progress.

I think, Mr. Schlesinger, the facts that you've said, that since 2004, the value of unlicensed software in use in China more than doubled to \$7.6 billion in 2009, really illustrates there's a problem, and I presume at the upcoming JCCT, there will be yet another memorandum of understanding or some sort of something that people will stand up and say the Chinese government has committed to do this, and if past is prologue, you guys-- maybe not you directly, but you guys will put out a statement commending the administration for yet another agreement when we know that we're not making any progress on this.

So I come to it with a couple of questions, frustration about the industry itself here, though, I will really say, Mr. Schlesinger, in particular the recording industry had been in front of this, and I credit Jay Berman for that, that the recording industry was one of the first places that stood up back in the 1990s, early 1990s, and said there's a problem here.

But can you tell us, as you look at this, as you look at these lost opportunities, how many jobs would be created here in the United States if this kind of piracy, this level of piracy wasn't happening, and how many lost jobs is this responsible? How do we translate this into who is bearing the costs for this?

Is it the shareholders? Is the workers? And how do we quantify that so that people get a handle on this?

MR. SCHLESINGER: That's a wonderful question. I wish that I could tell you that I have the statistics off the top of my head, but I don't, but I will tell you that the market research firm IDC, in conjunction with the Business Software Alliance, has engaged in studies to demonstrate the effectiveness or the multiplier effects of reducing piracy.

They said if we reduced piracy by ten percent in a particular country, what number of jobs in the IT sector, what amount of tax revenue, and what amount of contribution to GDP would that create? There is a number for China. I just don't have it off the top of my head. I apologize for that. [According to the BSA and IDC, reducing the PC software piracy rate in China by 10 percentage points in four years would deliver: US\$15.97 billion in new economic activity; 250,102 new IT jobs; and US\$4.4 billion in additional tax revenues by 2013.]

COMMISSIONER BARTHOLOMEW: Could you provide it for us?

MR. SCHLESINGER: Absolutely, I will provide it after the testimony today.

COMMISSIONER BARTHOLOMEW: Mr. Wasch, any comments on it?

MR. WASCH: Yes. One additional comment that piracy certainly affects employment in the software business. But I'm going to take the opportunity to go a little off topic and argue in favor of immigration reform to enable America to hire more high-tech workers, increasing the H-1B visa cap.

One of the great concerns for many of the software companies that we represent is that they can't get sufficient software engineers here in the United States, and so, yes, when piracy affects employment in the software business, we are naturally going to think that this affects employment here in the United States.

But the people who are not being hired are often software engineers, and today our companies are hiring software engineers all over the world because they can't get sufficient, they can't import sufficient talent here into the United States.

So it's an argument in favor of, one, we need to curb software piracy, but, two, we want to be able to bring in more talented software engineers to work in the United States rather than in some of the other centers around the world.

COMMISSIONER BARTHOLOMEW: And we have certainly heard a lot about that with our Chairman, Commissioner Reinsch, in his day job who works on some of these issues. MR. WASCH: All these issues are related.

COMMISSIONER BARTHOLOMEW: They are. My thinking on that one, all of the complicated stuff about it aside, is if young people don't see that there is a future in U.S. intellectual property, I'm not even convinced that they want to be coming here. If we don't get piracy under control, why don't they just go to China, which is what a lot of people are doing?

So I'm just going to add that as I think another dynamic, but I also think you guys raise an important point. When you look at the ripple effects, we were told back in the 1990s that America had lost manufacturing, and that was okay because our future was our intellectual property.

Now, it turns out losing manufacturing isn't okay, but it also turns out that if we are saying that our economic future is intellectual property, we are, forgive my language please, screwed. And you raise an important point, this ripple effect--when you talk about tax revenue, look at California and the terrible budget crisis it has.

If we could make sure that this intellectual property is not being ripped off, it would have healthy effects, not only for people working in this country, but for the communities in which they live and they work.

MR. WASCH: Absolutely.

COMMISSIONER BARTHOLOMEW: And so I guess it's more a plea to you

both that as we go through the process, over the course of the next few weeks and the next few months and the next few years, that you don't allow an abundance of caution to prevent you from supporting calls for bold action on dealing with this because doing the same thing over and over again, it's not getting us anywhere.

Thanks.

HEARING CO-CHAIR D'AMATO: Thank you, Commissioner Bartholomew.

I have just one or two questions. Mr. Schlesinger, you had a menu of remedies in your 301 submission: enforcement, legislation and market access. And if you had your three wishes, which of those recommendations in each category would be the one you would focus on the most to get the best bang out of our buck here in terms of focusing on remedies?

MR. SCHLESINGER: I'll take an opportunity to focus on the two sectors that we've talked about today. On the software side, there's absolutely no doubt that if China follows through on its commitments from the JCCT and the Obama-Hu summit to ensure legal use of software by government and SOEs, that U.S. software companies would make significant progress in terms of the revenues generated, in terms of all of the ripple effects that we've been talking about, and that is the four aspects that I think we already talked about today.

The second major thing that could happen on the software side is this clarification of the criminalization of end-user piracy. This could result in enormous gains if the Chinese government, which seems increasingly during this special campaign, which started in November, to be referring cases for criminal prosecution in the area of online infringement.

If they were to do the same with respect to unlicensed use of software in businesses, we could make really serious headway.

The third one would be what we've talked about in terms of this indigenous innovation policy, and I think several of the speakers, including the Congressman and the Senator this morning, have touched on how the Chinese are going to do what they feel is in their own best interests to develop their own national champions, if you will. Perhaps Baidu is an example of that.

What we need to impress upon them, I think, as strongly as possible--and here I do think that organizations like ours working with you can be very bold in pressing the Chinese--to recognize that a level and fair-playing field is what's required here. It is simply unfair to require U.S. intellectual property owners to cede with their intellectual property as a chit or as a bargain for being able to enter the market.

Just quickly, on the recording industry side, I'll add that the promised judicial interpretation which would find that fostering infringement is subject to civil liability and therefore also potentially to criminal liability is what's most needed to deal with services like Baidu, with services like Xunlei.

The Chinese intellectual property courts over the last ten or 12 years,

I think we have seen some progress in terms of civil cases, Chinese companies versus Chinese companies. We are seeing the incremental developments of a more sophisticated, more mature IP system in China.

What we need now is to make sure that these so-called "national champions" that are being protected by the Chinese government, companies like Baidu and Xunlei, are brought to bear in terms of civil liability, and the Supreme Judicial Court can certainly help in that regard.

HEARING CO-CHAIR D'AMATO: Thank you.

Mr. Wasch, do you have anything to add to that? Do you have one big wish that you think you would like to promote in terms of remedies?

MR. WASCH: I think it's--we've been talking about it for so long--which is the legalization of software in use in state-owned enterprises, and so we have a lot of hope of the agreement that was reached in January to audit 30 large state-owned enterprises, and we're anxious to see what the results of that are going to turn out to be.

It's really enforcement by example. If 30 large, state-owned enterprises legalize their use of software, and a culture of compliance starts to spread, that can only be beneficial for American companies that sell in China.

HEARING CO-CHAIR D'AMATO: Thank you so much.

One last question. Commissioner Bartholomew.

COMMISSIONER BARTHOLOMEW: Yes. Just a clarification. This audit of the 30 large state-owned enterprises, who is doing that audit? Is it a Chinese company that's doing the audit?

MR. SCHLESINGER: Yes, the Chinese are doing or conducting the audit, and I would just note that the 30 companies are not the key SOEs that our industry is looking to legalize. What we need--and the 30 that have been noted by the Chinese as pilot companies, but they've actually listed thousands of companies that are going to be subject the audits.

COMMISSIONER BARTHOLOMEW: Right. I just hope that the auditors are not going to be under the kinds of pressure that sometimes happens where there might be certain state-owned enterprises that are doing things that have connection to people who have connection to the auditors who have an outcome in seeing certain kinds of returns.

MR. SCHLESINGER: We're extremely concerned about this. We're also concerned about statements that might come out of the results of those audits indicating, well, we found that the companies have properly implemented software; they've just chosen Chinese software. And we know from experience that while they may deploy legal Chinese software, and this is, again tied into the indigenous innovation, that they're putting U.S. software, unlicensed software, on top of those systems.

COMMISSIONER BARTHOLOMEW: Thank you.

HEARING CO-CHAIR D'AMATO: Thank you both very much for your presentations, and we hope to stay in touch with you.

This will conclude the first panel, and I think we'll take a ten minute

break, and then we'll proceed to the second panel. Thank you so much.

MR. SCHLESINGER: Thank you very much.

MR. WASCH: Thank you.

[Whereupon, a short recess was taken.]

PANEL III: CHINA'S INDIGENOUS INNOVATION POLICY

HEARING CO-CHAIR SHEA: Let's begin now our third and final panel, which I would like to introduce now. Thea Lee and Alan Wm. Wolff are both trusted authorities on China's economy and industrial policy and have appeared before the Commission to testify on these topics in the past. We welcome them both back today and thank them for their participation.

Thea Lee is the Deputy Chief of Staff at the AFL-CIO, where she has also served as the Policy Director and the Chief International Economist. She also currently serves on the State Department Advisory Committee on International Economic Policy.

Alan Wolff is the Co-Chair of the Dewey & LeBoeuf International Trade Practices Group, and I think that's a combination of two firms; right? Dewey Ballantine and--

MR. WOLFF: And LeBoeuf Lamb.

HEARING CO-CHAIR SHEA: --LeBoeuf Lamb and Levy; right. In that capacity, he has defended American interests many times against unfair trade practices, such as dumping, illegal government subsidies and violations of intellectual property rights.

Mr. Wolff was the United States Deputy Special Trade Representative, well, Special Representative for Trade Negotiations during the Carter administration.

I don't need to inform either of you what the ground rules are since you've been participants before the Commission before, but why don't we just start with Ms. Lee, and then we'll go to Mr. Wolff.

STATEMENT OF MS. THEA LEE DEPUTY CHIEF OF STAFF, AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS, WASHINGTON, DC

MS. LEE: Thank you so much, Chairman, and members of the Commission, I appreciate the opportunity to come today and talk about such an important topic: China's indigenous innovation policies and what the impact has been on American workers and businesses.

It's true that the Chinese government's indigenous innovation policies present a threat to the United States. But it's also true that indigenous innovation has to be seen in the broader context of overall Chinese government policies which have created significant competitive disadvantages for American workers and producers, as I know you all know, as you've discussed and written extensively on this topic.

The trade relationship between the United States and China is enormously imbalanced and problematic. And there are several areas in which this is the case. The Chinese government has repeatedly and systematically violated its international obligations with respect to workers' rights, human rights, currency manipulation, export subsidies, and intellectual property rights.

Last year's implementation of indigenous innovation policy simply extended and deepened this pattern of violations, and each one of these trade violations contributes to the erosion of America's industrial base.

Our technical and innovative capacities today and in the future are essential to our economic and national security. Dr. Joel Yudken prepared a report last year for the AFL-CIO Industrial Union Council, and the report details the American manufacturing crisis and the erosion of the U.S. defense-industrial base. One of the key points has to do with technology and innovation and intellectual property rights and what the connections are.

In the past, we sometimes had the view that we can outsource a lot of our manufacturing production and keep all the good jobs here in the United States--the science-based, the research and development-based jobs. What we're starting to see now, particularly with this very aggressive policy by the Chinese government, is that it's not so easy to do that, that once you take the manufacturing jobs offshore, a lot of the research and development and technology that goes with it and intellectual property rights also are at risk.

There are three points that I want to make today: first, that the indigenous innovation policy is part of a broader strategic pattern of behavior by the Chinese government in violation of both U.S. and international trade law; second, that the actions by the Chinese government have eroded the U.S. industrial base, and therefore threaten the nation's economic and national security; and third, that the U.S. government needs to take action on trade law violations and at the same time establish appropriate domestic policies, priorities and strategies to restore America's industrial leadership.

On this last point, particularly with respect to the trade law violations, we'd like to see our government be more timely, more aggressive, and more consistent in addressing some of the violations that occur.

We have a lot of the necessary tools at our disposal. They exist. The U.S. Congress has given the executive branch some of the tools to address these violations, and yet it seems like there's a certain timidity or reluctance on the part of our own government to act in a really aggressive and consistent manner, and that is hurting American jobs and businesses.

One of the points that maybe we'll talk about more in the discussion is that when you lose the jobs, when you lose the business, when you lose the technology, it doesn't just impact the current set of workers and jobs. It impacts our trajectory into the future, and I think that's what we really need to take into account.

The Chinese government's economic growth strategy relies heavily on export-led growth, primarily to the U.S. market. And elements of this strategy include: maintaining an undervalued currency through massive intervention in the foreign exchange market, as I know you all have studied extensively; an industrial policy of targeting favored sectors and technologies through below-market loans and subsidies; and protection of domestic markets through overt and covert trade barriers such as indigenous innovation.

The Chinese government has broad industrial and technology strategies aimed at building up its capacity in cutting-edge technology areas across the manufacturing sector. Many of the Chinese government policies include strong incentives designed to attract foreign investment in R&D and production in advanced technology areas, and this, in turn, encourages transfers of U.S. technology and production capacity offshore, including some of the design for civilian technologies with defense applications.

The application of an indigenous innovation procurement policy, with a specific goal of reducing the degree of Chinese dependence on technology from other countries from 50 percent to 30 percent or less by 2020, took this set of policies a step further. The timing coincided with massive public investments at the height of the economic crisis.

The action makes transparent what other government practices on technology transfer had been doing by other means, and the result is apparent even to some formerly reticent businesses that have now publicly declared that they're gradually being squeezed out of the Chinese market by government policies that first demand technology transfer in exchange for market access and then favor domestic companies.

China is no longer just playing catch-up with the United States and other developed nations regarding basic manufacturing productions and technology. This Commission warned in 2005 that China is developing and producing technology that is increasing in sophistication at an unexpectedly fast pace.

China has been able to leapfrog in its technology development using technology and know-how obtained from foreign enterprises in ways other developing nations have not been able to replicate. And that 2005 admonition has become a 2011 reality.

Since it has become central to the global supply for technology goods of increasing sophistication, China has gained increased leverage in global systems of production. And the AFL-CIO shares this Commission's concern that this central role raises the prospect of future U.S. dependency on China for certain items critical to the U.S. defense industry as well as vital to continued economic leadership.

The spiraling U.S. trade deficit with China paints a troubling picture of debt and loss of technical and productive capacity.

I'm going to skip over the trade deficit issue because I think this Commission has studied that very well.

One of the key concerns that we have with respect to indigenous innovation has to do with green technology and China's desire to pioneer in environmental technology. This is an important area because it's crucial to the United States. It's something that our own government aspires to do: we would like to reduce our dependence on foreign energy; we would like to become a leader in this technology.

And yet the Chinese government has employed a number of policies to stimulate and protect its domestic producers of green technology, ranging from wind and solar energy products to advanced batteries and energy-efficient vehicles, and these policies have permitted and allowed China to become a dominant supplier of a number of green technologies, draining manufacturing and R&D investment from the United States to China, costing American workers the high-skilled green jobs of the future and increasing the U.S. trade deficit.

This is an important area because, again, we know this is going to be a growing area. We know there are a lot of jobs, there's a lot of new technology in this area, and that the United States is poised to and ought to be a leader in green technology and green production, and yet the Chinese government's policies have made it very difficult for the United States to do that.

Many of these policies and practices are direct violations of China's obligations at the WTO. Other policies are subject to challenge at the WTO if they cause serious prejudice to U.S. industries and workers.

The United Steelworkers Union has, in fact, filed a case that lays out in great detail a number of these issues. We are very supportive of the steelworker petition, and we would urge the U.S. Trade Representative to follow up on more of the five areas that the steelworker petition laid out as problematic.

Let me skip to the strategy for the future in terms of what the United States needs to do in order to compete here. If the United States is to be a leader in the global economy of the future, we're not going to do so by having cheap labor and last year's technology. We can only do so if we invest in our workforce, if we invest in our infrastructure, and we invest in our transportation, communication, and energy networks.

So these are the kinds of things that we need to do. In addition to getting our trade policies right, we also need to engage in a comprehensive program to restore domestic manufacturing, including a recommitment to investment in our infrastructure. We need to reform our tax policy so that we no longer have incentives built into our corporate tax policy that encourage and reward companies that offshore jobs.

We need a new energy policy that encourages the production and the development of technology here in the United States, as well as the production of the products that will make that a reality.

And in terms of innovation, and this is, I think, the most important for today's subject, the United States is the world's engine of innovation, but

our lead is declining. More and more U.S. companies are moving their research and development laboratories overseas, especially to China, and there's a direct correlation between R&D and production.

If we don't protect our nation's innovative leadership, we will lose not just the manufacturing jobs, but our ability to lead in the future. So we need to maintain strong intellectual property protections to ensure that companies have the incentive to make investments in plant and equipment here at home. We must increase efforts to fight the intellectual property rights violations of competitors that seek to profit from the creativity of our people or even creativity which in many cases is funded by taxpayer dollars.

Increased support for R&D here in the United States coupled with support for testing and deployment of these new technologies will ensure that we are able to expand our manufacturing capabilities.

More than three-fifths of all U.S. patents are generated by our manufacturing sector, and we must recognize that innovation and manufacturing capacity go hand-in-hand.

Workforce development is the last piece I'd like to talk about. America continues to have the best and the most innovative workers in the world, but to stay ahead of the competition, we must constantly upgrade our skills and our training. Revitalizing our manufacturing sector requires that we invest in our people to ensure they're equipped to meet the needs of industry.

Our skills deficit fuels our trade deficit and becomes an excuse for offshoring of jobs. And now is the right time to renew and expand investments in our workforce. With high unemployment, this is a time when the U.S. government ought to be investing in deep training, and skills and education policies. When people are out of work, it's a good time to make sure that they're ready when the economy picks up, that we don't start then trying to train people for the new jobs that have been created.

So Congress must increase access to training funds for people who are out of work as well as those who want to enhance their skills with on-the-job training.

Ultimately, a high-skills workforce is one where the rights on the job and the ability to speak up are protected and made real through strong labor laws and strong unions.

So, in conclusion, the AFL-CIO, like the rest of the global labor movement, would like to see China become more prosperous, more stable, and more fair, but that won't happen if the Chinese government continues on its current path of repression, dictatorship, and unfair trade practices.

We need our own government to get its priorities straight with respect to China and our own economy, and we look forward to working with this Congress, with the administration, and with the Commission, to develop and implement appropriate policies.

I thank you for your attention. I look forward to your questions.

[The written statement follows:]

**PREPARED STATEMENT OF MS. THEA LEE
DEPUTY CHIEF OF STAFF, AMERICAN FEDERATION OF LABOR AND CONGRESS
OF INDUSTRIAL ORGANIZATIONS, WASHINGTON, DC**

Co-Chairs D'Amato and Shea, Members of the Commission, thank you for inviting me to appear today on behalf of the twelve and a half million working men and women of the AFL-CIO to talk about China's indigenous innovation policies.

I want to start by commending the Commission for taking up today's timely subject. Much is at stake in improving our economic relationship with China, particularly with respect to technology and innovation.

It is true that the Chinese government's indigenous innovation policies present a threat to the United States. But it is also true that indigenous innovation must be seen in the broader context of overall Chinese government policies, which have created significant competitive disadvantages for American workers and producers.

The U.S. trade relationship with China remains enormously imbalanced and problematic. The Chinese government has violated its international obligations with respect to workers' rights, human rights, currency manipulation, export subsidies, and intellectual property rights. Last year's implementation of indigenous innovation policies simply extended and deepened this pattern of violations.

Each of these trade violations contribute to the erosion of America's industrial base. Our technical and innovative capacities – today and in the future -- are essential to our economic and national security. Dr. Joel Yudken prepared a report in 2010 for the AFL-CIO Industrial Union Council, entitled *Manufacturing Insecurity: America's Manufacturing Crisis and the Erosion of the U.S. Defense Industrial Base*. This report has been submitted in support of this testimony, and it documents these concerns in detail

My testimony today makes three essential points:

- Indigenous innovation is a serious problem, but it does not exist in isolation. It is part of a much broader strategic pattern of behavior by the Chinese government in violation of U.S. and international trade law.
- The actions by the Chinese government have led to the erosion of the U.S. industrial base, and this poses a direct threat to the nation's economic and national security.
- The U.S. government needs to take action on trade law violations and at the same time establish appropriate domestic policies, priorities and strategies to restore America's industrial leadership.

China's Export Platforms Target Technology and U.S. Industrial Sectors

The Chinese government has charted out an economic growth strategy that relies heavily on export-led growth, primarily to the U.S. market. The elements of the strategy include maintaining an undervalued currency through massive intervention in the foreign exchange market; an industrial policy of targeting favored sectors and technologies through below-market-rate loans and subsidies; and protection of domestic markets through overt and covert trade barriers, such as indigenous innovation. This is well-documented in this commission's annual reports, as well as elsewhere.

The Chinese government has broad industrial and technology strategies aimed at building up its capacity in cutting-edge technology areas across the manufacturing sector. Many of the Chinese government policies include strong incentives designed to attract foreign investment in R&D and production in advanced technology areas, which encourages transfers of U.S. technology and production capacity offshore, including some of the design for civilian

technologies with defense applications.⁶⁷ For example, years ago the Chinese government made development of the semiconductor sector a national priority, and has fostered its development with government support for research and development, preferential tax treatment, and the use of the technology standard-setting process to favor its domestic firms.⁶⁸ They have taken the same approach to the clean energy sector

The application of an indigenous innovation procurement policy, with a specific goal of reducing the degree of dependence on technology from other countries from 50 percent to 30 percent or less by 2020, took it a step further. The timing coincided with massive public investments at the height of the economic crisis. Their action made transparent what other government practices on technology transfer had been doing by other means. The result is apparent to some formerly reticent businesses that “have publicly declared that they gradually are being squeezed out of the Chinese market by government policies that first demand technology transfer in exchange for market access and then favor domestic companies.”⁶⁹

China is no longer just playing catch-up with the United States and the other developed nations regarding basic manufacturing production and technologies. This commission warned in its 2005 report to Congress that China is developing and producing technology that “is increasing in sophistication at an unexpectedly fast pace. China has been able to leap frog in its technology development using technology and know-how obtained from foreign enterprises in ways other developing nations have not been able to replicate.”⁷⁰ That 2005 admonition has become a 2011 reality.

Since it has become central to the global supply for technology goods of increasing sophistication, China has gained increased leverage in global systems of production.⁷¹ The AFL-CIO shares your concern that this central role raises “the prospect of future U.S. dependency on China for certain items critical to the U.S. defense industry as well as vital to continued economic leadership.”⁷² The spiraling U.S. trade deficit with China paints a troubling picture of debt and loss of technical and productive capacity.

Trading Away Jobs and Innovation

Our trade deficit, especially with China, is symptomatic of the challenges we face in maintaining our industrial base. Although the overall trade deficit is down by a quarter from the record levels of 2008, the 2010 U.S. goods trade deficit with China broke all previous records. Through the decade our goods trade deficit with China soared, tripling since WTO accession -- from \$84 billion in 2001 to a record \$273 billion in 2010. China’s share of the U.S. trade deficit in manufactured goods rose steadily -- from 28.5 percent in 2002 to 75.2 percent in 2009. In 2010, we ran a trade deficit with China in advanced technology products of \$94 billion, while with the rest of the world, we ran an ATP surplus of \$10 billion. The enormous and growing U.S. trade imbalance with China in ATP should be a clear warning signal that our overall trade relationship is severely imbalanced in ways that are detrimental to our economic potential and future.

U.S. foreign direct investment (FDI) in China has jumped, especially in manufacturing. FDI in China is all about new production and job creation, unlike in the United States where new FDI tends to signal a change of ownership, not new production. The Economic Policy Institute has estimated that the growth in the U.S. trade deficit with China between 2001-2008 displaced about 2.4 million American jobs.

Perhaps even more disturbing than the aggregate growth in the U.S. trade imbalance with China is the composition of our imports and exports. Our top fifteen exports to China (by 4-digit HTS code) include five categories of waste

⁶⁷ USCC (2005), *op.cit.*, p.97.

⁶⁸ USCC (2005), *op.cit.*, p.32.

⁶⁹ USCC (2010), p.20

⁷⁰ USCC (2005), *op.cit.*, p.86.

⁷¹ USCC (2005), *ibid.*

⁷² USCC (2005), *ibid.*, p.85, 88.

products (ferrous scrap, paper scrap, copper scrap, aluminum scrap, and offal); two categories of raw materials (soy and polymers), and at least three categories of parts. In contrast, all of China's top fifteen exports to the United States are manufactured products or parts.

This is clearly not the trade profile that the U.S. government predicted as the likely outcome of China's WTO accession. But it is the result of concerted strategic interventions, starting with currency intervention, by the Chinese government over many years – and inaction by our own. With an explicit export strategy targeting key industries, sectors, and technologies, China has captured a growing share of U.S. and world markets. It has used a wide array of unfair trade practices, including currency manipulation, export subsidies, widespread suppression of worker rights and wages, and tariff and non-tariff barriers to exports, to support this strategy.

The financial crisis has proved to be another opportunity for the Chinese government. By controlling access to its market in crucial sectors with indigenous innovation, the Chinese government buys time to build dominant industries and technology powerhouses that will have a clear competitive advantage over their lagging counterparts in other countries. This is already underway in the clean energy sector, where these export policies work in concert to ensure market control. The 301 clean energy trade case filed by the United Steelworkers union and the currency legislation passed by the House last fall are aimed at stemming these practices.

China's Green Technology Practices Violate WTO Rules

The Chinese government employs a number of policies to stimulate and protect its domestic producers of green technology, ranging from wind and solar energy products to advanced batteries and energy-efficient vehicles. These policies have permitted China to become a dominant supplier of a number of green technologies, draining manufacturing and R&D investment from the U.S. to China, costing American workers the high-skilled green jobs of the future, and increasing the U.S. trade deficit.

A number of these practices are direct violations of the obligations China undertook when it joined the World Trade Organization (WTO). Other policies are subject to challenge at the WTO if they cause serious prejudice to U.S. industries and workers.

The United Steelworkers union – which represents workers in a number of the sectors being harmed by the Chinese government's policies – filed a petition under Section 301 of U.S. trade law to give the Administration the ammunition it needs to bring a successful WTO case against these unfair trade practices. The petition covers five areas.

1) Restrictions on Access to Critical Materials. Dozens of vital green technologies – solar panels, wind turbines, advanced batteries, energy efficient lighting, and more – depend on critical raw materials derived from rare earth elements and other minerals. China produces more than 90 percent of the world's supply of these minerals, and it uses a variety of means to restrict exports of these minerals to users in the U.S. and other countries. These restrictions raise prices for manufacturers outside of China, lower prices for those within the country, and create a powerful incentive to shift production to China in order to secure necessary supplies. These export restrictions are a clear violation of China's WTO commitments.

2) Performance Requirements for Investors. When China joined the WTO, it committed not to require that foreign companies use domestic suppliers or transfer technology as a condition of investment approvals. China's laws state that transfer of advanced technology should be included in foreign joint venture agreements, and gives the government the right to approve or reject such agreements. In practice, it appears that foreign investors face hurdles setting up wholly-owned ventures in China. Once they partner with a state-owned joint venture partner or a state financier, their investment contracts invariably contain technology transfer requirements. For example, in 2009, Evergreen Solar had difficulty raising funds to open a plant in China, and so it entered into a joint venture agreement (backed by provincial authorities) that required Evergreen to license solar wafer technology to the new venture. As a result, Evergreen is now shifting panel production from its Massachusetts facility to China.

3) Discrimination Against Foreign Firms and Goods – Indigenous Innovation The Chinese government bids out the construction of wind farms and solar power plants to competing firms, and grants the winners concessions and the right to guaranteed power purchases by government-owned utilities. In the wind sector, no foreign firms have ever won a major wind farm concession, despite highly competitive offers. In addition, the Chinese government prohibits foreign firms from getting international emissions credits for such projects (which are often key to their financial viability), unless the foreign company allows a Chinese partner to own a majority of the venture. In the solar sector, those foreign firms that have been granted the right to build solar power plants have been subject to conditions that they produce the needed solar panels domestically and license valuable technology. This discrimination violates China's WTO obligations, including specific commitments made in its protocol of accession.

4) Prohibited Subsidies for Advanced Technologies. WTO rules prohibit China from granting subsidies that are contingent on export performance or on the use of domestic over imported goods. The petition points to subsidies for wind turbine manufacturing and the development of other advanced green technology products that violate these rules. In addition, the petition demonstrates that China's export credits and export credit insurance programs for green technology are prohibited export subsidies. China's exporters benefit from concessional loans and guarantees that dwarf those provided by other countries – in fact, in 2008 China's Export-Import Bank granted more loans than the export credit agencies of all G7 countries combined. Because the Chinese government refuses to play by the rules that prevent other countries from engaging in a race to the bottom in the export credit arena, it can freely undercut and outbid U.S. exporters of green technology products around the world.

5) Trade-Distorting Domestic Subsidies. The Chinese government offers a broad range of subsidies to producers of green technologies, including in the solar, wind, biomass, geothermal, hydropower, nuclear, advanced battery, alternative vehicle, and energy-efficient consumer products sectors. China's subsidies in these areas are so enormous that they are distorting trade and harming producers in other countries. In its economic stimulus package, for example, the Chinese government gave more than \$216 billion to subsidize green technologies – more than twice as much as the U.S. spent in the sector and nearly half of the total "green" stimulus spent worldwide. These massive government subsidies are helping Chinese producers ramp up production, seize market share, drive down prices, and put global competitors out of business. WTO rules give the U.S. the right to challenge such subsidies to mitigate the severe competitive harm they are causing.

The Green Technology 301 trade case shows how a combination of policies are being used by the Chinese government to propel its nation to the forefront of the global green economy, while U.S. firms and workers still struggle to develop a robust green technology supply chain here at home. These policies have helped China acquire foreign investment, technology, and expertise, while restricting foreign access to its raw materials and its market. Nor do these exist in isolation. The export platform strategy relies upon foundational subsidies, including the prolonged undervaluation of the renminbi that has distorted trade, investment flows, and currency markets across the globe.

Undervalued Currency Subsidizes Exports and Investment

Through systematic and one-sided intervention in currency markets, the Chinese government has kept the renminbi approximately 40 percent undervalued with respect to the U.S. dollar for many years in support of its export strategy. The undervalued Chinese currency serves the government's strategy of building powerful export markets rather than boosting its own domestic consumer market. Undervaluation takes market share and jobs from the United States by penalizing our exports. It subsidizes imports into this country while encouraging outward investments into the Chinese economy.

This is not free trade, nor is it the way the major economies of the world have agreed to behave. And the Chinese government's actions influence the monetary policies of other countries compounding our trade problems. The U.S. Treasury bi-annual currency reports acknowledge the fact that other nations mirror the Chinese government's behavior.

While addressing the Chinese government's currency manipulation is one of the highest priorities for workers and employers in the manufacturing sector, it is time to recognize the broader impact of China's practices. Lost manufacturing jobs lead to lost tax revenue and higher budget deficits that limit our ability to invest in our future. This puts substantial pressure on federal, state and local budgets, resulting in layoffs of teachers, police and other emergency responders. And it has undermined our future by undercutting the array of career choices and educational opportunities, especially in science, engineering and the technical occupations needed for a vibrant innovative manufacturing economy.

Taking action to end currency manipulation will generate jobs and investment in the U.S. economy. Nobel laureate Paul Krugman estimates an end to the manipulation would produce a net export gain to the United States, Europe and Japan amounting to about 1.5 percent of GDP, increasing growth in the U.S. economy by about \$220 billion. The Peterson Institute and the Economic Policy Institute agree that a 25 percent to 40 percent revaluation in the renminbi would reduce the U.S. trade deficit between \$100 billion and \$150 billion per year, adding between 750,000 and 1 million jobs to American payrolls.

It is time for Congress and the Administration to act decisively to end currency manipulation and other illegal trade practices.

Taking Action: A Strategy for the Future

The juxtaposition of the world's two largest manufacturing economies could not be clearer. Our manufacturing economy has been in a decade long crisis, with the loss of more than 5.5 million jobs and the closure of more than 50,000 manufacturing facilities, a stunning loss of technical and industrial capacity. At the same time, China's manufacturing economy, fueled by massively subsidized domestic production and exports and policies discriminating against imports and foreign companies, experienced explosive growth.

While the economic crisis that began in 2007 has done massive damage to our country, the truth is that many of our economic problems have long-term roots in a generation of mistaken economic strategies. The Chinese government has a manufacturing strategy, and we do not. This is our problem, as well as that of the Chinese government. When the Chinese government engages in illegal actions in support of its manufacturing strategy and vision, we have done too little to challenge those actions. The Chinese government's indigenous innovation policy is a real concern, but it does not exist in a vacuum.

The AFL-CIO calls on our government to aggressively address the Chinese government's trade violations, as well as to establish our own strategic priorities and policies. We believe a healthy and robust manufacturing sector is central to a sustained economic recovery and to our national security.

In addition to the trade reform elements outlined above, the following elements are essential to a comprehensive program to restore domestic manufacturing:

- **A re-commitment to investment in infrastructure:** America's infrastructure needs—energy, roads, transit, bridges, rail, water, etc.—are huge. We have a \$2.2 trillion infrastructure deficit, according to the American Society of Civil Engineers. Not only will spending here employ people right away, it will lay the foundation for economic growth in the future. And there is no conflict between more spending now and efforts to address fiscal imbalances down the road. Indeed, an improved America is the legacy we should leave to our children and grandchildren.
- **Tax policy:** Eliminate tax incentives and loopholes that encourage financial speculation rather than investment, outsourcing and off shoring production, and enact tax incentives for companies that produce domestically.
- **Energy:** Enact measures to encourage the deployment of renewable energy, advanced automotive technology and other clean energy technologies. This can be accomplished by expanding

funding for 48(c), industrial efficiency projects, other policies to encourage development of renewable sources of electricity and by providing higher loan authority and additional funding for section 136, the Advanced Technology Vehicles Manufacturing Incentive Program. These efforts must be coupled with expanded utilization of domestic supply chains. We cannot simply trade dependence on foreign oil for a dependence on foreign sources of clean energy production equipment. Clean and green jobs must become a reality: America must not cede leadership of this industry to other nations. We must invest in these 21st century infrastructure technologies on a similar scale to our investment in replacing the failing infrastructure of the last century.

- **Innovation:** The United States continues to be the world's engine of innovation, but that lead is declining. More and more U.S. companies are moving their research and development laboratories overseas—especially to China. There is a direct correlation between R&D and production and we must protect our nation's innovative leadership. Doing so requires that we maintain strong intellectual property protections to ensure that companies have the incentive to make investments in plant and equipment here at home. We must also increase efforts to fight the intellectual property right violations of competitors that seek to profit from the creativity of our people. Increased support for research and development in the United States, coupled with support for testing and deployment of those new technologies in our factories, will ensure that our manufacturing capabilities expand. More than 3/5ths percent of all U.S. patents are generated by our manufacturing sector and we must recognize that innovation and manufacturing capacity go hand in hand.
- **Workforce development policies:** America continues to have the best and most innovative workers. To stay ahead of the competition, however, we must constantly upgrade our skills and training. Revitalizing our manufacturing sector requires that we make investments in our people to ensure they are equipped to meet the needs of industry. We cannot afford to have a skills deficit, which would only fuel a trade deficit. Now is the time to renew and expand investments in our people. Congress must increase access to training funds for people who are out of work as well as those seeking to enhance their skills. Ultimately, a high-skills workforce must be one whose rights on the job and ability to speak up are protected and thus made real through strong labor laws and strong unions.

Economic security and national security are inextricably intertwined, and a strong manufacturing base is key to both. This Congress and the Administration have the opportunity to take steps to restore our nation's manufacturing capabilities.

The AFL-CIO, like the rest of the global labor movement, would like to see China become more prosperous, stable, and fair – but that can't happen if it continues on its current path of repression, dictatorship, and unfair trade practices. We need our own government to get its priorities straight with respect to China and our own economy, and we look forward to working with this Congress and the Administration to develop and implement appropriate policies.

HEARING CO-CHAIR SHEA: Thank you very much.
Mr. Wolff.

**STATEMENT OF MR. ALAN WM. WOLFF
OF COUNSEL, DEWEY & LEBOEUF LLP
WASHINGTON, DC**

MR. WOLFF: Thank you, Commissioner Shea, Commissioner D'Amato,

and your fellow Commissioners.

I appreciate the opportunity to testify today. The work this Commission does is extraordinarily important to our country. It is also a pleasure to appear with Thea Lee. The U.S. government is very fortunate to have her advice.

While economists may not believe that nations compete, in fact, that is not the view of governments, including some middle-sized governments, but certainly the major trading nations. Every country's government promotes science, technology, engineering and math, and tries to promote innovation. They want higher-paying employment; they want a higher share of world trade and higher-value products.

They want to increase their economic rate of growth. It's been estimated by Dale Johnson at Harvard that one-half a percent of our GDP growth is due to the application of information technology. The World Bank's estimate for developing countries is two to three percent.

So information technologies are an engine of growth that every country seeks. Brazilian President Rousseff traveled to Beijing a couple of weeks ago to discuss her dismay at the composition of Brazil's trade with China: Too much in the way of exports of raw materials, too little in the way of exports of manufactured goods, but she, also, according to press reports, was interested in learning more about the Chinese model of economic development. Should it be applied to Brazil to achieve greater success in Brazilian development?

So we are back in a very serious competition. And it is not competition between communism and capitalism; it is a competition between the so-called "Beijing consensus" and a Washington consensus.

At the same time there is a policy argument within the United States as to how we are going to proceed. There is also a debate in other countries as to how they are going to deal with international competition. Innovation is central to the competition, and in some respects what we do and what others do does not differ all that much. We foster science, technology, engineering and math education. We graduate, as China does, many engineers--but there is a tendency in the application of industrial policy to always overshoot and this is what is happening in China. Countries for years overshot demand with respect to the production of steel, and a number of other areas, solar panels is now a case in point in China.

Well, when a country overproduces numbers of engineers, the quality is not necessarily all perfect. The estimate in the mid-decade performed by Duke University was that China produced 350,000 engineers a year. Similarly, state involvement leads to the creation of too many patents, not always of high quality, requiring and getting almost no review.

We have had enormous success with science and technology parks like Research Triangle, Silicon Valley, and the area of Route 128 around Boston. The Chinese have supersized the idea of S&T parks. Go outside of Shanghai, I'm sure you've visited Pudong, the Zhangjiang, and other science and

technology parks. They are immense

So far, in what I have listed are all things one doesn't complain about (except I'll come back to a problem in the area of patents in a moment), and this includes public spending on basic, precompetitive R&D.

Some of the effort may be wasteful, producing scientific papers in huge numbers, an exponential increase, as well as patents, not always of the right quality. Many of the patents are utility model patents, just having incremental technological change, requiring and getting no review. These could be used as an offensive tool, and can cause problems for those who hold valid patents, especially foreign companies and individuals.

China also promotes self-innovation in a way that causes problems for others. It has put forward a concept of "indigenous innovation," that is Chinese intellectual property owned by Chinese companies. This policy has metastasized into a variety of policy areas within China, in settings and sectors. It holds that China is going to grow on the basis of homegrown intellectual property content--a new form of protectionism but in effect very much like local content requirements.

When these policies become fully effective through measures, they are a complete block to trade and sales by companies that have invested in the Chinese market. They stop access to that market. This policy is in addition to complaints of other barriers, lack of adequate IP enforcement that you heard of from your prior panel, use of national standards instead of international standards--each of which impose impediments to trade.

Other issues involved China's failure to join the government procurement agreement and its use of an undervalued currency to discriminate against foreign products and give an advantage to its exports. On top of all of that, adding indigenous innovation as a requirement will seriously strain commercial relations between China and the other countries with which it trades.

For this reason, when visiting Washington in January last year, President Hu Jintao promised to take a number of remedial steps with respect to rolling back "indigenous innovation" policies. (My written testimony contains some background on how that situation came about and the nature of the problem).

In short, statements from the highest levels in China over a large number of years have an impact. Chinese entities, ministries, provinces, municipalities, are responsive to central government leaders' pronouncements, especially when they see it as being in their own self-interest to fall into line with statements and edicts from the central government.

State-owned enterprises are also responsive. If a corporation has only one shareholder, then chances are it is going to be pretty responsive to that shareholder. That is sort of the nature of things. Your job, your promotion, is dependent upon listening to and adhering to what the government guidelines are--so it matters when these statements are made.

We all knew a lot about the kinds of problems involved in state-developmental capitalism when China acceded to the WTO. Actually I think the accession commitments are reasonably good, although not necessarily easy to enforce. We were under not a great number of illusions about what we were getting into when we brought China in.

While we did not foresee indigenous innovation as a policy, but many of the other state-owned enterprise issues were visible, and having dealt with Japan over a number of years, we had some sense of the issues involved in dealing with state developmental capitalism.

So what are we faced with now in practical terms? If state-owned enterprises buy only inputs that have Chinese IP from Chinese-owned companies, the policy fosters, for example, in a result in which supercomputers by year end 2011 are to include only integrated circuits manufactured with Chinese IP.

In autos, this is a policy to have only Chinese brands. In wind equipment, with state-owned enterprise (SOE) procurement, foreign share in large state projects dropped from 77 percent in 2005 of to 13 percent over five years, by the end of 2010. Our firm did a study for the National Foreign Trade Council on that subject.

In software and encryption hardware, the multi-level protection system, Level 3 and above, basic information telecommunications, broadcasting TV networks, Internet information services entities, systems related to transportation, banking, insurance, commerce, education, culture, labor and social security are all national security issues, and are to use indigenous innovation products and services. So we are seeing a proliferation of these measures.

And government procurement catalogs. The AmCham in Beijing, the U.S. AmCham, has said there are 61 indigenous innovation catalogs at the provincial and municipal level, and noted that in Shanghai's catalog, of 523 products made in China, only two appeared to involve foreign companies, and in these two cases, the companies were joint ventures with majority Chinese partner ownership. These are catalogues from which products are chosen for purchases by government entities.

There are the large state projects. The giant state projects in the Medium and Long-Term Science and Technology Plan, 2006 to 2020, that the State Council published covers pretty much the whole future of most areas--solving problems of diseases, large commercial aircraft, integrated circuits, renewable energy equipment that Thea Lee talked about--all to be subject to the requirement of using indigenous innovation products. This is not necessarily government procurement, but is nevertheless subject to indigenous innovation requirements.

A future policy instrument to be worried about is the Antimonopoly Law, and how it will be applied to intellectual property.

In terms of recommendations, there is no magic solution, no silver bullet. The recipe is, first, understanding the problem, which understanding

this Commission very much contributes to; two, having a strategy to deal with it, which I don't think we do at this stage; three, assigning finding solutions to it a sufficiently high priority, which we do not do in this country; four, having first-rate intelligence and analysis. We do not have that either, and that is unfortunate. Next what is needed is the dedication of sufficient resources. If one is going to investigate these matters, then a fair amount of effort needs to be put into it. One thing I would suggest is that there be seconding of resources to USTR from other departments.

There have got to be the resources in government to do this, and you can't raise the headcount, I can tell you, in USTR. When I was there, we had 49 positions including secretaries and two messengers. No president wants to increase the headcount in the Executive Office of the President.

Six, persistence is needed. The United States solved the semiconductor problem with Japan. It took quite awhile to get there including retaliation by President Reagan to get the Japanese to open their market. Today that market is completely open, and the largest DRAM producer in Japan is Micron Technologies of Idaho.

And it took 14 years to get soda ash into Japan. This cannot be done for every product. To do so just for one product is one very large lift.

And one needs leverage, which you were taking about earlier--looking for leverage.

There is no substitute, I think, for this recipe, and there are no secret means out there for other means to attack this problem.

In the final analysis, the strongest leverage is China understanding that the policies about which foreign governments complain are not in China's own interests. It occurs to me, I don't know whether you do it, that you should publish some of your materials or a summary of them in Mandarin, get them up on the Web, that might have some utility in informing Chinese policy makers of the self-defeating nature of a number of their policies.

China is really not monolithic. I've found in dealing with specific issues with the Chinese government that various ministries have different opinions, and I would suggest that you get the words out, at least some of the word out.

On details of the strategy, first (and Thea Lee talked about doing the right things at home). I won't get into area very much today. In this recession, Germany did not have a lot of layoffs for a variety of reasons. It invests a lot in worker training. While it is not in my testimony, there are areas in which we can make substantial improvements at home. This is probably not the forum to talk a lot about domestic policy, but if our industries are not competitive, they cannot succeed. We learned that in semiconductors. The Japanese did something very nasty. They sold products that had higher quality for less money, and while we didn't like the dumping part of it, but you had to match quality with quality, and performance with performance. There was no alternative. Well, we have to

match worker training with everybody else in the world; and we are not doing it.

Two, monitor closely what the Chinese policies are doing and the competitive harm they cause to U.S. commercial interests.

Three, engage in a continuing intensive dialogue with the Chinese government. Two days from now, John Holdren will chair the U.S.-China Innovation Dialogue. I don't hold out hope that instantly scales fall from people's eyes and they change their ways, but it's worth engaging in conversation as to why we think our method of innovation is more effective.

I'd also say that China cuts itself off through its indigenous innovation policies. They will not produce an iPad or an iPhone. Our companies have worldwide sourcing. If somebody else makes a better chip that goes into that thing, our people can use it. The world has become globalized. China's cutting itself off as an autarchic island is going to be extremely destructive to its commercial future.

But these policies will cause a lot of harm to others, including our industries, on the way to China harming its own economy.

The Strategic and Economic Dialogue. I don't expect any near-term conversions out of that either.

Four. Seek to obtain from China prompt, effective and full compliance with its commitments--like the Hu Jintao commitment on government procurement which was alluded to by the last panel. It has to actually be implemented within China. That means saying things in China in Chinese to those entities that are affected by it. And that didn't take place after the commitment was made in January.

And by the way, that commitment applies to very little, if anything, at present, even if it were implemented because the Chinese aren't part of the government procurement agreement so if they say they're not going to apply indigenous innovation in government procurement, it strikes me that Chinese government ministries are still free to simply not buy to the extent they can avoid buying foreign goods.

Five. Litigate WTO cases more aggressively. I think there is more to be done.

Six. Negotiating binding disciplines. There is a desultory negotiation on a Bilateral Investment Treaty (BIT). I think it has to be the right agreement. The last administration wanted to rush into one. It was modeled on the Rwanda Agreement. China and Rwanda differ in some respects. So I think that we need to have a 21st century Bilateral Investment Treaty.

The Trans-Pacific Partnership is the place where we have a live negotiation, and there ought to be a state-owned enterprise chapter in it. It may apply some day to China, but the fact of the matter is we have to set an international standard as to how state-owned enterprises are supposed to behave, and not just in a working party report of China's accession. It has to be in a detailed formal agreement. As TPP members may find China's

development model attractive.

I'd say a policy of containment is needed with respect to the Beijing consensus. Start with the TTP.

Seven. Consider what leverage exists, gather together with allies when possible.

Eight. Encourage China to take a leading positive role in multilateral negotiations. It could do so to its own benefit as well as the world trading system if it took a lead on liberalization of information technology products, environmental goods, and export controls on food and feed, for example. China is heavily dependent on foreign raw materials. The idea is counterintuitive that it would restrict exports of rare earths and at the same time know that it would be very vulnerable to export controls by others, it wants to import a lot of food but would be vulnerable to export controls on food and feed. China should have some interest actually in an international regime on export controls that addresses these subjects.

Nine. Success does depend ultimately on an evolution of the Chinese leadership's views. The idea of openness and international competition was a primary driver of domestic reform in China so the concept is not foreign to China's leadership. Deng Xiaoping enunciated these principles. Now China has to live up to them.

There is a darker vision of the future if China continues to pursue policies that distort trade and investment. Congress can be creative in coming up with measures. Escalating reciprocal imposition of restrictive measures would serve no country's interest. China knows how to do it. After President Obama's decision to restrict tires from China, China moved to restrict imports of chickens from the U.S. So, China knows how to engage in responses to foreign measures aimed at its practices.

Alternatively, there are things the two countries can cooperate on. Renewable energy, improving global health, and shared leadership, as I mentioned, in the WTO.

In conclusion, I would say the United States has to revert to its basic strengths. We do have a formula that works, That makes our countries' industries competitive. We've been ignoring parts of that formula for success. We do have something that makes us internationally competitive. And we cannot accept our economy being shaped by the industrial policies of other countries

Thank you.

[The written statement can be read on the USCC website at: http://www.uscc.gov/hearings/2011hearings/written_testimonies/11_05_04_wrt/11_05_04_wolff_testimony.pdf.]

PANEL III: Discussion, Questions and Answers

HEARING CO-CHAIR SHEA: Thank you both very much for your very

thoughtful testimony, and thank you, Mr. Wolff, for complimenting the Commission for contributing to understanding the problem. I hope you meant we contribute to the understanding part of the sentence as opposed to the problem part of the sentence, but I think I got your drift.

But we'll start our first question with Commissioner Wessel.

COMMISSIONER WESSEL: Thank you both for being here today, for being here in the past, and the work that you both have done over many, many years.

I want to first, Thea, commend you for the opening comments you made regarding human rights, workers rights and the overall goals, because all too often we're getting down into the weeds now in talking about indigenous innovation and a number of other issues and failing to look at the broader goals that really were supposed to be aligned with the WTO accession back in 2000.

So thank you because human rights is not always given as much importance and understanding, and, in fact, I would argue that the innovation and the issues we're talking about, IP theft, et cetera, in fact, fuel China's activities on diminution and attacks on human rights and workers rights.

The recent Jasmine Revolution, or ongoing Jasmine Revolution, that has been fueled in part by technology, Facebook, et cetera. China's theft of IP, its control of many of the resources, has done damage to the promotion of rights.

But let me turn, if I could, to the innovation issue, which our President talks about, both of you talked about, and get some thoughts.

I agree, innovation is key, but when our students look at this and hear about rampant and growing IP theft in China, they see increasing migration of U.S. R&D capabilities to China, and they see U.S. companies doing little to combat that--we had that discussion with the previous panel, many of them worried about specific retributions, so they hide behind their associations who I don't believe do enough--and then also fight for, for example, increased imports of foreign workers with the skills that they say they need rather than investing and calling for greater training and opportunities for our own people, how do we square all of this?

And, Alan, as well as Thea, but Alan, your experience in the 1980s with Japan, which you talked about, the great things in the semiconductor industry, the fact with SEMATECH, with DARPA's activities, with the MOSS talks, and the whole slate of policies, there's nothing new here.

The fact is if we were to stand up, they would open up. But we don't have a clear consistent concerted effort here to do the things that you've identified. All the policies you talked about are not rocket science.

They've been on the list for awhile, but we're not executing. Congress finally got fed up in 1988, passed the Trade Act, did a number of things. Do you have faith, either one of you, that this is going to change? What do we do about innovation? Are we sowing the seeds of our own demise?

Thea, do you want to start?

MS. LEE: Okay. Just a few small issues--

COMMISSIONER WESSEL: In less than a couple of hours.

MS. LEE: --thrown out there. Mike, you've put your finger right on the key issue, and it is the divergence between the interest of an individual company and the country as a whole. An individual company when faced with demands from the Chinese government to move production and R&D and to give over its intellectual property to Chinese companies or to the Chinese government, doesn't want to take a stand, and it's maybe not in its short-term interest to take a stand, but it is devastating for the United States as a whole, certainly for workers and for our kids, if we don't figure out how to prevent these kinds of transfers.

I have a little bit of hope. I'm a little bit optimistic. I appreciate this hearing today, and about a month or so ago, there was a hearing on the House side also about indigenous innovation. One of the things that we saw was a lot of consensus between business and labor, between Republicans and Democrats, that this is an issue that should be addressed. I'm hoping that that consensus can build into action that we can shore up our own collective national backbone to take more decisive action on this front.

I appreciate the point that you raise about students looking to the future. I'm the mother of an 11th grader, and I try to think about her future. I hope it will be a future that's intellectual and innovative and international, but I don't want her to grow up thinking, well, all the good jobs are somewhere else, and U.S. companies aren't interested in investing in me. I know it's expensive to do education right.

I've been on a spring college tour, and you can see the kinds of resources that go into research and laboratories and science and technology and so on. What I worry about is that our companies aren't as interested in making those national investments as the rest of us, and without that backbone, the government loses interest.

But it's possible to do, and the U.S. government certainly has recognized that indigenous innovation policies are a step too far. The question is why does it take so long, and why do we act so slowly? Even with the recent WTO challenges by the U.S. government, there are still many current policies that are flagrantly prima facie violations of WTO rules.

It takes a year or so, maybe a year-and-a-half, to figure out that we're going to act. Then we act and we file the case, and there are cases being heard, and then there's an appeal, and then, a couple of years down the road maybe the Chinese government is forced to withdraw its policy.

The United States needs to think a little bit differently. We have \$270 billion trade deficit with China, and maybe we need to be quicker about acting unilaterally, acting more decisively, but I think it's within our reach if we have the collective backbone to do it.

MR. WOLFF: I certainly subscribe to those views. You talked about history, Commissioner Wessel. Bob Galvin appeared before the Congress in

the late '70s and then in the mid-'80s. In 1979, I was sitting next to him on a panel. I had just come out of government, and we were testifying before Senate Finance. He talked about Japanese "industrial targeting." No one in the room, including me, knew what he was talking about. Motorola was experiencing it, understood it. It was a process by which industrial policy built up a highly competitive industry abroad, with excess capacity and a large amount of finance, and it could and did do with great damage to American industries.

Five years later he was touring the U.S. government agencies saying that "with the value of the dollar overvalued the way it is, I'm going to be forced to move offshore. I can't stand it. We'll go out of business." And he got no hearing. Beryl Sprinkel at the Treasury said that the market would take care of everything. And they did. There was a lot of movement offshore of U.S. industry until Jim Baker got the Plaza Accord.

We just don't have a clear sense of the national interest, and we're not fostering it. And companies are not going to do so by themselves. There is history here, too. Boeing did not take on Airbus for decades, although it knew the subsidies were there. Nor did the U.S. government do so. The U.S. government is responsive to industry complaints. It is very difficult for the U.S. government to act without having a client. The government is sort of in-box driven, and the result is no strategy, not enough information. That is why we need to have a sense of the national interest, as Thea was saying, and we need to have an information base on which to act.

You understand this. You commissioned a study by RAND on the aircraft industry in China. There will eventually be large commercial aircraft coming out of China. And that competition may hit Bombardier and Embraer first before they get around to hitting Boeing and Airbus, but it's going to be a problem. What are we going to do about it?

I think we have to know sector-by-sector what the problems are that we are going to face. Moreover, China is hurting itself. We did a study for the Semiconductor Industry Association that included a survey of where American companies placed their R&D. We thought that it would be in China. There are lots of engineers over there, at much cheaper pay than engineers elsewhere, and the companies were not taking their R&D there. As a proportion, U.S. company R&D wasn't growing much at all in China. It was under one percent.

Where did the American companies go to make their R&D investments? They went where countries subsidized plants to get process technology and where countries produced inexpensive engineers who are very good, but the intellectual property protection issues are not great, they went to have semiconductors designed. And that turned out to be central Europe. You would naturally see a growth abroad proportionately as the United States accounts for less of a share of global GDP, but the R&D wasn't going to China because China is not protecting IP.

HEARING CO-CHAIR SHEA: Thank you.

COMMISSIONER WESSEL: Thank you.

HEARING CO-CHAIR SHEA: Commissioner Fiedler.

COMMISSIONER FIEDLER: A couple of comments and then a question. You've both gone after the issue, and, Thea, you talked about it as leverage and dependence. Ambassador Wolff, you talked about it in terms of strategy.

Let me, there's a couple of preconditions that seem to be necessary for the United States to act. One, you mentioned, we have to determine what's in our national interests. Let me say it a little more or less policy-oriented, that we've had enough, and it seems we have to have enough on a number of different levels, whether it's Iran, North Korea, indigenous innovation, pushing state capitalism.

The government, whether it is run by President Bush or President Obama, has a lot of considerations, not just indigenous innovation, and the question becomes from a negotiating point of view whether the other country is vulnerable at any point in time?

So more, I would argue that they're more vulnerable now because of leadership change, their fear of party survival that is at its height, inflation, they're about to have a property bust, and the elite is starting to take its money out of the country. Now no better time, it would seem to me.

On the other hand, you could argue all of those things make for an unstable China, and the United States policy, to my mind, has always been, it is much more in our interest to have stability in China, and we sublimate all those other ad hoc problems, whether they be intellectual property, currency, this, that or the other thing.

So the question is, is there critical mass? What you're talking about is the United States having a comprehensive policy to deal with China, even a half comprehensive policy to deal with China. My question is do you agree at all? Do you think we have a comprehensive policy? Forget whether we reach a bipartisan national interest determination. The President is the President, one party. He is the primary mover of foreign policy.

Can we have a comprehensive policy? I haven't seen the ability of any government in the United States to have one. You're all talking about it, but what, so what--indigenous innovation--it affects "x" number of people. There's a lot of things all together affect everyone. When are we going to realize that?

MR. WOLFF: I don't think we have a comprehensive policy. We certainly don't have a comprehensive strategy. When I lecture to foreign area officers at the Naval Post Graduate Institute, I quote from the "Arsenal of Democracy" speech of Franklin Delano Roosevelt. It is very interesting.

He says, well, we're faced with major challenges now, but we have the ability to meet those challenges because we have within our economy the ability to produce the industrial goods that are now needed in great quantities, but we had the capability within the United States to act.

When World War I came along, Britain didn't have enough steel to fight World War I. Why? The American cartel and the German cartel had pretty much wiped out the steel capability of Britain. I think there's a national security issue here, our national security is fundamentally based upon the strength of our economy. We don't look at it that way.

If we start from that premise, other things follow, and as I said in my written statement, it seems to me that the competition that we are dealing with in these hearings and the strength of the U.S. industrial base are much more important than the war in Afghanistan.

So if that war cost \$110 billion a year, tell me how much is spent on learning about international competition as it affects the U.S. industrial base. One percent? Not a chance. A tenth of one percent? Unlikely. So are there things to be done to build domestic consensus and strategy and determine what the national interest is? Yes.

COMMISSIONER FIEDLER: Thea.

MS. LEE: Yes. Thank you.

Well, that's the easiest question we've been asked today. Does the U.S. have a comprehensive China policy or strategy? The answer is definitively no. We don't have anything resembling it, and I think Alan is exactly on target. If you look at U.S. policy towards China, what I see from the outside is a hierarchy: foreign policy dominating everything else, so-called foreign policy, and I think you're absolutely right.

COMMISSIONER FIEDLER: You mean national security policy?

MS. LEE: Yes, national security, relations with other countries including Taiwan and North Korea.

COMMISSIONER FIEDLER: National security.

MS. LEE: Sudan policy, and other odd issues. We're actually remarkably unsuccessful in getting China to be supportive of things that we like, but it seems like we act out of fear in all of our China policy. We seem to be afraid China is going to do something we really hate, and so we mute our criticism, and we have a complete muddle in terms of message.

So foreign policy and national security are the dominating themes. Economic policy is subordinated to that in a way which is idiotic. When you think about the United States, and you think about the strength of the United States and our relationship, there's, I think, a lack of respect from China for the United States because we've allowed the economic relationship to be so imbalanced for so long.

And then a distant third--not really even in the picture, are the human rights and democracy and worker rights issues that Mike mentioned. I agree with you, Mike, that these are actually integral. They're not like, well, when you get around to it, after you fix the foreign policy and the economic policy, then maybe if it doesn't irritate the Chinese government too much, maybe we could just raise this pesky human rights/democracy issue.

COMMISSIONER FIEDLER: Freedom of association.

MS. LEE: Which nobody wants to talk about. The Chinese government

obviously doesn't want to talk about those issues, no autocratic government ever wants to talk about workers' rights, democracy or human rights, especially not a government which is in egregious violation of those principles.

But if you think about these things as being connected to each other, then you would maybe come up with something that was a more coherent way of approaching the Chinese government. If you put democracy back at the center of it, how do we have such an economically vital relationship with a country that is unaccountable to its own people, that violates the basic principles of international relations, where a small cadre of very wealthy and well-connected people are making decisions that are not necessarily in the interest of the broader population?

Even on things like currency manipulation, or economic policy, it's not clear that the Chinese government is looking out for the Chinese worker. The Chinese government is looking out for its own power and for continuing its own power, and yet our government engages with that government as though we are equals, as though we are both democratic legitimate governments engaging in a rational discourse, and that is not the case.

And so if we turn our policy all the way upside down and put the economy at the center of it with worker rights and human rights and democracy being a central part of that, I think the foreign policy would actually make more sense, and we might be more successful than we've been in the past.

When I think about the U.S. economy and the imperative that we have, President Obama's national export initiative, and the importance of job creation, to this economy coming out of the recession, our imbalanced trade relationship with China is really at the center of what's wrong with our economic policy, and so it shouldn't be subordinated to anything else.

Thank you.

COMMISSIONER FIEDLER: Thank you very much.

HEARING CO-CHAIR SHEA: Commissioner Slane.

VICE CHAIRMAN SLANE: Thank you so much for taking the time. It's been very, very helpful to me.

When you view indigenous innovation in connection with several recently enacted laws, the labor laws, the patent laws, and the antitrust laws, et cetera, that are really directed at foreign companies, it seems to me that what the Chinese are ultimately going to do when they master the technology in various industries is to force out the foreign companies.

And my question is, do you see it this way, and do American companies like General Motors believe that their days may be numbered in China?

MR. WOLFF: My feeling is that public companies are going to be driven by the quarterly results, and as long as there are high profits, and China is a huge, rapidly growing market, and profits are coming from there, and there is a hope of even greater profits, companies are going to say,

well, it's not that we're blind to the threats that are down the road, it's just that we've got to look out for current returns.

I think that there is a high risk that if the Chinese pursue their current policies, our automobile companies will be driven out of that market. I think you're right, absolutely right, but if that's five years from now, and there's a 25 percent return on investment, it's not irrational for someone who has to report quarterly to the stock market to take those returns and take the risk. Maybe things will change. Maybe it will all work out differently, but the risk is there.

MS. LEE: I'm not so sure it is rational, depending on what kind of company you are and how important the intellectual property rights are. I agree with the premise of the question. I think that companies are in danger of being forced out, that that probably is the ultimate goal of the Chinese government. Foreign investment was invited in at a point when it was needed, and then wrung dry, where every last bit of intellectual property was squeezed out, and at that point, when the foreign company is no longer needed, I think it can be kicked out, and that's dangerous.

What are companies thinking? I don't know. For many years now we've been saying to companies, gee, this seems dangerous, this seems problematic. Certainly for companies like Boeing, whose whole lifeblood is their technology and their intellectual property, to make deals at many stages along the way where technology is handed over to the Chinese government, either overtly or inadvertently, seems crazy.

So even if you're getting good returns in the short term, your ability to make money over any medium or long-term period depends on you not making those choices in the short term.

VICE CHAIRMAN SLANE: When I look at all of these laws, it seems obvious to me where the Chinese government is. They have no intention of turning over their domestic market to foreign companies.

So if I'm on the board of directors of General Motors, and General Motors wants to spend \$1 billion to open up a factory in some city in China, and they're going to need ten, 15, 20 years to amortize that factory, it seems to me that they're kidding themselves, and it's my hope with this indigenous innovation is that these American companies realize this, and they start to think about not making these major investments, and now they're over a barrel, and they have no choice but to stay there.

And maybe to Alan's point, our whole corporate governance structure, really we should be looking at that, and this whole 90 day and all the short term, and the CEOs with three years to make their bonuses, it just seems to be really destroying our manufacturing.

MS. LEE: Just one last point, if I may. I recall pretty vividly that arguments that were made on both sides during the debate around China's accession to the WTO. The pro-PNTR crowd was all saying, "Well, WTO accession is about the United States being able to export to China," and so many companies caved so quickly.

Companies seem to believe that in order to sell in China, they have to move their production there, and then they get their intellectual property stolen, and then they're left with nothing. The whole point of WTO accession is supposed to be that you didn't have to move to China in order to sell there. It's also supposed to be that you don't have to give your technology over in order to sell there, and then at some point, there is some protection in international trade rules that would protect a company whose choice was to export product with its own proprietary intellectual property from the United States to China, and that seems to be lost. We don't even pretend that we're aiming at that anymore.

HEARING CO-CHAIR SHEA: Let me just follow up that question with a question for Mr. Wolff. In your testimony, you indicate that a central feature of China's indigenous innovation strategy is an effort to ensure that emerging technologies become dependent internationally upon the application of Chinese technical standards, and we've seen that policy applied with some vigor, particularly in the telecommunications area.

We have also seen, following up on Commissioner Slane's point, a more recent tactic, that of filing patent infringement claims against foreign companies seeking to do business in China.

Let me just read something from the Chamber of Commerce report. This is the Chamber of Commerce. It says, in March 2009, the Chinese Supreme Court encouraged local courts to dramatically raise compensation awards against patent infringers, but most of these cases have been brought against foreign companies by Chinese holders of the utility model patents or design patents which are even less rigorous than the utility patents.

Both of these patent categories are considered to be junk patents by most patent attorneys and regulators. Hundreds of thousands of these patents are filed every year in China as part of the indigenous innovation drive.

Now, a recent case came to my attention involving a U.S. company that produces something called--a new technology called mobile digital television chips. And this company claims that it's being shut out of the Chinese market through patent abuse and other measures and will suffer, likely suffer competition not just in the Chinese market but in U.S. and global markets.

And my understanding is that the Foreign Trade Antitrust Improvement Act extends Sherman Act protections to foreign conduct that has direct, substantial, and foreseeable effect on U.S. trade.

So my question is what other relief do U.S. companies have or what really should be constructed for them if they might suffer competitive harm in the U.S. market or global markets as a result of Chinese indigenous innovation policy?

MR. WOLFF: Part of the distortions caused by the indigenous innovation push, as I mentioned, is to create incentives to have, for example, Chinese national standards depending on Chinese indigenous

innovation, which means based on Chinese IP.

I had a foil at one point, a PowerPoint produced by a Japanese company, and it was across the whole range of electronic products. And in 90 percent of the cases, there was a separate national standard in China as opposed use of to the global standard. That has to be, since a lot of those standards, I am told, were just tweaked to make them a little bit different, just like in the patent case, that the result was--

HEARING CO-CHAIR SHEA: Re-innovation.

MR. WOLFF: --re-innovation. Well, re-innovation is not necessarily a bad thing if it's an incremental improvement.

HEARING CO-CHAIR SHEA: Right.

MR. WOLFF: But if it's a means of blocking, closing market access, it is a real problem. And I understand WAPI (the wireless LAN standard) hasn't gone away. We thought a stake was driven through its heart, and the forced technology transfer was not pursued, but it's come back as a standard in cell phones, I understand. So standards are a problem.

Responding to you on the question of patent infringement claims based for example on utility model patents. If the Chinese government says go forth and create engineers, go forth and create scientific papers, go forth and create Chinese national standards and patents based on Chinese IP, then a lot of them will be created because that is the nature of a centrally-driven system.

Utility model patents are not well reviewed, if at all. They're certainly not of high quality, and, as a general proposition, they are based on incremental change of one form or another in process or technology, and nothing fundamental. And if these patents are used as an offensive weapon, this is going to be a real problem.

In terms of remedy, while I can't comment on the facts of a particular case, either the Chinese provide a remedy or we have to. And it may be that if there's a pattern of this sort of thing, that it becomes a cause for a government case on a broad pattern of activity.

The U.S. government is not likely to intervene in the individual case, but the U.S. government could take on a pattern of behavior. So would there be a response? I think there will be a response, and every possible avenue should be pursued because our IP, as Thea said, is part of our country's future.

The problem of the infringements that you just described and that you heard of this morning, is not only loss of sales in the Chinese market but a loss of sales in third-country markets as well. The burden of litigation will cause U.S. companies that are trying to compete to have to compete in the courts with foreign patents that are really not very valid.

HEARING CO-CHAIR SHEA: Thank you.

Commissioner D'Amato.

HEARING CO-CHAIR D'AMATO: Thank you very much, Mr. Chairman.

I want to commend both of you, as well as my fellow Commissioners,

for this dialogue. This is the kind of dialogue that this Commission was created for.

You talked about the fact that our economy has national security implications. Well, the theory underpinning the creation of this Commission by Senator Byrd was that the national security implications of our economic situation are what we're supposed to talk about here. The economic situation is a national security matter.

And it's disturbing to hear you say, which I have to agree with, that we have no strategy and no solutions and no analysis. That gets down to basics. That tells me we have no leadership. And that we haven't had any leadership for quite a long time, and we don't stand up for ourselves.

What I'm hearing is that we have to get back to basics, to take action when our interests are attacked, and the question is where do you start? And my theory is we start with taking a look at the sleeping pill, which I call the WTO. The WTO is a sleeping pill.

You can bring a WTO case, it will eventually get solved, well, eventually the grass will grow, too, next summer. So the question is what other remedies are available beyond the WTO that we should be pursuing more aggressively?

We had Senator Gorton, former Senator Gorton, here this morning, who talked about using tariff law in some respects. And the question I have is should we be moving away from this theory that the WTO is our panacea toward more of a mutuality of market access theory, that if we find our markets and IP and whatever being eroded and infringed, that the thing that the Chinese value the most, which is our market, is put at risk, and regularly we should make sure that any kind of action the Chinese take to infringe on our rights has a direct impact and rather rapid impact in its access to our market?

That would be my theory, that the next stage of what we should do in the way of remedies, moving away from the WTO because the WTO has not proven to stop this kind of behavior, is the question of looking at more tools. The Congress should look at more tools to hold our market at risk in a fair way that the Chinese understand.

The Chinese understand market access. That's what they want. They understand when it's being taken away from them, and why. So is that a useful path to follow in terms of trying to start remedying this problem?

MS. LEE: Yes. One way of thinking about it is to think of the slowness of the WTO as being on our side in this issue. If there are areas where we want to act unilaterally, then we should use the tools at our disposal. If one day we get challenged at the WTO, over whether we are allowed to do that, whether it is legal or so on, it will take them several years to work through the remedies.

And I know that's anathema to trade nerds and trade lawyers everywhere, but I actually think that the current situation warrants it, and there are a couple of areas where we could do that. I think you know that

the AFL-CIO has filed two Section 301 cases against China in the past, one on currency manipulation and one on worker rights violation.

And the allegation in both has been that the actions that the Chinese government has taken in these areas are unfair trade practices, and they are actionable. We've asked our own government to look into this and to review the arguments that have been made and then to take action.

With respect to currency manipulation, as you all know, there's legislation in the Congress that would direct our government to be more precise about determining what constitutes currency manipulation, and when that reaches the level of an illegal subsidy under WTO rules and then to act, and I think that's the key thing.

The point that you made, Commissioner, is exactly right: the threat of sanctions or the use of sanctions concentrates the mind wonderfully. The endless talk and dialogue that we've had with the Chinese government really is serving the Chinese government's purpose much better than it's serving the U.S. government's purpose. You can drag out these dialogues for many years, as we've all seen, without ever reaching a conclusion on the things that are important to us.

So I agree with you. When you run the kind of trade imbalance that the United States runs with China, the power, the economic power in this relationship is on our side. We just haven't recognized it and we haven't been willing to use it.

HEARING CO-CHAIR D'AMATO: Thank you.

MR. WOLFF: I would say the following about the WTO. One is it has a number of deficiencies. I was not a fan of binding dispute settlement, and the night before the end of the Uruguay Round, I recruited Clyde Prestowitz, and we went to see Mickey Kantor, who by then was absolutely physically and mentally drained. He had been up many nights in a row. We said, you know, you can't accept this binding dispute settlement. Well, it had been done in the last administration and was part of the deal. It was too late. Nothing was going to change.

It's not all bad. But if the rules don't cover a particular trade distortion, and many of them don't, or if there is a fact-intensive case, the system does not deliver results. We brought a case on Japan closing its photographic film market, and we, the United States government and Kodak, got our heads handed to us. The panel was not up to dealing with a fact-intensive case, at that time anyway.

But there are some WTO tools. I don't know why this government--well, I do know why--but I think this government should have brought a currency case under the GATT and subsequently under the WTO against China. This should have been done a long time ago and still should be done.

WTO/GATT Article 15. Why is it there? It provides that no WTO member shall use exchange measures to frustrate the intent of the Articles of Agreement of the WTO, the GATT. Well, what's going on? Why isn't this the sort of emblematic case to use the WTO?

Why do we think that TRIPS isn't being violated when just because you have foreign intellectual property, you can't sell something in China, or anything in China, if indigenous innovation policy measures prevail? Why is that the protection of intellectual property as required by TRIPS? It seems to me that there is a valid case to bring before the WTO for this conduct.

And, of course, the steelworkers have brought a case on green technology equipment.

Jack Danforth, whom some will remember, talked in the '80s about reciprocity. I believe in reciprocity, and we've got to find the means to actually employ it. The Chinese actually understand, and, as I said, with respect to tires and chickens, they sort of had a rough feeling about reciprocal action.

Well, we have to think through some ways in which we can have some reciprocal actions ourselves.

HEARING CO-CHAIR D'AMATO: Thank you. Thank you.

HEARING CO-CHAIR SHEA: Thank you.

Chairman Reinsch.

CHAIRMAN REINSCH: Thank you.

Nice to see both of you again, particularly you, Thea. I don't get to see you very often now that I'm not on the ACIEP anymore.

MS. LEE: I know.

CHAIRMAN REINSCH: But, which is having a meeting this afternoon, I think. That's just the Sanctions Subcommittee. That's not the full one.

MS. LEE: Okay. Good. You made me nervous.

CHAIRMAN REINSCH: I think most of this discussion ends up talking about we all agree what the problem is. So what do we do about it? So we end up talking about enforcement. There were a couple ideas that emerged before your panel that I'd like you to comment on, and maybe since you weren't here for them, it might be a little bit unfair. Maybe you can get back to us.

But one was Senator Gorton's idea that we simply assess a tariff, if you will, or a penalty of 150 percent of the amount of the estimated value of intellectual property piracy, acknowledging there were calculation problems, but the idea would be a more than--a punitive tariff was one idea.

Another idea that Commissioner Wessel raised with a subsequent panelist was using SEC's enforcement powers to go after violators, and if that's not clear, then--

COMMISSIONER WESSEL: Forced disclosure.

CHAIRMAN REINSCH: What? Pardon me.

COMMISSIONER WESSEL: Forced disclosure.

CHAIRMAN REINSCH: --forced disclosure of what was going on via the SEC.

The third one, which didn't come up, that Ambassador Wolff in particular may want to comment on, is to start bringing nullification and impairment cases via USTR which would raise sort of different issues and

provide I think kind of a different evidentiary basis for these things since we seem to have problems in assembling evidence, if you will, due in part to the reluctance of aggrieved parties that step forward.

Can you comment if any of those make sense, if any of those are viable, in your judgment, both of you?

MR. WOLFF: I did read former Senator Gorton's testimony. I certainly don't favor the imposition of a tariff wall. I think that would be counterproductive rather than productive.

On SEC enforcement, I agree that it ought to be explored. I take the comment of the person who was sitting in this chair, that is if we do so, the question is, what are the balancing considerations? If you want those companies to register on the New York Stock Exchange so that there is some disclosure, I don't know the effect of that proposal. I think it is worth a look. It is worth considering.

And Chairman Reinsch's question regarding nullification and impairment cases, I agree entirely. The solution to the evidentiary problem is a matter of rolling up one's sleeves and getting the evidence. I don't think the U.S. government has the resources to do this. We have intelligence services. They do things like track down Mr. bin Laden. That is how they're graded. That is how they should be graded. We are not going to change their mission.

So the assignment has to go elsewhere, and that is a matter of resources and priority and getting the job done. It can be done. I really think it is doable.

In the NFTC study on the renewable energy equipment, I think you find out a fair amount of relevant information. On the aircraft study from RAND, you find out a number of things that are useful to this inquiry. Now you could take the research into each sector some levels deeper. There will be things that you can't get on the record that you have to find out by going out in the field and interviewing, by looking at patterns of trade. This is a doable job. It just does not have the necessary resources devoted to it.

Now, would the WTO dispute settlement system be up to the task of deciding a nullification and impairment case? I think it has to be tested, and when and if it failed, the U.S. has to consider its options. Only then does the U.S. end up closer to Senator Gorton--maybe, but we're not there yet. I think we have to do our homework. We have to use the remedies that we have.

CHAIRMAN REINSCH: Thank you.

Thea.

MS. LEE: Well, I'd want to look at all the details of Senator Gorton's proposal before weighing in on it. But I think, in general, we agree with the direction of being more aggressive, and I agree with Alan, that we should exhaust all the remedies at our disposal and make sure that we aren't leaving anything on the table in terms of violations that exist.

In order to do that effectively, I think that goes back to one of the

points you made earlier about needing more resources for the U.S. government to do some of the investigations and so on.

I don't know whether the SEC is the right format for that. I think we should use whatever means we can, and some of this information is proprietary to companies, and some of it is in the hands of the Chinese government. The data that are proprietary to U.S. companies, it seems like we ought to be able to get better access to them than we have, and so I certainly agree with anything that would improve the transparency and the disclosure and our ability to assess the situation.

In general terms, I think the choices we have with respect to China are match, challenge or do nothing. So when China violates international rules, we can either try to match them--so if they subsidize, we subsidize. They do something, we do the same thing. That's obviously not ideal.

I think it is better if we can challenge and win--what's the point of having an international structure of rules if we can't enforce them in our own interests? And doing nothing, obviously, I think you've all heard me say I don't think that's the right approach.

Thanks.

CHAIRMAN REINSCH: Thank you.

HEARING CO-CHAIR SHEA: Commissioner Mulloy.

COMMISSIONER MULLOY: One, I want to thank you both for terrific pieces of prepared testimony, and then also the very helpful conversation that we've had here this morning.

I was encouraged yesterday. I was invited to a meeting at the U.S. Chamber of Commerce where they were looking at China, and among the other things was China's indigenous innovation policy, and a major figure in the Chamber talked about the national security implications of all of this, and I don't want to quote him, but the concept was that companies who are being charged to transfer technology are looking short term, but this is a far bigger issue than that, and that the U.S. government needs a strategy and a vision to deal with this, which I thought was very welcome thing coming out of a meeting like that.

But I was disheartened by a discussion at lunch by a senior U.S. government official where he was talking about investment from China into the United States. Thea, you talk about that in your testimony on page three, where you're talking about the Chinese investment here is not greenfield investment but acquisition investment.

I wanted to just run this by you. I think of Chinese investment coming into the United States as different from European investment because Chinese investment is from state-owned enterprises or from state-owned investment funds. We have not wanted our own government owning chunks of our economy. Now we're on a road where I think we're encouraging the Chinese government to own chunks of our economy.

In our own test, under CFIUS, we look at the national security implications, and we have to find that something is not in our national

security interest to turn it down.

In Canada, their investment law says you have to find an acquisition is in the net benefit of Canada before making a judgment. I'm wondering does that Canadian test sound like it would be a better way to look at the Chinese investment to you, and particularly Chinese government-owned enterprises coming into this country and buying things?

Thea, and then, Alan, if you want to comment.

MS. LEE: Sure. I think it's certainly an important question, and one that we don't have enough information about. In terms of inward foreign direct investment, people assume this is a good thing. They're going to bring jobs into the United States, and the labor movement hasn't taken a blanket position. I think people often think we're opposed to foreign investment into the United States. Of course, we're not.

If companies come to the United States and treat their workers fairly and abide by the laws, then we're fine with that. What we often see, though, is companies, whether they're European or otherwise, coming to the United States and playing by a different set of rules. Some of them might have a strong union back home in Germany or Sweden, and they come to the United States, and all of a sudden are busting the union.

That's just a general point about foreign investment, but I think the point that you're raising is different. And this goes to the discussion we had earlier about state-owned enterprises and state-owned investment. Are our rules adequate to this task? Probably not.

We need to be much more careful and vigilant about what the difference is for the United States economy, for national security, when a state-owned actor comes in because we don't know what the motivations are.

It's pretty straightforward with most companies. They might have short-term and long-term profit motives, but they're basically about making money. If you have a state-owned enterprise that comes in, it could very well have a very different set of agendas. That's where some of the concerns have been discussed around communications and technology, where CFIUS maybe isn't adequate to address some of the national security implications. We have to be careful, and we should certainly look at the Canadian standard to see whether that gives us more flexibility than the current CFIUS.

COMMISSIONER MULLOY: Yes.

MR. WOLFF: I was called by a reporter when a Chinese company was going to acquire a GM power steering unit in Saginaw, Michigan, and not knowing anything really about the transaction, I said, look, I'd rather have Chinese investment in greenfield plants in the United States. I don't know the circumstances of this particular plant. GM is trying to sell it apparently. I'm sure there will be some transfer of technology. Is the plant going to go out of business if GM does not take Chinese money to keep it going, meaning people get thrown out of work; and then Saginaw is worse off?

I don't know what the plans are of the Chinese company seeking to make the investment--the acquirer. Are they going to close the plant in a couple of years? What is their intention? —Frankly I think we should welcome Chinese investment. I wish it were in greenfield plants and bringing in technology. I think each case has to be examined.

And if the Chinese do what they did in the case of Coca-Cola, seeking to acquire a juice company in China, which was probably not a national security issue, by any means--being facetious about that--China is likely to find some reciprocity back here at some point.

There has to be the ability for foreign companies to actually acquire Chinese companies more freely, and in automotive investments in China, as you know, there is a limit often to minority stockholding instead of a takeover of a Chinese entity. If the Chinese want openness here, they're going to have to be open there.

But it's worth a closer look as part of the strategy that we're talking about this morning.

COMMISSIONER MULLOY: I want to follow up just one second. Under the current CFIUS, we do make a distinction between government investment and non-government investment. We have to do a more searching analysis of the investment if it's a government-owned enterprise.

That's where they got into all that problem on the ports issue, Dubai Ports, because that was a government-owned thing, and they didn't do the longer analysis. So my thinking is when you've got a centrally-planned economy or a government-owned enterprise, controlled by Communist the party coming in, and these enterprises are buying U.S. companies, that maybe we ought to have a different test than just is it against our national security, something to show this is in the net benefit to the United States.

That would permit us to do the more searching analysis you've just been talking about, Alan, on the power steering, Saginaw, Michigan issue.

Thank you.

HEARING CO-CHAIR SHEA: Commissioner Bartholomew.

COMMISSIONER BARTHOLOMEW: Thank you very much to both of you, both for appearing today and for the work that you've done consistently over a number of years.

Ambassador Wolff, you just used the word "reciprocity." And I guess I could hope. Why do you think that people in trade policy, people in consecutive administrations, are so resistant to this concept of reciprocity?

MR. WOLFF: The reasons given at the time for insisting on reciprocity were economies vary, a market economy model versus state-developmental capitalism. We're not talking about a sectoral reciprocity, some sort of narrow reciprocity that if we export so many tons of soybeans, we're going to have a balance in soybeans. But that was not I think what Jack Danforth had in mind frankly.

What he had in mind was getting an equal opportunity to sell, competitive reciprocity ("substantially equal competitive opportunities"),

and I think we have to go back to that idea, but academic economists tend to shy away from the notion that the composition of an economy matters. But what we are faced with is many foreign governments, and China is on the leading edge of them, that care about the composition of their economies, and we don't.

HEARING CO-CHAIR D'AMATO: That's right. That's what national champions are all about.

MR. WOLFF: And I think we have to change our view frankly, and then we will care a little bit more about what the lack of reciprocity does in terms of the shaping of our economy.

We've suffered a lot in manufacturing, not just because of the dollar being overvalued at times, but because we haven't looked outside at what other countries' industrial policies are doing. I dealt with steel for years, and had to face the reality with each Administration that we just didn't care as a country whether we had a steel industry or not. Why did it matter?

With respect to semiconductors there was a difference, it had a futuristic feel to it, involving the future of the country, and there was a sense that it mattered, an innate sense, but not a calculated sense that it mattered.

As one of the Commissioners said, we put money into SEMATECH and a variety of things were done to strengthen our competitive ability. At the same time we said to Japan, which was unprecedented, "your companies will not dump anyplace, not just in the U.S. market, your companies will not dump in third-country markets, and we will have access to your market." The whole idea was we were going to put a stick in the spokes of Japan's industrial policy because it was harmful to us. Now we do not see that foreign industrial policies do harm to the U.S. economy. We do not don't recognize it, and we don't see it, and we've got to change that.

Too long an answer possibly, but reciprocity has to involve a look at what the impact will be on particular sectors.

COMMISSIONER BARTHOLOMEW: Thea.

MS. LEE: It's a good question, and I wish I knew the answer. I think that reciprocity certainly for normal people has an enormous appeal. It's a common-sense concept. You trade so that you can have open markets back and forth and fair rules that allow the interchange of goods.

What's interesting is as an economist you know the theory of trade assumes balanced trade. The basic model of economic comparative advantage and so on assumes that adjustments are made through currency and through other things so that essentially the volume of trade is balanced.

And yet, all the people who criticize the labor movement for being unhappy with our current trade policy, they call us protectionists. They claim a lot of the benefits for trade that are actually based on a model that's very different from the world we live in--of full employment, balanced trade, no externalities and so on.

It's an important model, but we've gotten so far from it. Even in the

launch of the Doha Round, there was a basic contradiction. The launch of the Doha Round said that we're not even going to ask developing countries for reciprocal market access because this is supposed to be a development round.

So we're supposed to open our own market, take down our highest tariffs and not even ask developing countries for reciprocal market access. And the developing country category included not just least-developed countries like Haiti or sub-Saharan Africa, but even emerging market developing countries, like China, India, and Brazil. At the same time the U.S. Congress was instructing the executive branch through the TPA not to enter into any agreements that didn't include reciprocal market access.

So it's just one of those odd conundrums that you've put your finger on where there's a real conflict between what the American people expect of their leaders and what they actually get. The American people expect their leaders to seek reciprocity, and yet what we've grown accustomed to living with is very far from that.

COMMISSIONER BARTHOLOMEW: Some of what we're arguing for, of course, is redefining the debate. As some of us have been saying, how do we compete if we don't have an industrial policy?

And when I think of people talking about reciprocity, I think, okay, this is the way it unfolds. Somebody raises reciprocity. Somebody else says no, that's protectionism. And if we go down that path, it's going to be a trade war, and they raise Smoot-Hawley. It's just like you can sort of predict that that's going to come up.

[Laughter.]

COMMISSIONER BARTHOLOMEW: And I was recently at a dinner where there was a distinguished ambassador who is going to be leaving D.C. He was a foreign ambassador, and he started talking about how important it is to avoid protectionism. And you hear that everywhere. And I just wonder whether we all need to do a better job of saying we need reciprocity? To match that drumbeat of you can't do anything because it's protectionism with a more aggressive proactive message?

MS. LEE: Sounds good.

HEARING CO-CHAIR SHEA: Well, we'll close on the note of reciprocity then. Unfortunately, I don't think this relationship has been reciprocal. I think we have benefited more from your testimony than you have benefited from our questions, but thank you both for being here today and for participating.

And before we close, I just want to thank three Commission staffers who have put this hearing together: Paul Magnusson, Nargiza Salidjanova, and Dan Neumann. Thank you for your efforts.

MS. LEE: Thank you.

HEARING CO-CHAIR SHEA: The hearing is closed.

[Whereupon, at 12:34 p.m., the hearing was adjourned.]