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Parallel Imports & Intellectual Property Restraints
The Australian Competition & Consumer Commission's Perspective

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Introduction

Thank you for the opportunity to address this conference on the interaction of intellectual property with competition policy. I will discuss parallel imports as an example of the issues involved.

Intellectual property laws encourage innovation by granting statutory exclusive property rights. Without intellectual property laws, third parties might copy the goods produced through the application of intellectual property, thus reducing the incentives to create further intellectual property.

It is the possibility of success in the market place, attributable to superior performance, that provides the incentives on which the proper functioning of our competitive economy rests. If a firm that has engaged in the risks and expenses of research and development were required in all circumstances to share with its rivals the benefits of those endeavours, this incentive would be very likely violated.

It was once believed that intellectual property laws gave the owners of intellectual property a legal or economic monopoly over a particular piece of intellectual property. This led to concern that the unrestrained application of competition law to intellectual property may undermine intellectual property rights.

It is now accepted that intellectual property laws do not clash with competition laws because they do not create legal or economic monopolies. Intellectual property laws create property rights and the goods and services produced using intellectual property compete in the marketplace with other goods and services. Only in particular cases will intellectual property owners be in a position to exert substantial market power or engage in anti-competitive conduct.

Recently, there have been renewed debates about what kinds of incentives are necessary to encourage innovation. Such debates usually revolve around one or two issues:

- The first is whether greater proprietary rewards to the innovator (ie. appropriability) or increased competition work better to spur innovation efforts to the level that is “best” for society.

- The second is whether society benefits most if it rewards initial innovation through broad intellectual property protection, or if it fosters successive

innovations (incremental or “leap-frog”) by requiring access to the intellectual property of the initial innovator.

We often talk about how important patents are to promote innovation, because without patents, people don’t appropriate the returns to their innovation activity, and I certainly very strongly subscribe to that. On the other hand, some people jump from that to the conclusion that the broader patent rights are, the better it is for innovation, and that isn’t always correct, because we have an innovation system in which one innovation builds on another. If you get monopoly rights down at the bottom, you may stifle competition that uses those patents later on, and so, the breadth and utilisation of patent rights can be used not only to stifle competition, but also have adverse effects in the long run on innovation. We have to strike a balance.

Some of these debates have arisen in the context of antitrust enforcement to prevent anticompetitive combinations of R&D efforts. Analysts have questioned whether antitrust enforcers can make sound judgements without more information about how much competition is necessary to maintain innovation. Future customers, by contrast, have stressed the importance of maintaining at least a few innovation efforts to ensure timely, high quality, and competitively priced new products.

Other debates have involved new kinds of intellectual output such as software and biotechnology. There, intellectual property advocates have asserted that broad protection and strong enforcement of intellectual property rights are necessary to protect innovation. Although others agree that strong enforcement is appropriate where a patent or copyright has the proper scope, they claim that innovators in biotechnology and software often receive very broad intellectual property rights, which, when combined with strong enforcement, allow intellectual property rights to become tools for anticompetitive conduct.

Finally, some of the debates have arisen in the context of networks and the standards that networks require for interoperability. There, some argue that the initial innovation that built a network or standard to which access is desired would be deterred if access were required. Others counter, that successive innovation will be deterred if access is not required.

In sum, the information currently available supports antitrust enforcement that is assertive in maintaining competition as a spur to innovation, yet cautious to avoid unwarranted interference with intellectual property incentives for innovation.[1]

THE ECONOMICS OF PARALLEL IMPORTS

The general approach of Australia's trade and industry policy in recent years has been to encourage contestable markets that are supposed to provide the best possible prices for consumers.

One of the most controversial areas surrounding intellectual property in Australia in recent years has been the issue of parallel imports.

Parallel imports are goods manufactured outside the jurisdiction by or under the authority of the copyright owner but which are subsequently imported into another country (possibly back into the country of origin) by someone other than an authorised importer or distributor. Unlike pirated copies, parallel imports are legitimate products, which are imported into a country by an unauthorised distributor. Conversely, a pirate copy is a reproduction of a copyrighted work manufactured without the permission of the copyright owner. For instance, parallel importation occurs when an Australian retailer imports a particular CD from an overseas wholesaler who has been authorised by the record company (copyright owner) to reproduce the CD but has not been authorised to distribute it to the Australian retailer.

ARGUMENTS FOR PARALLEL IMPORTS

1. Hinders international price discrimination.

The scope for price discrimination is likely to be greater internationally, as disparities in demand elasticities across countries generally exceed those across regions within a country, due to the greater differences in per capita incomes between countries that within countries. Without parallel imports a copyright owner can separate

[1] An innovation market consists of the research and development directed to particular new or improved goods and processes, and the close substitutes for that research and development. The close substitutes are research and development efforts, technologies, and goods that significantly constrain the exercise of market power with respect to the relevant research and development, for example by limiting the ability and incentive of a hypothetical monopolist to retard the pace of research and development. The Agencies will delineate an innovation market only when the capabilities to engage in the relevant research and development can be associated with specialised assets or characteristics of specific firms.

markets without fear of competition in distribution and then charge different prices in each country.

2. Hinders collusion

Supporters of parallel imports argue that restrains on parallel imports facilitate collusion between holders of intellectual property rights. In Australia it has been argued that parallel importing of CDs may cause record companies in Australia to retaliate by price competition, undermining any collusive pricing which might exist between domestic copyright holders. Under this argument, intra-brand competition may actually facilitate inter-brand competition.

3. Increases product range

In smaller markets such as Australia, the holders of the copyright may not make available a wide product range. For example in the DVD market, the US film companies have a significantly smaller range of titles in Australia than they do in other markets. The possibility of parallel importing can enhance the product range and the pace at which products such as movies, CDs, video games and computer software are made available.

ARGUMENTS AGAINST PARALLEL IMPORTS

1. Permits free riding on authorised dealer's sales promotion.

With parallel importing, a local authorised distributor may have less incentive to advertise and promote a product because it cannot internalise all the benefits of the promotion activity. The profits of the parallel trader can be increased by free riding on the advertising of the local authorised dealer. Of course this problem can be overcome by shifting responsibility for advertising from the local authorised dealer to the producer.

2. Increases likelihood of piracy

A total ban on parallel imports minimises importation of pirate product. Of course if the pirate or counterfeit product is of domestic origin, the restriction on parallel imports does not assist in piracy detection.

3. Inconsistent product quality

Parallel imports may not have the same quality as the domestic production. However for most intellectual property this is not an issue. Imported CDs, videos,

computer software etc from legitimate overseas sources would likely meet the quality requirements imposed by the holder of the intellectual property rights.

AUSTRALIA'S INTERNATIONAL OBLIGATIONS AND PARALLEL IMPORTS

Neither TRIPS (Trade Related Aspects of Intellectual Property Rights) nor the 1996 WIPO (World Intellectual Property Organisation) copyrights treaties directly address parallel imports in the manner it feels appropriate.

Article 6 of the TRIPS specifically states that:

"nothing in this Agreement shall be used to address the issue of the exhaustion of intellectual property rights"

The term 'exhaustion' refer to the territorial rights of intellectual property owners after the first legitimate sale of their intellectual property protected products. Australian copy right historically was based on the principle of 'national exhaustion' which meant that exhausting of rights only applied to sales within Australia and thus the rights owner could prevent parallel importation of its product from a foreign country.

Australian is now moving closer to a system of 'international exhaustion'. This means that the rights owner loses the exclusive privilege after the first legitimate distribution of the product anywhere in the world, thus allowing parallel imports from another jurisdiction to enter the domestic market.

PARALLEL IMPORTS – RECENT CHANGES TO THE LAW

I will now turn to the issue of parallel imports.

In Australia, the debate over parallel imports of copyright protected products has spanned nearly two decades. The *Copyright Act* originally prohibited parallel imports except for personal use. In 1983 the question of whether the importation provisions of the *Copyright Act* should be reformed was referred to the Copyright Law Review Committee (CLRC), which reported in 1988. The CLRC felt itself unable to evaluate the conflicting claims about the likely consequences of reform for prices, but were concerned about problems in the availability of some copyright product, in terms of delayed release and range of product. This was followed by a series of reports by the former Prices Surveillance Authority (PSA) (a predecessor of the Commission) into the relative prices of books, recorded music and computer software. While availability was still an issue, particularly for books and to a lesser extent sound

recordings, the PSA's main focus was on international price discrimination. It found that Australia was paying higher prices for all these products than consumers overseas, particularly in North America. After further debate by inter-departmental committees and politicians, the CLRC and PSA recommendations are gradually making their way into Federal Parliament, where they have been the subject of further Senate Committee Inquiries and eventually amendments to the Act.

I am pleased to report that both Australia and New Zealand have both recently made significant changes to the laws regarding the importation of copyright material. New Zealand has effectively made amendments to allow the parallel importation of all copyrighted goods. The Australian amendments are more limited and I will discuss these in detail.

SOME DETAILS OF THE AUSTRALIAN CHANGES

Two Australian Acts passed in July 1998 bring competitive influences to bear on the importation of copyright material and promise benefits as a result.

Copyright Amendment Act (No 1)

The *Copyright Amendment Act (No 1)* included amendments to the law in relation to ownership of copyright in commissioned photographs and the works of employed journalists. The first Act also included an amendment to the law to prevent the distributors of goods not protected by copyright from using the copyright in the packaging or labelling of the goods to prevent anyone from importing the goods.

This form of copyright protection had been used as a tool to restrict imports of non-copyright goods by parties other than the appointed Australian distributor, and therefore competitors, for which the packaging and labelling is an 'accessory'. This issue had been the subject of a Court decision during the Copyright Law Review Committee (Committee) inquiry, in which the makers of Baileys Irish Cream were able to prevent parallel importation of the product by claiming copyright in the label. The NSW Supreme Court held that the importation infringed the copyright in the artistic work held by the manufacturer and assigned in Australia to the distributor, namely, the picture on the bottle label. The use of this protection had been very far reaching, covering such products as drinks (sports drinks, wines, beers, soft drinks and juices), books, toys, clothing, footwear, spare parts, soaps, cosmetics, perfumes and many others.

In essence, the amendments allow the importation of goods with copyright packaging or labelling without the permission of the copyright owner, if the owner of the copyright had agreed to the use of the copyright material with the goods.[2]

As some industry representatives argued that the removal of import restrictions on goods with copyright packaging and labelling would impose some hardship on firms which had entered into commitments in good faith, the new arrangements commenced in February this year (2000).

Copyright Amendment Act (No 2)

The *Copyright Amendment Act (No 2)* amends Parts III and IV of the *Copyright Act* to allow importation into Australia of copies of published sound recordings without the licence of the makers of the recordings and the composers of the works recorded, if the copies were made without infringing copyright in the country of manufacture. Where there is no copyright protection of sound recordings in the country of manufacture, the copies can be imported without the Australian copyright owner's consent only if their manufacture was undertaken or approved by the maker or other copyright owner of the sound recording in the country where the original recording was made. The amendments also allow trading and other commercial dealing with copies that have been imported in accordance with the provisions just referred to.

The definition of a "non-infringing copy of a sound recording" is limited to copies made in countries that provide copyright protection to the works recorded in a

[2] For example, the Act now prevents rights' holders of the copyright in packaging, booklets or artwork which accompany compact discs to prevent parallel importation of the separately copyrighted sound recording. The amendments do not, however, affect the operation of the law governing trade marks, insofar as the packaging or labelling includes a trade mark. The Olympic symbol is explicitly excluded from these amendments. The definition of "accessories" to goods also excludes a manual sold with computer software for use in connection with that software.

"Non infringing accessory" is defined by an amendment to the Act to include a label, packaging or a container. The new section 44D(4) provides that it is not an infringement to import a non-infringing accessory to accompany a copy of a sound recording, while s.44D(5) states that s.38 of the Act (which provides for infringement by commercially dealing with imported copies) does not apply to a non-infringing accessory that includes a copy of a work and the importation of which did not infringe copyright.

The new definition of a "non-infringing accessory" operates only in respect of particular countries which provide minimum standards of copyright protection. To be non-infringing, the new definition requires that the accessory be made in a country that is a party to the Berne Convention for the Protection of Literary and Artistic Works or a country that is a member of the World Trade Organisation and has a law that is consistent with the WTO Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) in certain respects.

manner consistent with the relevant obligations in the international treaties dealing with copyright to which Australia is a party.

To allay concerns about increased piracy, the second Act also amended Part V of the *Copyright Act* dealing with remedies for copyright infringement. A new section is inserted to provide that, in proceedings for infringement consisting of unlicensed importation of unauthorised, ie. pirate, copies of sound recordings and commercial dealings with such copies, once the plaintiff has established that the copy was imported without the consent of the relevant copyright owner, the defendant will then have the onus of establishing that the copies are legitimate and not pirate copies. This is an important safeguard to ensure that those who source stock from overseas will need to be satisfied that it is legitimate or risk legal action against them by the copyright owner.

The amendments have substantially increased the maximum penalties:

- Individuals, who previously faced fines as low as $500, will now be liable for fines of $60,500 and/or five years imprisonment;

- A company, which previously faced fines as low as $2,500, will now be liable for fines of $302,500 for offences in relation to copyright material, including the importation of sound recordings.

Increased fines will now apply to both sound recordings and to films. All penalty provisions have been amended to provide for a maximum global penalty, replacing the complex multi-tiered penalties regime for first and subsequent convictions and for infringement regarding different copyright material.

Courts will now have the discretion to determine the most appropriate penalty having regard to all the relevant factors in the case and as such will bring the penalties provisions of the *Copyright Act* into line with Commonwealth criminal law policy.

The increase in the level of fines reflects the Government's concern that copyright infringement will be properly punished. The threat of substantial fines and possible imprisonment is expected to act as a strong deterrent to pirates and those who infringe the rights of those who create and invest in musical and other artistic works.

Copyright owners will continue to be able to enlist the aid of Customs in seizing infringing goods through lodging appropriate notices of objection to importation of pirated or counterfeit sound recordings but they will not, as they can at present, be able to object to third party importation of sound recordings *per se*.

These amendments effectively implement the recommendations made by the PSA in its *Report of the Inquiry into Sound Recordings* in 1990.

PARALLEL IMPORTING OF SOUND RECORDINGS – A YEAR OF TENTATIVE PROGRESS

The removal of the restrictions on parallel imports of sound recordings in July 1998 has been the most well known recent development in Australian copyright law. Since there has been so much heat and noise generated over this issue, it is appropriate to review what has happened in the 18 months since the passage of the legislation.

While it does not have any price monitoring powers in this area, the Commission has been interested in the progress of this reform. Staff members in our regional offices around Australia have collected retail price information at regular intervals in order to estimate the effect on prices, and other market inquiries have occurred. As well as making market checks, we have been particularly interested in any attempts to prevent market participants – retailers, importers or wholesalers – from exercising their legal right to source CDs and cassette tapes from the best available supplier. Such obstacles may be a restraint of trade and in breach of the *Trade Practices Act*, whether the supplier is here or overseas. In this context, the Government tabled a further amendment in May 1999, the *Copyright Amendment (Importation of Sound Recordings) Bill* 1999. This expands the definition of "accessory" to enable the parallel importation and sale of sound recordings (particularly 'enhanced' compact discs) where ancillary copyright material accompanies the recording. This follows threats of legal proceedings made to numerous retailers by Australian copyright owners, that they remove from sale sound recordings which have other copyright material added, such as film clips. The Government regards this as contrary to the spirit of the 1998 amendments.

It has never been the case that the Commission has had a bias towards imported products, but it does admit to a bias towards supporting increased competition. In the sound recordings market, this means allowing music product legally produced and marketed overseas to be available to Australian consumers. This has already improved the supply side of the market, with tangible benefits to music consumers, and few, if any, negative effects elsewhere.

The predictions of doom and gloom made by opponents of the reforms have not come to pass. The technical quality of imported product has been found to be very high. Retailers and consumers have been getting better deals from Australian producers. Australian made product is now often enhanced by the inclusion of a CD ROM feature, foldout booklets, bonus tracks or bonus CDs. However, we are still interested in seeing head to head competition, as it may be that consumers prefer to buy the standard music product at much lower prices, rather than the enhanced product at higher prices. Only market competition can resolve this.

Retailers report that advertising and promotional spending is continuing, and the indent services provided by producers has improved. Very little has been heard about damage to artists' incomes from parallel imports. Few Australian artists sell their music overseas, so it was no surprise that this did not become an issue. While the industry predicted rampant piracy, the available reports are that the incidence of piracy is very low, and arises mainly from Australian sources.

The situation is obviously fluid, but these are all important developments. We believe that the key to understanding price movements is the presence or absence of competition, and we are confident that the benefits will be even greater if retailers can achieve diversity in their sources of supply, and a good supply of product. Whereas the conventional wisdom up until this year was that the USA was the alternative source of supply, most of the imported Top 40 product to date has come from South East Asia. This is due to the depreciation of the Australian dollar against the US. If and when the exchange rate appreciates again and the US is back as a viable supplier, the diversity and volume of product available from US wholesalers and 'one stop' stores will magnify these competitive influences on the Australian market. Reports from the industry are that this will happen when the Australian dollar gets back in the 68 to 70 cents range.

The new flexibility in pricing and the ability of some suppliers to sell CDs for very low prices has no doubt led many consumers to reassess whether they are getting value for money. The industry may find it will need to accommodate a more discerning and demanding clientele over the next period. This is also a much needed pressure which the industry needs to improve its performance.

BOOKS AND COMPUTER SOFTWARE

As I have already briefly mentioned, the PSA conducted inquiries into the prices of books, sound recordings and computer software.

Books

The PSA's 1989 inquiry into book prices produced considerable evidence that the lack of international competition in the book trade had resulted in significant disadvantages for Australia: price discrimination; poor availability; and high costs.

Following the release of the PSA's book report, amendments were made to the *Copyright Act* in 1991 which enabled Copyright holders to retain exclusive distribution rights provided they can guarantee supply within a specified time frame.

The PSA was asked by the Government to monitor and report on the effects of the 1991 reforms on the price and availability of books. In 1995 the PSA held a full public inquiry which concluded that while the 1991 amendments had resulted in an improvement in distribution efficiencies and improved the speed with which most new releases become available in Australia, prices of some books continued to be high relative to overseas, particularly in the technical and professional and mass market paperback areas. Further, booksellers had also found the 1991 amendments difficult and costly to implement.

The PSA considered that only an open market, with no restrictions on parallel imports could deliver competitive prices over the long term and overcome the administrative difficulties inherent in the 1991 reforms. The PSA recommended that the importation provisions be repealed in full, or as a fallback position that the 1991 reforms be simplified and streamlined.

Computer Software

The PSA's 1992 inquiry into computer software prices found substantial international price discrepancies, with Australian consumers paying an average of 49 per cent more than their US counterparts, and recommended repeal of parallel import protection for computer software. Meanwhile, the CLRC was inquiring into the general issue of protection for computer software and in 1995 recommended that parallel import protection be retained.

ACCC Report

No action has been taken on these PSA recommendations to date, the current Australian Government has asked the Commission to report on the potential consumer benefits of repealing the importation provisions of the *Copyright Act 1968* as they apply to books and computer software.

One of the main aims of the review is to provide the Government with up-to-date and rigorous comparisons of book prices and computer software prices in Australia compared with overseas. Nevertheless, in order to provide a balanced assessment of the overall effect of repealing the importation provisions the Commission has also considered the likely impact of an open market on producers, distributors and retailers of books and computer software. The Commission's report will be released soon.

RECENT DEVELOPMENTS

In April 2000, the Intellectual Property and Competition Review Committee released its Interim Report. The Committee had been established to inquire into the effects on competition of Australia' intellectual property law.

The Committee identified three main issues relating to intellectual property rights which have a direct and significant impact on competition. They are: restrictions on parallel imports; exemptions given to certain intellectual property transactions in Australia's trade practices legislation; and the operation of a patent system.

With regard to the first issue, parallel imports, the Committee found that there was no convincing evidence that restrictions on parallel imports materially advanced the goals of copyrights and intellectual property system generally and that restrictions which precluded import competition should be closely examined with a view to their possible removal.

With regard to the exemptions that certain intellectual property transactions have from competition law, the committee recommended that such exemptions be narrowed and that intellectual property rights should continue to be protected but in a manner consistent with the structure and goals of Australian competition law.

In the case of patent, the Committee stated that the grant of a patent needs to be made on the basis of clear and well understood criteria including a clear distinction between invention and discovery. Further it stated that genuine disclosure must result from the patent granting process.

CONCLUSIONS

This examination of the interface between intellectual property rights and competition policy raises a number of difficult issues which have received scant attention in the past. One general outcome of the Australian debate - is that a great deal of interest has developed in the economic justification for copyright laws, an area previously neglected by economists and general policy makers.

Australia and New Zealand have both recently made significant changes to the laws regarding the importation of copyright material. Australia has repealed the restrictions on the parallel importing of sound recordings. These took effect on 30 July 1998. It has also amended the *Copyright Act* to prevent copyright in labels and packages being used to control parallel importing of products with such labels and packaging: this took full effect in February 2000. New Zealand has made even more extensive changes. It has effectively made amendments to allow the parallel importation of all copyrighted goods.

Finally, I would like to say that the Commission advocates repealing the importation provisions of the *Copyright Act*. We believe that this would lead to greater competition in supply with consequent reductions in prices and improvements in the speed with which products are available in Australia and also the range that is available. There is even a case for doing so comprehensively, across the board at this stage, rather than proceeding on a case by case basis. At any rate, it is to be hoped that the Government will maintain the momentum of reform it has started in relation to sound recordings, labels and packaging.