

# ELEMENTS

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## Faking It. China's slow battle against counterfeiting

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At first glance, "Cho"\* seemed like the type of entrepreneurial success story that had dried up after the collapse of the Internet boom in 2001. Born in China, he graduated from the University of Alabama and moved to Hong Kong, where he sold luxury handbags through a series of web sites he designed in Malaysia. During his last year of operation, Cho's sales were valued at \$500 million.

But Cho's profits were illegal; his handbags were counterfeit. Working after-hours in his father's legitimate handbag factory in Guangzhou, Cho used his father's equipment to produce his own handbags. He would slap the labels of famous handbag companies on his bags and sell them across the globe.

Robert Holmes, CEO of the company IPCybercrime.com first heard about Cho in 2004, after he had been contacted by "well-known luxury handbag companies." (Because of confidentiality agreements, he declined to name specific companies).

Holmes began investigating Cho in 2004, even going as far as having his investigators follow Cho to karaoke bars in Hong Kong. Based on Holmes' sleuthing, in 2006, Cho was apprehended, and his operations shut down by Chinese officials. It is believed that Cho spent "some time" in jail, but his current location is unknown.

Cho is just one of the many entrepreneurs in China who profits by selling counterfeit goods in the United States. China is the world leader in counterfeiting; according to the U.S. government, 81 percent of all counterfeit goods that enter America come from China.

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#### **Faking It.**

China's slow battle against counterfeiting

Quantifying the scale of counterfeiting is difficult. According to a 2007 study by the Organisation of Economic Cooperation and Development, \$769 million (.01 percent of imports) worth of counterfeit goods were seized in 35 countries, including the United States and China, in 2005. However, that figure just accounts for the counterfeit goods that were captured by authorities. The OECD estimates the total of counterfeit goods worldwide may be as much as \$100 billion dollars. In the United States, \$150 million dollars worth of counterfeit goods were seized in 2006.

### ***“Keys to the Kingdom”***

While Cho used his father’s equipment to make fake handbags, counterfeiters normally use the equipment of the large American companies that pour capital into China. Foreign direct investment in China was over \$60 billion in 2006. Nike, for example, manufactures 35 percent of its footwear in China.

When companies expand into China, they must form a joint venture with a Chinese company to comply with local law. Often, the Chinese company will exploit the American-bought equipment to produce excess goods, which they then sell on the black market.

“Maybe their supplier has been requesting 1,000 parts,” says Amelia Wong, who analyzes the auto part industry for the consulting company Frost and Sullivan. “Maybe they produce 500 more and they will use their own label and in the market, it’s exactly the same, but you cut off the margin from the original manufacturer.”

Because the same equipment and manufacturing techniques have been used, only the materials distinguish the counterfeited product from the real thing.

“If component parts are readily available, essentially they’ve been given the keys to the kingdom,” says Vaughn Volpi, president of Pica Corp, a company that investigates counterfeiters.

But using different materials may compromise the quality of a counterfeit good, sometimes with dangerous side effects.

In August, 2006, a Johnson and Johnson investigation traced counterfeit LifeScan OneTouch test strips to Halson Pharmaceutical in Shanghai. The strips are used by diabetes patients to monitor blood-sugar levels. Although no injuries were reported, Johnson and Johnson was alerted to the fake strips after receiving 15 customer complaints. In response to the fakes, the Food and Drug Administration issued a class I recall, which is issued when there exists “reasonable probability” the product will cause “serious adverse health consequences or death,” according to the FDA.

The fake strips demonstrate that many times, China’s counterfeit goods are inferior to the real product.

In 2006, Dan Harris, an international lawyer and co-author of Chinalawblog.com, considered buying his teenage daughter a counterfeit North Face jacket. He quickly dismissed the idea, however, when he noticed the poor quality of the fake jackets.

“There is no way in hell she would have worn [it], in a Seattle-area public high school,” he says. Harris believes that counterfeiting figures are exaggerated, because consumers buying fakes could not afford the real thing anyway. Consumers who can afford real products wouldn’t accept the inferior quality of counterfeit goods.

“If they weren’t buying fake North Face jackets for \$20, they would be buying no-name jackets,” he says.

However, in some market segments, the gap in quality between real and counterfeit has narrowed as the Chinese adapt to the technology advancements brought into the country. “Now the manufacturing level has increased,” says Dan Chow, a professor of intellectual property law at Ohio State University says. “[Before] You would buy a fake Rolex on the street and it was very clear that it was fake.”

In the entertainment industry, for another example, movie and song copyrights are easily pirated because they do not require much equipment and the material can be easily found on the Internet.

“You can buy a movie in China for a buck, and it’s just as good as any other,” Harris says. Another easily counterfeited product is computer software. In June 2005, Microsoft filed lawsuits against three Virginia companies for distributing counterfeit software. Although Microsoft does not calculate figures for their losses, Microsoft’s Cori Hartje estimates that counterfeit software account for 35 percent of worldwide software. That translates to a value of \$31 billion dollars. Hartje is the Worldwide Director of the Global Software Initiative, a Microsoft program designed to combat counterfeiting.

The most commonly pirated products are operating systems like Windows XP and Windows Vista. These products are typically distributed in the United States through maverick brokers who operate on a smaller scale than other distributors, according to Robert Russell, sales manager for Ill Open Technologies, a Virginia Beach-based computer reseller.

“It’s always a broker or some fly-by-night company,” he says.

Because Russell buys his products directly from major companies, he says that he is largely immune from buying fake software. But that doesn’t mean his business isn’t hurt from counterfeiting.

“There certainly is a siphoning off,” he says. “Most of the diminishing revenue would happen on the software side.”

One way that Russell can tell that counterfeit software has infiltrated the market is when clients ask him for computer hardware but not software. Such a request indicates that the client may have bought pirated software at a discount to Russell’s price. Russell estimates that he loses between \$10,000 and \$20,000 from such transactions.

Although he can’t be sure that all of that loss is because clients have already bought counterfeit software, he acknowledges that it is a problem. Most companies look the other way at buying counterfeit software and don’t investigate their suppliers.

“From what we’ve seen on the software side, they [software buyers] prefer the ambiguity of the situation,” he says. “They’d rather be ignorant.”

Golf equipment is another product that has been successfully counterfeited. For example, Callaway Golf Company needs forensic experts to identify fake clubs, according to Tony Nikae, managing director of the independent research firm Havocscope Illicit Markets.

Ultimately, however, the consumer is the final judge of the product. So far, the consumer has embraced the abundance of Chinese counterfeit goods. In China, only the wealthiest sliver of the population insists on real goods; the rest of country is perfectly content to pay less for slightly inferior products.

“It’s very dependent on demand,” Wong says. “For more economic cars, like Minis, they [the Chinese consumers] don’t mind paying for counterfeit.”

In the United States, the consumer is usually oblivious to the fact they are buying counterfeit merchandise. The United States Customs and Border Protection inspects less than 10 percent of the 11 million cargo containers shipped annually into the country.

The CBP only pinpoints the most suspicious cargo to inspect. For example, if company X ships all their goods through the port in Newark, a sudden shipment to San Francisco may alert customs officials to inspect it.

But when 15-20 percent of goods coming from China are believed to be counterfeit, the inspections cannot possibly stem the flow of fake goods into the United States.

“It’s a matter of too many bad guys, and not enough good guys,” Holmes says.

### ***“Cops without Guns”***

Legally, China has protections similar to the United States against counterfeiting. Since its inclusion in the World Trade Organization in December of 2001, China, like the United States, has been subject to the Trade-Related Aspects of International Property Rights (TRIPS) agreement.

Section 5, Article 61 of the TRIPS agreement states that, “Members shall provide for criminal procedures and penalties at least in cases of wilful trademark counterfeiting or copyright piracy on a commercial scale. Remedies available shall include imprisonment and/or monetary fines sufficient to provide a deterrent.”

But so far, China has failed to deter counterfeiters, and its failure to comply with article 61 explains much of why counterfeiting still prospers today.

“There is not a lot of deterrence,” Chow says. “The problem is the penalties are so light,” Criminal prosecutions are only leveled on counterfeiting offenses where the damages total more than \$6,000 for individual counterfeiters and \$18,000 for corporate violators.

The lack of compliance with article 61 was the center of a U.S. complaint to the WTO in April. The formal complaint was against a Chinese law stating that criminal prosecutions for DVD pirates would only occur if 500 fake DVDs had been made. The obvious flaw was that pirates could make 499 fake DVDs with impunity.

“It created a loophole,” says Joseph Simone, a Hong Kong-based lawyer with Baker and McKenzie. “Smart infringers say, ‘Well, I’ll just keep my quantities low.’”

The complaint was the first filed against China since they joined the WTO. The United States had been giving China time to adjust to the new intellectual property restrictions.

The Public Security Bureau (PSB) is the only branch of the Chinese government with the power to jail counterfeiters. The Administrations for Industry and Commerce (AIC) deals with counterfeiters administratively through seizures and fines. The AIC could not be reached for comment.

Last year, the AIC handled 33,900 counterfeiting cases. Less than 1 percent of those cases were referred to the PSB.

“Cops without guns,” Simone says about the AIC. “They could certainly do a lot more, especially since investigations are being done by trademark holders.”

China’s large population and provincial structure hampers these organizations’ ability to control the counterfeiting problem. China’s police-to-population ratio is roughly one officer for every 833 citizens, according to 2006 estimates from the Chinese newspaper “The People’s Daily”. The United States has more than 1 officer per 500, according to 2003 estimates from the non-profit research firm the Rand Corp.

Local police are prohibited from crossing province lines to shut down counterfeiting, so if officials in Beijing find fake DVDs coming from in from Guangzhou, they cannot stop it. Many provinces, dependent on the tax revenues from counterfeit companies, turn a blind eye to counterfeiting. For example, Shanghai is more vigilant towards counterfeiting, while in provinces like Guangzhou and Shenzhen enforcement is especially lax.

“In Shanghai, you could and should sue and probably win,” Harris says.

### ***Private Sector Solutions***

Some American companies operating in China do their best to aid officials. For example, Nike sends inspectors to the border to work with Chinese customs officials, showing them how spot fake sneakers, according to Harris.

Other companies hire private sector companies like Holmes’ IPCybercrime.com or Volpi’s Pica Corp. to investigate counterfeit claims and locate counterfeiters. The groups will identify and locate counterfeiters and turn them over to the Chinese government.

“The private sector really supplements what government does,” Harris says. “Without the private sector, it’d be more difficult for the government to do its enforcements.”

But other companies chose not pay the large sums of money required for sufficient brand protection. Particularly, small and mid-size companies lack the resources necessary to secure adequate protection against counterfeiting. These companies accept the loss from counterfeit products as a cost of doing business in China, a cost outweighed by China’s cheap labor force. Nike on the other hand, will go as far as to sue counterfeiters even if the settlement is less than the legal fees, Harris says.

Other companies use different tactics to prevent their products from being counterfeiting. For example, Microsoft has signed a deal with the Chinese government to use Microsoft products. The deal ensures that at least some Microsoft products in China will be real. Film and record companies have lowered the prices, and movie studios have cut the release time from theatres to DVD, hoping to close the window for counterfeiters to pirate their videos. Typically, movies are delayed from the time they air in theatres to the time that they are released on DVD, but that cycle has been compressed.

### ***“The Currency of the Future”***

This isn't the first time a booming Asian nation faced international criticism of a lax intellectual property structure. In the early 1970s, Japan's economy grew at 8 percent, but like China today, they lacked coherent regulation regarding counterfeiting. As Japan's economy matured, they adopted intellectual property standards on par with the rest of the Western world. Japanese companies like Sony led the move towards tighter standards.

“Once a country becomes intellectually advanced to the point they realize IP is the currency of the future, then, they'll start turning around,” Holmes says.

Most experts believe that China will follow a similar pace, as its national manufacturing sector matures, and big Chinese nationals demand that their products are sufficiently protected. Harris cites a lawyer friend he has in China, who has stopped buying the Chinese drink Moutai, because it is so frequently counterfeited.

“Do you think the very successful Chinese company is happy about that?” he asks. “Hell no, companies like that are going to force change.”

But it will be a slow process. Because of China's communist history, the concept of intellectual property is a relatively new idea that has only become established in the late 1990s and in the beginning of the millennium. The government did not begin protecting intellectual property until it joined the WTO.

“They are just now getting to the point where they believe [counterfeiting] to be theft,” Volpi says.

But already the Chinese government has taken some steps to reduce counterfeiting.

Last July, the government began the “100 Days” campaign against intellectual property theft. They seized 58 million counterfeit publications, according to the Chinese newspaper “People's Daily.” Some critics dismiss the campaign as mostly a public relations effort, but data compiled by the International Anti-Counterfeiting Coalition shows that seizures by Chinese customs officials have increased by 100 percent since 2005.

“I think it's moving in the right way, it's just moving slowly,” Volpi says. “Certainly with Olympics, there's been an effort [to reduce counterfeiting]. Hopefully, it would continue after the Olympics.” Holmes agrees. “We're starting to see more cooperation with the Beijing Games, but it's hard to tell what's sincere and what's for show.”

\*-Full name not used to maintain confidentiality.