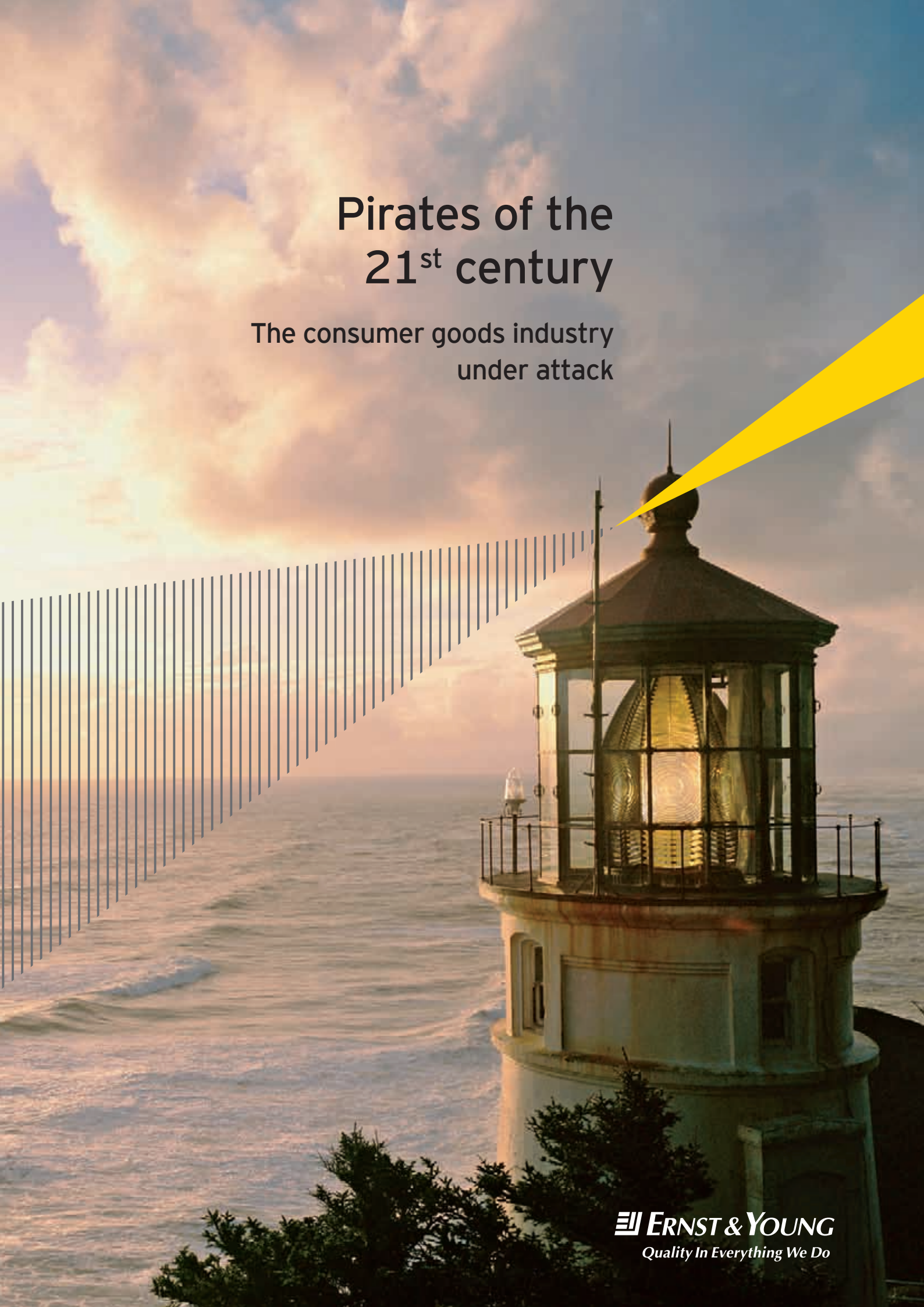


Pirates of the 21st century

The consumer goods industry
under attack



Foreword by Christoph Kannengiesser,
Chief executive of Markenverband, the German Trademark Association

Protecting intellectual property - combating trademark and product piracy effectively

Trademarks are synonymous with intellectual property and an important cog in the economic wheel. They represent quality in terms of health, safety and reliability and are the most valuable asset in many companies' portfolios these days. Intellectual property is just as significant as tangible property as a building block of a healthy market. The counterfeiting and piracy of brands and products is often dismissed as a petty offense. In fact, it is a highly criminal activity which is taking on increasingly menacing dimensions. Piracy damages brand value and companies, threatening prosperity and jobs. Furthermore, counterfeit goods pose a huge threat to consumer health and can even have fatal consequences.

This study highlights once again that counterfeiting is no longer restricted to luxury goods, but that trademark and product piracy have infiltrated every branch of the economy, including everyday items on a large scale. It is essential, therefore, to increase the deterrent through tighter legal sanctions. The economic gains far outweigh the risks that criminals take today in producing and trading pirated items. Markenverband is therefore campaigning to get

the counterfeiting of brands and products into the German Criminal Code as a criminal offense. Our main aim is to introduce minimum penalties.

The study also makes it alarmingly clear how socially acceptable the purchase of counterfeit goods is for many consumers. It also shows that while companies are already investing heavily in brand protection, there is still more that could be done in this area. In addition to improving the potential for legal action, it is therefore essential that we also make companies more aware of the dangers and provide them with comprehensive information concerning technical and process-oriented opportunities to protect against the counterfeiting of brands and products. The most important thing, however, is to get through to consumers on a wide scale and show young people in particular what ethical, economic and even health risks are associated with the purchase of counterfeit goods. Preventing the infringement of intellectual property rights and developing unified efforts to combat piracy in our globalized economy is also high on the agenda. Markenverband is committed to brand protection at all levels.



A handwritten signature in black ink, appearing to read 'Ch. Kannengiesser', written in a cursive style.

Christoph Kannengiesser

Content

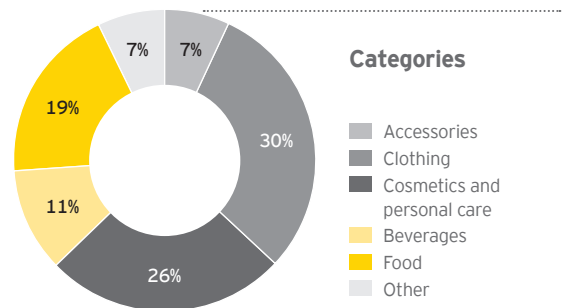
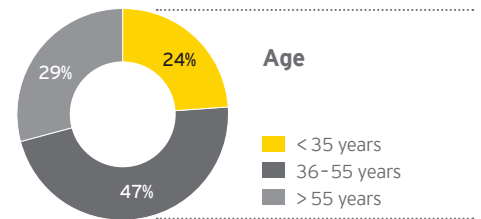
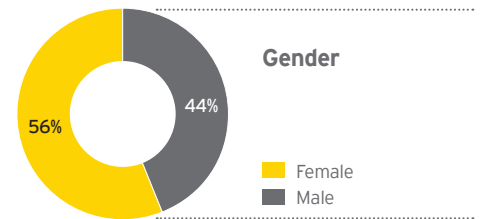
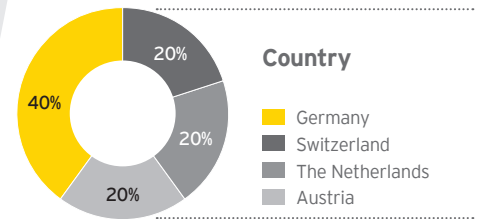
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The design of the study

Trademark and product piracy is increasingly becoming a serious threat to companies in the consumer goods industry. It is difficult to put a figure on the economic damage, not least on account of the high number of unreported cases. Based on expert appraisals and our surveys, damage to the European consumer goods industry comes to an estimated EUR 35 billion annually. Not only do companies lose out on sales, but the image of the company and brand also suffer from counterfeits which are not recognized as such. Potential deficits in processing or inferior quality of raw materials utilized can have negative effects on consumer health. Counterfeiting has a considerable impact on the economy through the loss of jobs and tax revenue.

The aim of this study is to better understand patterns of supply and demand of counterfeit goods, identify the extent of the damage to the consumer goods industry and pinpoint solution-oriented approaches for process-oriented brand protection. Therefore, an independent market research institute¹ was engaged to survey 2,500 consumers in Europe on their position on counterfeiting.

In addition, 27 European manufacturers of consumer products were surveyed on counterfeiting and brand protection using an extensive questionnaire. Representatives from eleven companies were surveyed in person and sixteen companies took part in an online interview. The number and nature of the companies surveyed allows general statements to be made concerning the difficulties faced by the companies as a result of counterfeiting and form the basis for solution-oriented approaches to combating the problem.



The main results in brief



Damage from counterfeiting

Two thirds of companies are affected by counterfeit goods

Over 78 percent of the companies surveyed are regularly affected by trademark and product piracy. Not only clothing, accessories, cosmetics and personal care products are affected by trademark and product piracy - pirates also target companies in the food and beverages industries. One in two companies in these segments has been confronted by counterfeiting. Companies in all product sectors expect a further increase in the risk of counterfeiting for the coming years.

The financial damage is not systematically evaluated by the companies themselves

Few companies have implemented a system to evaluate the direct and indirect damage of counterfeiting, despite its prevalence. The risk of counterfeiting is therefore often not objectively recorded at a company and is therefore difficult to communicate internally. The lack of information also makes it difficult to assess the effectiveness of brand protection measures by means of a cost-benefit analysis.

The role of the consumer

Consumers are aware of the dangers of counterfeiting

The consumers surveyed have a pronounced awareness of the dangers posed by counterfeit goods. The risk of accidents brought about from the processing of inferior quality materials was identified by 67 percent. 61 percent of those questioned deemed health risks a possibility, while 48 percent expect financial risks. Furthermore, 74 percent of the consumers surveyed were aware of the fact that criminal groups are involved in the production and sale of counterfeit goods, with 79 percent of them also conscious that work safety and environmental considerations are neglected.

More than one in four consumers in western Europe buy counterfeit goods

Despite this awareness, the demand for counterfeit goods is high. 28 percent of the consumers surveyed have purchased counterfeit goods in the last three years, with demand decreasing steadily with age. While 39 percent of those under the age of 35 buy counterfeit goods, the figure falls to just 18 percent for the over 55s. Over 60 percent of all those who buy counterfeit goods admit to being fully aware of doing so. This is true for all segments affected.

Consumers are seduced by the low price of a "false bargain"

The prestige and emotion of a branded product at a supposed bargain price tempts consumers to buy. They are prepared to

knowingly sacrifice the quality, safety and ethical principles of a branded product in favor of a "false bargain".

Counterfeit goods are socially accepted

More than 90 percent of consumers would not expect to go down in their friends' and relatives' estimation for purchasing a counterfeit product. Despite being aware of the many criminal and unethical working and environmental practices used in production, many of the consumers surveyed tolerate counterfeiting of brands and products as peccadillo.

The role of the counterfeiter

Counterfeit food and beverages originate primarily from eastern Europe, counterfeit luxury goods from China

Suppliers of counterfeit luxury goods base production to a large extent in China, while counterfeit food products are frequently produced in eastern Europe. The latter involves particular dangers for consumers: The consumption of counterfeit food products can carry health risks. In addition, due to the geographical proximity to production plants, the counterfeit goods can be more easily "palmed off" onto European consumers.

Counterfeit goods are barely distinguishable from the genuine article

The production of counterfeit goods has moved from backyards to fully equipped factories which increasingly employ industrial production methods and machines.



Often only experts can tell these products from the original. While counterfeiters may produce a product which is barely distinguishable from the original based on appearance, they often care little about the content and quality.

Pirates make use of all distribution channels

Pirates make use of all distribution channels. Counterfeit goods reach consumers through “mobile” traders in 41 percent and via the internet in 33 percent of cases. Also wholesale and retail are susceptible to being affected by counterfeit goods.

Combating counterfeiting

Brand protection is a matter for the boss

Brand protection is a matter for the boss: 77 percent of the companies surveyed see brand protection as the responsibility of management. 23 percent are of the opinion that the company management plays a supporting role in it at least. The companies therefore recognize brand protection as a “strategic” task. Strategies for brand protection have until now tended to be implemented in legal and marketing departments and less so in the departments responsible for quality control, risk and production management.

Measures to combat counterfeit goods concentrate on the legal side

Legal measures have until now fronted efforts to protect brands at the companies surveyed. 72 percent of the companies

have already systematically implemented such legal measures. Anyone aiming to make things difficult for the counterfeiters, however, needs to take the entire value-added chain into account. Otherwise, no matter how well secured the ship, the pirates can gain access up the wide open gangway.

Companies demand the support of politicians and associations

Companies see the government as well as associations as the first line of defense against pirates. 79 percent of the companies surveyed view the government as being principally responsible, with a further 52 percent also citing associations. 29 percent of companies believe that they have further scope for action against piracy of their products and brands, while 19 percent of the companies surveyed are of the opinion that they have exhausted their options.

Companies demand improved consumer information and tighter legal sanctions

70 percent of the companies demand harsher criminal deterrents through tighter legal sanctions. By the same measure, they also believe that improved consumer information concerning the dangers and damage associated with counterfeit goods would help to combat the phenomenon of counterfeiting brands and products. More than half of the companies were in favor of improving the enforcement of industrial property rights.

Priorities in brand protection

The emphasis on safety and ethics-related aspects serves to protect brands

By communicating the criminal and unethical background of counterfeits and emphasizing the advantages of genuine products, companies can highlight the value of their products compared to the pirated versions and thus protect the value of their brands. The company and consumer surveys tally on this point.

Incorporating brand protection into risk management

Most companies have taken various but rather selective measures to protect their brands from counterfeiting. Effective brand protection should involve individual methods being incorporated into a process and constantly monitored. This process should be a fixed component in companies’ risk management systems. Companies can successfully confront pirates in this way. Pirates may not keep accounting records, but they know what they are doing.

1. Pirates of the 21st century

When you think of pirates you think of an exciting image from a bygone age. A swashbuckling fellow with sword and eye patch stands on the deck of a full rigged ship, looking out over stormy seas with his gaze fixed firmly on the bounty of a cargo ship, ready to make his move. Anyone who has opened a newspaper recently will have been confronted by reports of ships being captured off the coast of Africa and Asia with the crew taken hostage. Surely it is time to recognize that this misty-eyed image of the pirate does not correspond to the harsh reality. Modern pirates also pose a great threat, even if today's product pirates have little to do with that kind of piracy.

Having said that, the pirate who peddles counterfeit goods also sails under a foreign flag and doesn't reveal himself - even to those in the know - until the last moment. In this case, the foreign flags are brands, logos and product designs of brand manufacturers. The bounty is the consumer who believes he is bagging a bargain but at the end of the day has paid well over the odds for the purchase.

What exactly is meant by trademark and product piracy? A short definition and description of trademark and product piracy marks the beginning of the study.

1.1 Trademark and product piracy infringes intellectual property rights

The term piracy in relation to products and brands refers to the trading of goods which infringe intellectual property rights. Above all, this includes brands and patents, design rights, utility models, copyrights and related industrial rights.

The following general definition can be found on the website of the German customs authorities:

"Trademark piracy is the illegal use of signs, names, logos (brands) and business names that brand manufacturers use to distinguish their products.

Product piracy means illegally imitating or copying goods for which the lawful manufacturer holds rights for the invention, design or a particular process."

Counterfeiters use intellectual property for their own products without the permission of the company which has acquired them by financial means. Counterfeiters use the reputation of a brand, which manufacturers have built up on the basis of the quality of their products, to deceive consumers regarding the true origin and quality of the goods.

Overview of intellectual property rights

Brands - signs which distinguish goods and services from those offered by other companies. Signs might be simple letters and numbers, words, pictures, logos or 3D objects.

Patents - a technical development - an object or a method - can be protected by a patent if it is new and has inventive and economic value.

Utility models - utility models are specified for some items. They are often described as a "mini patent" and can be acquired more easily, quickly and at lower costs.

Design rights - design, shape and color are protected as design rights. The samples and models need to be new, unique and of commercial value as well as esthetically pleasing.

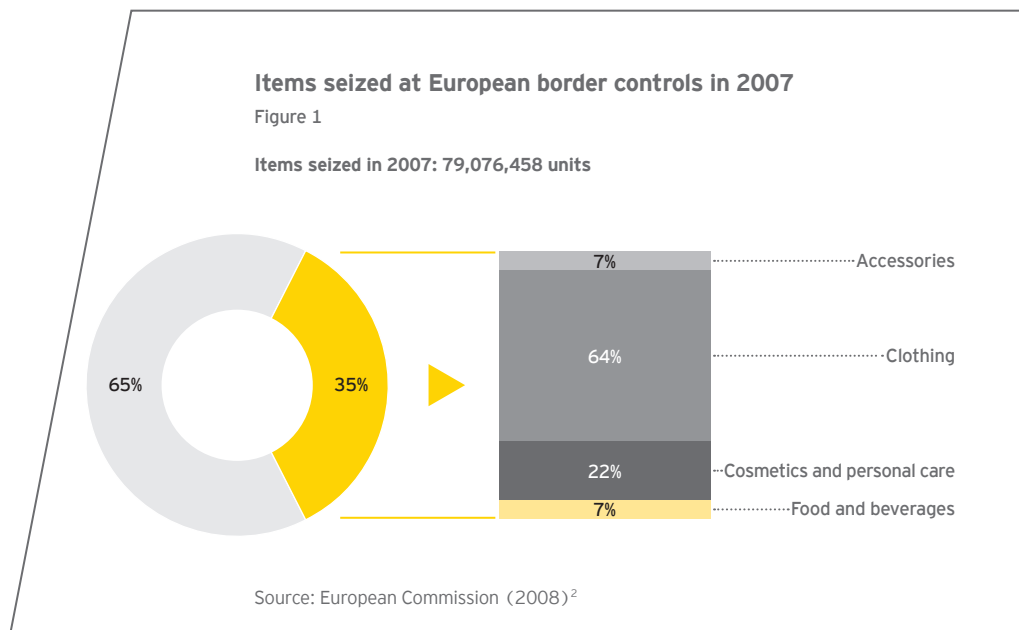
Copyright - the copyright aims to protect the idea of a work, such as literary works, films and photography.

1.2 Counterfeiting causes damage running into billions

We can only estimate the true extent of the impact of counterfeiting products and brands. On the one hand, pirates do not keep accounting records and on the other, it is a challenge to put a figure on the damage caused by counterfeiting. Less than five percent of goods in circulation are checked by European customs authorities. Therefore, we have to assume that the number of unreported cases is sizeable.

A reliable source of statistics is the European Commission², which publishes figures on the number of items seized (see figure 1). The statistics for 2007 state that customs officers in the member states discovered over 79 million copied and counterfeited goods. This study focuses on the product sectors accessories, clothing, cosmetics, personal care products as well as food and beverages, which at 27 million items account for 35 percent of the goods seized in Europe in the past year. The remaining 65 percent is made up primarily of cigarettes, pirate CDs, DVDs, electronics and pharmaceutical products.

These figures give us some idea as to the volume of counterfeit goods, but cannot offer us a reliable picture of the value of goods put into circulation by pirates. A study by the OECD³ estimated the value of counterfeit goods worldwide to be

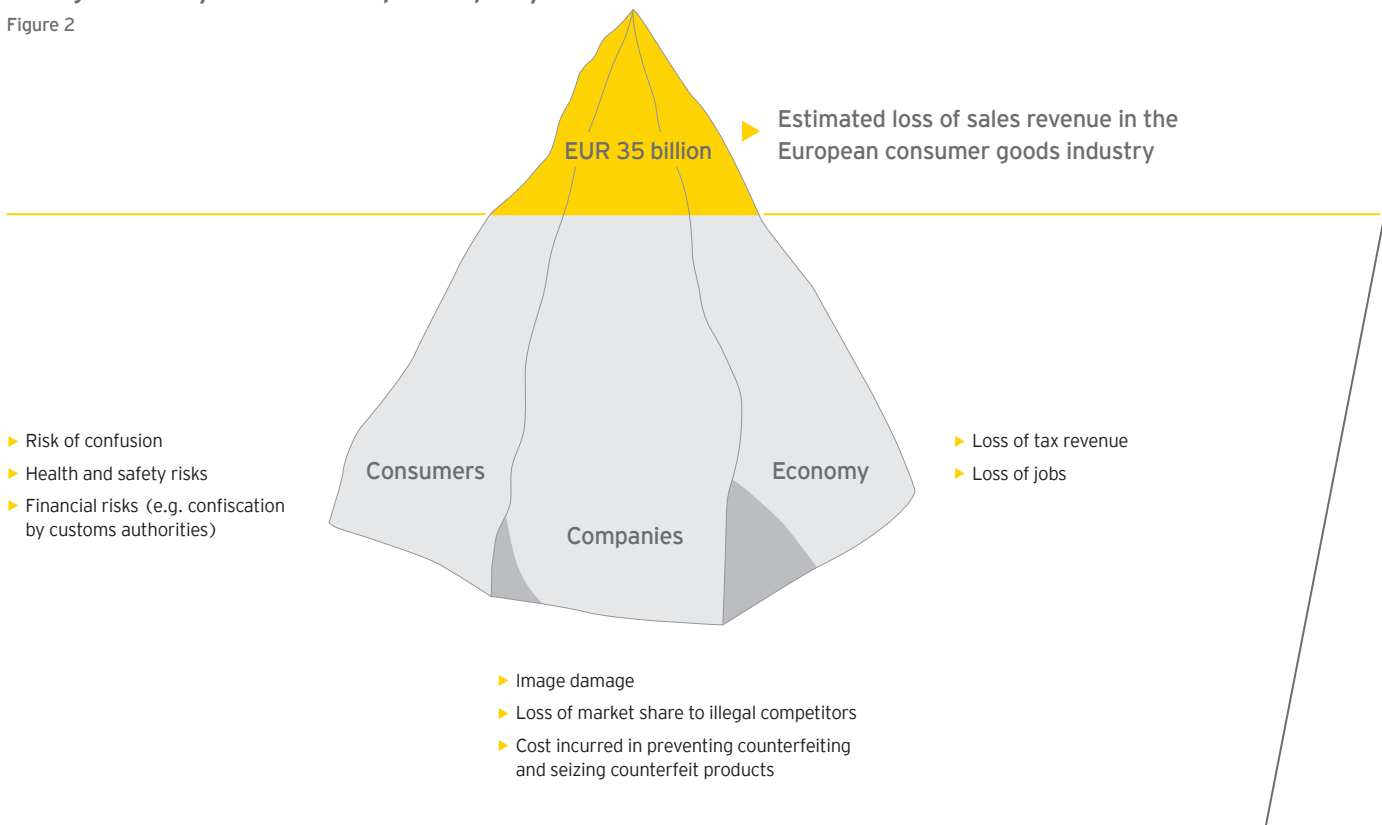


around USD 200 billion in 2005. This estimate only takes international trade into account and therefore goods which are produced and sold within one country or traded over the internet are not included. This means that the total figure could be much higher. A study by the International Chamber of Commerce⁴ came to the same conclusion, putting a figure of USD 600 billion on sales of counterfeit goods worldwide.

Based on these figures, we can assume a loss of some two percent of sales revenue for the European consumer goods industry as a result of trademark and product piracy. If we combine this rule of thumb with the results of our survey showing the prevalence of companies affected by counterfeiting, the total loss incurred by the consumer goods industry in Europe at the hands of product and brand pirates comes to an estimated EUR 35 million annually.

Damage caused by trademark and product piracy

Figure 2



Clearly: these figures are only the tip of the iceberg (see figure 2). Counterfeiting has a very serious effect on companies, consumers and the economy.

Not only do companies lose out on sales. Counterfeit goods which are not recognized as such by consumers damage the company's reputation and can cause a loss in brand value.

Consumers are exposed to health risks owing to possible deficits in processing or inferior quality, or may incur financial loss through a shorter product lifespan. In addition, a supposed holiday bargain might attract a hefty bill from the customs authorities. Consumers who unknowingly purchase pirated goods are misled by product and brand counterfeiters.

Further, we also need to keep in mind the macro-economic damage caused by counterfeiting which causes a loss of tax revenue and jobs.



2. The role of the consumer

Any attempts to stem the flow of counterfeit goods and to reduce the impact of trademark and product piracy must involve the market participants more closely. As a starting point, we need to look at the demand side - i.e., the consumer.

To this end, our study - carried out by an independent institute for market research - surveyed 2,500 consumers in Germany, Switzerland, Austria and the Netherlands on their attitude to counterfeiting. Our survey shows that many consumers are fully aware of the dangers of counterfeiting. Unfortunately, this awareness does not necessarily impede their readiness to purchase counterfeit goods. The prestige and emotions of brands at the low price of a counterfeited product tempt consumers to buy. These purchasers knowingly sacrifice quality, safety and ethical production principles of brand manufacturers for the sake of a "false" bargain. This behavior is relatively socially acceptable.

2.1 Consumers are aware of the risks

The majority of consumers surveyed are aware of the dangers associated with counterfeit goods and fully accept the accident, financial or health risks inherent in the purchase of counterfeit goods.

On average, 67 percent of the consumers surveyed for our study consider there to be a high risk of accident owing to the use of inferior materials or reduced product functionality of a counterfeit item. For example, a counterfeit pair of sneakers can significantly increase the risk of sports injury.

In addition, the materials used might cause skin irritation or allergies, in the case of counterfeit textiles, for instance. Counterfeit food products can even have life-threatening consequences, for example twelve babies died in eastern China in 2004. Their parents had unwittingly fed them counterfeit milk powder, which was completely devoid of any nutritional value. These health risks associated with counterfeit goods are recognized by some 61 percent of consumers.

Consumers consider the risk of counterfeit goods being confiscated by the customs

authorities and incurring a corresponding fine to be low, but 48 percent still see a financial risk in the purchase of counterfeit goods.

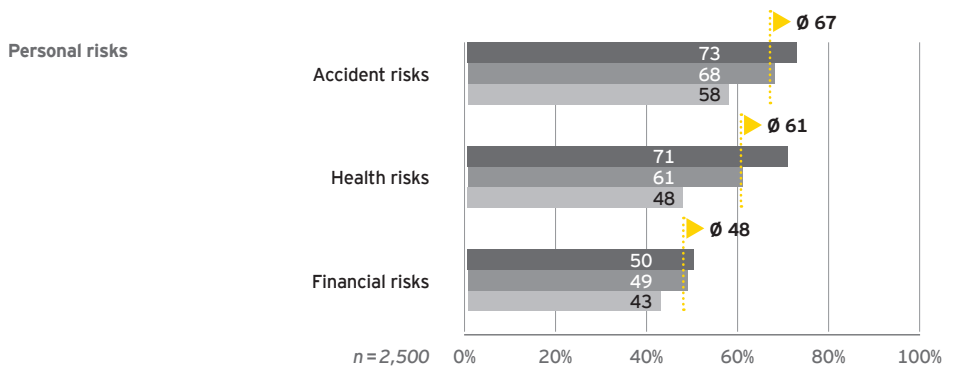
Consumers are not only aware of personal risks associated with counterfeit goods - they also understand that others are endangered. An average of 74 percent of consumers surveyed admit to being aware of the many criminal activities involved in the production and distribution of counterfeit goods, with 79 percent even aware that working and environmental standards are regularly neglected in the production of counterfeit goods.

The results of the survey also show that awareness increases with age, especially for health and safety risks. While three quarters of over-55s associate counterfeit goods with a high risk to health and safety, this is only true of half of under-35s.

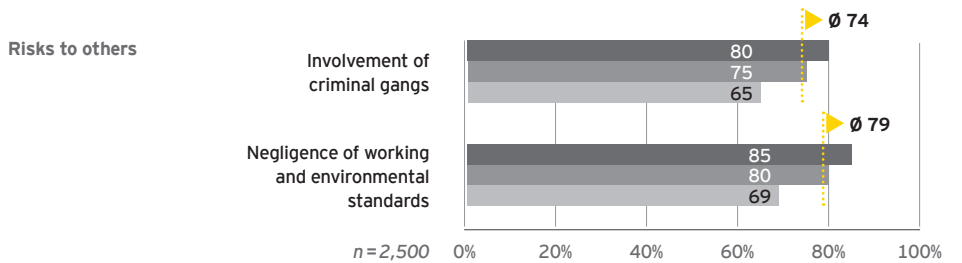
Younger consumers are more carefree in their attitude to counterfeit goods and less aware of risks than older consumers. Nonetheless, they are well aware of the dangers associated with counterfeit goods.

**Counterfeit goods are associated with certain risks.
Do you consider the following risks to be high?**

Figure 3



Are you aware that the following issues are often related to the production and distribution of counterfeit goods?



Age < 35 years 36-55 years > 55 years

2.2 More than one in four consumers in western Europe buy counterfeit goods - this includes everyday items

Consumers are aware of the potential risks associated with counterfeit goods. This awareness however, does not seem to have any impact on demand (see figure 4). An average of 28 percent of consumers surveyed for this study have bought counterfeit goods in the last three years. The consumers' background or gender seems to play little role in this, nor does their perception of the risks associated with counterfeit goods being high or low. More than one in four people in western Europe buys counterfeit goods.

The demand among those consumers who see counterfeit goods as risky - i.e., older consumers - also tends to be lower. While

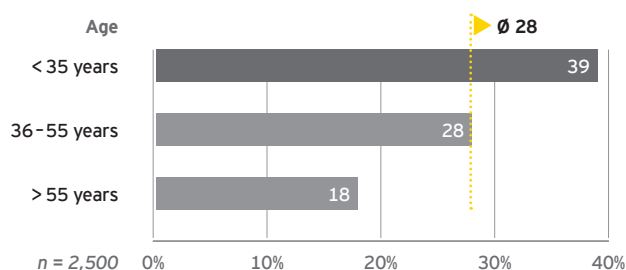
39 percent of under-35s consciously seek out counterfeit goods, interest falls down to just 18 percent among the over-55s.

This can be explained on the one hand by the lower awareness of risks among younger consumers. On the other, our experience shows that they have greater brand awareness and can access counterfeit items more easily, because of their generally higher experience and usage of the internet.

Demand for counterfeit goods is present in every product sector (see figure 5). This goes for top-end and expensive luxury and consumer products right through to everyday items. As expected, counterfeit clothing is most in demand with consumers. 23 percent of those surveyed, for example, have purchased counterfeit T-shirts, pants, sweaters, shoes or hats. In second place with 11 percent are accessories such as handbags, sunglasses, jewelry, watches and leather items. What is less expected and cannot be ignored is the demand for counterfeit goods from the cosmetics, personal care, food and beverages industries. 7 percent of those surveyed have already purchased counterfeit everyday goods such as razor blades, shampoo, toothpaste or even coffee powder and alcoholic beverages.

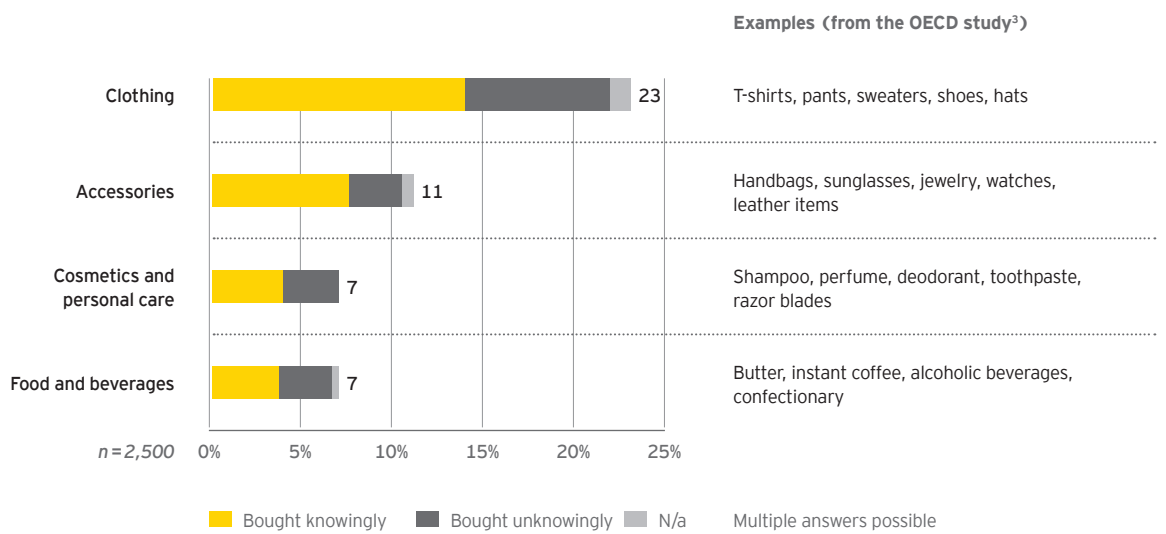
Have you purchased counterfeit goods in the past three years, either knowingly or unknowingly?

Figure 4



From which categories have you purchased counterfeit goods?

Figure 5



And it appears that consumers know what they are doing. An average of over 60 per cent of those who purchase counterfeit goods admit to knowingly doing so across all product sectors. The remaining 40 per cent, i.e., the unwitting consumers of counterfeit goods, also present a significant problem to companies. When consumers who would have been prepared to buy the genuine article unwittingly purchase coun-

terfeit items, the company directly loses out on sales revenue. Customers may not recognize the counterfeit goods as such, or only after purchase, for instance when they notice lower quality or a shorter product lifespan. Further, the company suffers a loss of image if consumers associate the genuine article with these negative experiences.

2.3 The low price of counterfeit goods tempts consumers to buy

So why then are so many counterfeit goods purchased if consumers are aware of the associated risks? 82 percent of consumers cite the low price as a reason for purchasing counterfeit goods. People who buy pirated goods are prepared to throw their moral reservations and risk awareness overboard in pursuit of a false bargain. Instead of paying EUR 200 for sunglasses, a counterfeit pair can be bought at the beach for EUR 15, or a counterfeit T-shirt purchased on the internet for a third of the price the original would cost.

Consumers are clearly aware that they have not purchased an original at this price, so what's the point? 43 percent of those surveyed do without the genuine article because they like the product itself, even without certain quality characteristics. For 33 percent of consumers, the product itself is not so important, rather it is the status symbol of appearing to own it that is significant.

In the case of some products, consumers seem to be indifferent as to whether they purchase a counterfeit version or the genuine article (see figure 7). Here, they don't see any appreciable advantages in the original over the counterfeit version. This becomes particular evident if we take into account the varying significance of various characteristics of brand products for consumers.

In purchasing a counterfeit item, consumers can buy the emotional associations and prestige of the genuine article. For both of these, the consumers surveyed were barely able to tell the difference between the original and the counterfeit product, with a difference of 0.1 and 0.2 respectively. Characteristics such as innovation, health or tradition were also not seen as distinguishing features.

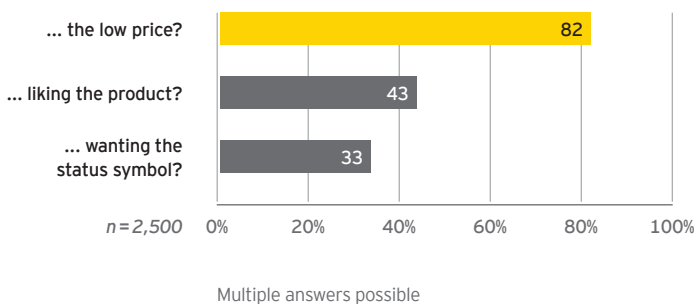
Emphasizing brand characteristics such as safety of use, ethical production principles and sustainability offers brand manufactur-

ers the potential to make the fundamental differences between original and counterfeit goods clear to consumers. These qualities are seen as important characteristics of brand products, ranked from 3.9 to 4.6 on a scale of 5 in terms of significance. However, these aspects are also evaluated as being just 0.4 points less important for counterfeit goods, even though consumers are fully aware of the inherent risks and ethical issues. This means that consumers are measuring original and counterfeit goods using double standards, something that needs to be clearly pointed out to them. The same is true of quality, which customers rate as a significant brand characteristic well above the quality of counterfeit goods.

A communication strategy could make consumers aware of the fundamental differences between original and counterfeit versions of a product and show them that the difference in price is justified in the light of significantly higher quality and safety of use as well as adherence to ethical principles and sustainability. Companies can target consumers with campaigns to make them more critical, develop awareness for quality and ethical aspects and stop focusing on prices alone when making purchases.

Do you think that there is a particular reason to buy counterfeit goods, such as ...

Figure 6

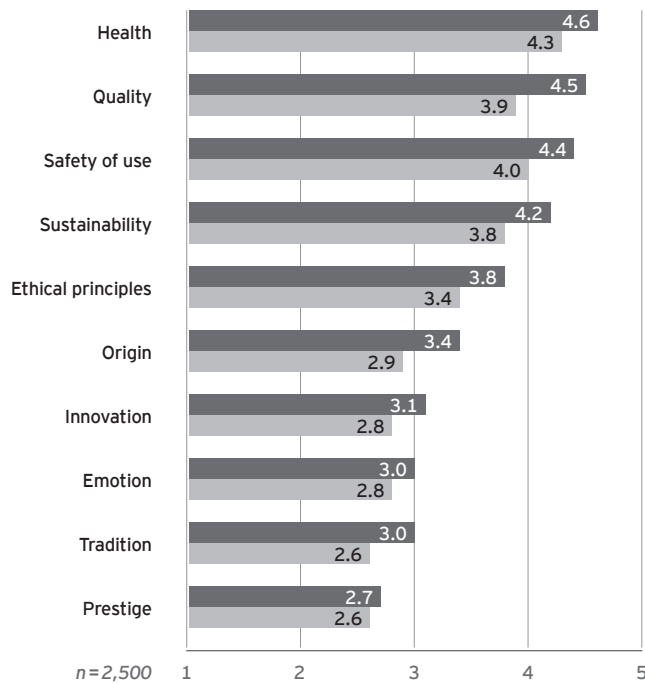




How important are the following characteristics to you when purchasing a brand/counterfeit product?

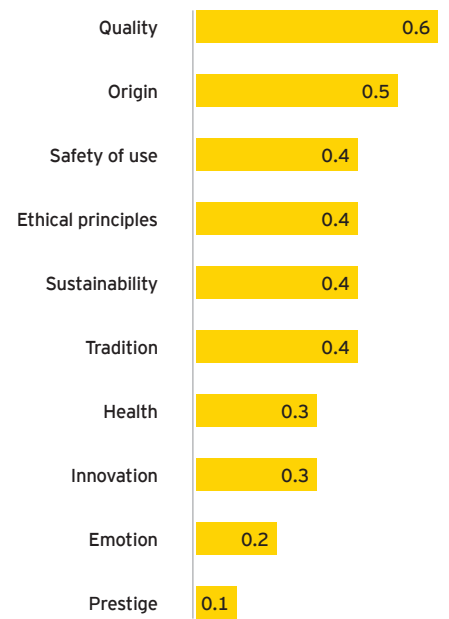
Figure 7

Average value



■ Brand ■ Counterfeit product

Difference



■ Difference between product brand/counterfeit

1 = Not at all important 2 = Quite unimportant 3 = Indifferent 4 = Quite important 5 = Very important

2.4 Counterfeit goods are socially acceptable

Imagine you have purchased a counterfeit product.
Would you go down in your friends' and relatives' estimation?

Figure 8



Counterfeit goods have found their niche in society (see figure 8). Nine out of ten consumers would not expect to go down in their friends' and relatives' estimation for purchasing a counterfeit product. It is clearly deemed "cool" by many people to wear counterfeit watches knowing that they were bought for a few euros on holiday and are virtually identical to the original.

The purchase of counterfeit goods is viewed in society as a way of saving money. The purchase of counterfeit goods is therefore dismissed as mere peccadillo. This attitude is not significantly affected by country of origin, gender or age. If consumers were to show less interest in counterfeit or copied goods and demand were to decline, the incentive for piracy would also be significantly reduced.



Duty paid on souvenirs

Only half of consumers is aware of the financial risks associated with the confiscation of counterfeit goods by customs authorities. At the same time, almost every holidaymaker has been tempted at some stage to bring back a counterfeit product. Copied articles are easily available in many holiday destinations as a “false” bargain. The severity of the penalty holidaymakers face for being in possession of counterfeit goods depends on the country visited.

In Germany, for instance, most get off fairly lightly. The purchase and possession of counterfeit goods is not punishable by law provided it is for personal use. This assumption is reached on the basis that goods do not appear to be for commercial purposes, are carried in the traveler’s personal luggage and do not exceed

a total value of EUR 175. This limit is calculated using the purchase price in the holiday destination.

Exceeding the limit or on suspicion of commercial trading might lead to the goods being confiscated by customs officials. Following this logic, ten identical T-shirts or three pairs of shoes are no longer seen as a holiday souvenir, even if they cost less than EUR 175. All goods are confiscated and destroyed. In addition, penalties may be incurred as a result of violating trademark rights or tax evasion. The maximum penalty is a five-year prison sentence. Furthermore, the company whose trademark rights were violated may claim damages.

Personal use is also decisive in the case of the Dutch customs authorities. The Netherlands defines personal use in terms of the number of items rather than value. Holidaymakers are entitled to bring back a maximum of three watches, three items of cloth-

ing and 250ml of perfume. If the limit is exceeded in any category, all products in that category are confiscated. Penalties can also be incurred in the Netherlands.

Since 1 July 2008, Switzerland also has a policy of seizing and destroying counterfeit goods instantly. In Italy, it is a punishable offense to purchase or possess counterfeit brand products, with hefty fines of up to EUR 10,000. A few years ago a 60 year-old woman from Denmark made headlines across Europe. She had to pay the maximum fine of EUR 10,000 for purchasing a pair of designer sunglasses for EUR 10 at a market in Tuscany.

These huge fines are designed to make it clear that trademark and product piracy is not mere peccadillo but a criminal offense which is damaging to consumers, the economy and society as a whole, and associated with real financial risks for consumers.

3. The role of the counterfeiter

Supply always rises to meet demand. This is particularly true when there are such financial gains to be won as in the case of piracy. It has become an enormously lucrative business. Figures from the Austrian customs authorities⁴ suggest that more money is to be earned from piracy than any other criminal activity, even drug dealing or trading counterfeit money.

The high profit margins and the low risk of prosecution provide the ideal conditions for the illegal activities of pirates to flourish. The penalties are often so mild that they fail to deter counterfeiters. The moment that one of them is stopped, the next is ready to fill that place.

According to the OECD study³, there are numerous signs that counterfeiting is increasingly not a one-off crime but that organized crime has moved in. "The groups involved in counterfeiting and piracy include mafias in Europe and the Americas and Asian 'triads', which are also involved in heroin trafficking, prostitution, gambling, extortion, money laundering and human trafficking" (OECD (2007), page 15).

To improve our understanding of the problems and scope of counterfeiting, we surveyed companies grouped by country of origin, production conditions and distribution channels, with the following results.

3.1 Counterfeit food products stem from (eastern) Europe, counterfeit luxury goods from China.

Asia is the main supplier of counterfeit goods (see figure 9). 69 percent of companies surveyed named China as the country of origin of counterfeit goods, with 38 percent citing other Asian countries, 35 percent Turkey and 17 percent eastern European countries. The "usual suspects" are therefore at the top of the list.

The country of origin of counterfeit goods depends largely on the product sector in question. In the case of accessories and clothing, Chinese counterfeit goods pose a problem to all companies, while copies from Turkey affect 70 percent of compa-

nies. Counterfeit cosmetics and personal care products are primarily from the Far East, with China in second place.

There is no dominant country of origin for counterfeit food and beverages, though more than half of this type of counterfeit originates from Eastern Europe. This is associated with particular dangers for consumers. For instance, counterfeit food products carry health risks. Besides this, it is easier to palm off counterfeit goods onto customers because the geographical proximity drastically reduces transport times.

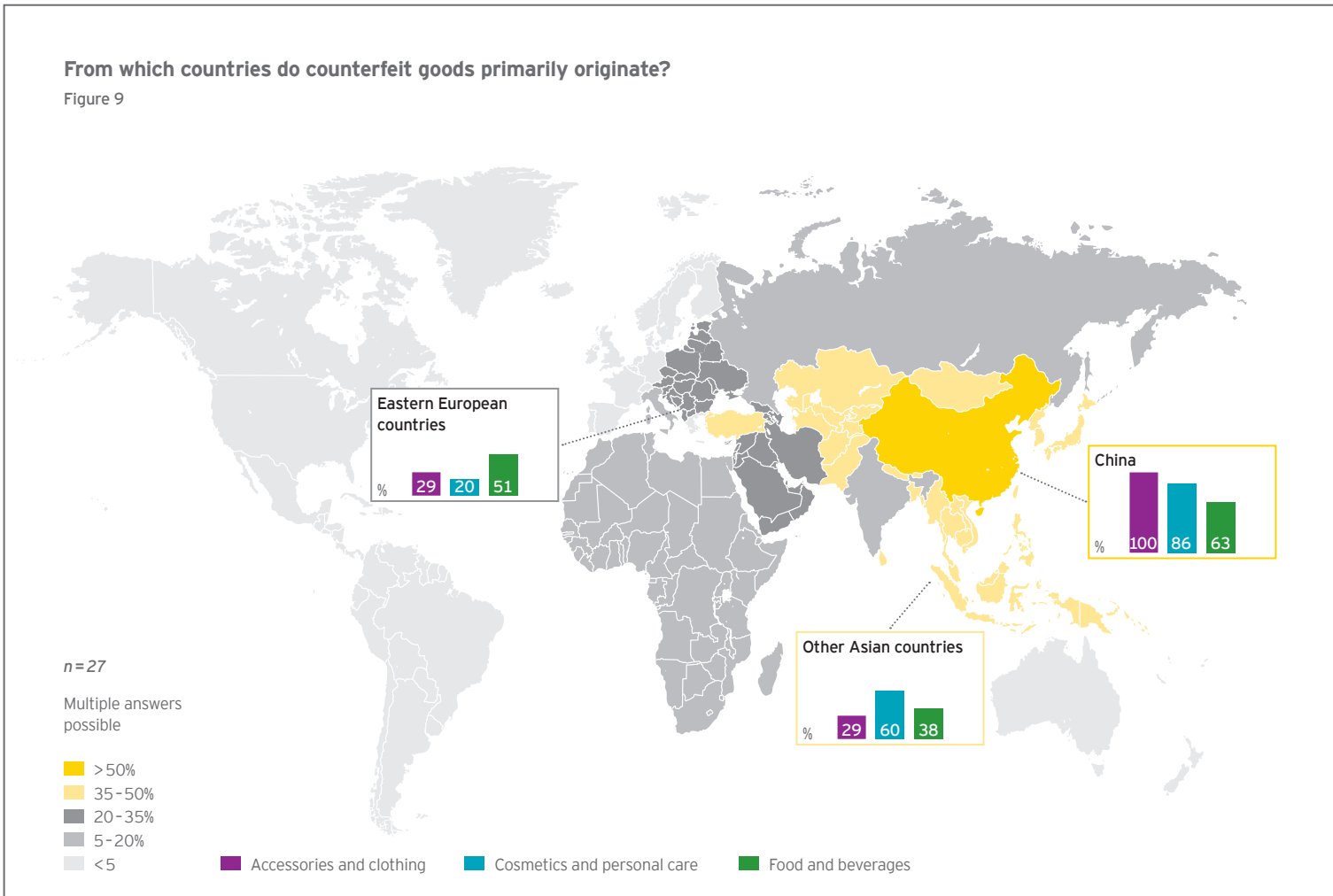
Cultural differences behind the piracy issue in China

Innovation is highly respected in Europe, with copying generally viewed as tantamount to "stealing ideas". In China, in contrast, copying is a cultural tradition. Perfectly imitating an idol or master is the first step forwards being innovative on your own. Even learning the Chinese language involves carefully copying the characters and internalizing them.

The cultural differences are illustrated in this anecdote from the Süddeutsche Zeitung on managerial life in China: "A manager of a company based in provincial Germany visits a trade fair in a Chinese industrial center. A Chinese man walks up to the stand and says: 'We build the same machine as you!' The Chinese man looks proud, as does the German. Then the Chinese man whips out a catalog. On the front is a copy of a patented German special machine, right down to the last detail including the copied company logos. Only the Chinese man is left smiling." (Süddeutsche Zeitung, Monday 22 May 2006)

From which countries do counterfeit goods primarily originate?

Figure 9



3.2 Production is moving away from the backyards

Brands assert themselves in the face of global competition through innovative design, materials, function and quality. The product pirates illegally copy this competitive edge and begin production on counterfeit versions as soon as branded products have been launched. Companies affected report that the first counterfeit goods appear on the market within weeks after the launch.

In copying, counterfeiters save themselves the costs associated with developing the brand as well as expenses for marketing or customer services and benefit from low-cost, often exploitive labor in production, generating considerable profits.

The production of counterfeit goods is increasingly moving from backyards to fully equipped factories which increasingly employ industrial production methods and machines. Using computer assisted production techniques, some counterfeiters are in a position to produce counterfeit goods on a grand scale. This is also one reason why counterfeit trading has exploded.

An increasing number of production plants for counterfeit goods are producing goods

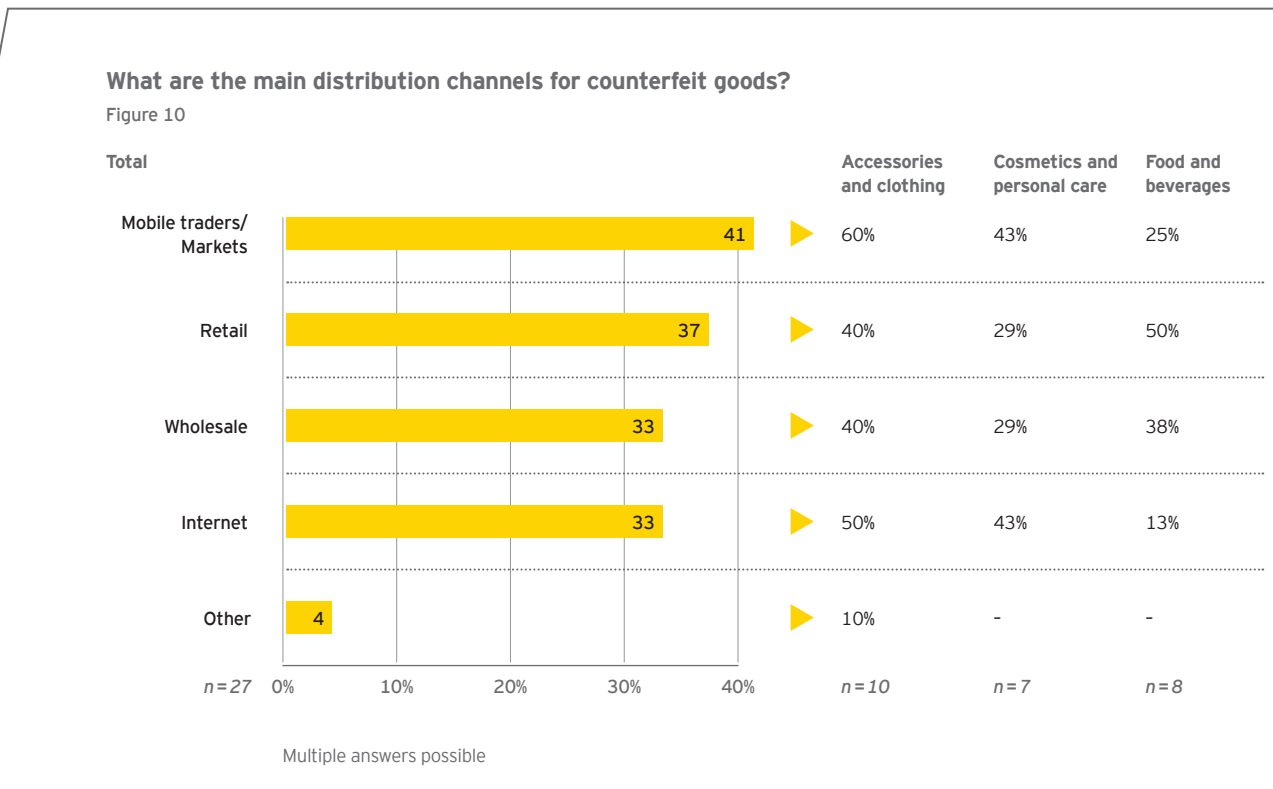
which are easily confused with the genuine product, but contain faults barely perceptible to the average consumer. For some counterfeit goods, the “only” thing that is wrong is the logo, while others use inferior quality materials or are poorly designed. There are numerous examples of this kind of counterfeiting in the archives of affected companies. Increasingly, however, counterfeit versions are astonishingly accurate from a purely visual point of view thanks to “more professional” production methods. Only experts are able to tell these products from the original.

While counterfeiters are primarily concerned with creating a product which looks identical to the original, they are rarely worried about the ingredients used. Legal requirements concerning product quality are neglected. This puts consumers at risk, especially in the case of counterfeit food, beverages, cosmetics and personal care products. They can only examine the packaging and not the content of the product. Perfumes, for instance, are imitated by mixing water with aromatic substances to produce the scent, but not the quality and safety standards of the original.



Production moves from the backyards to factories

3.3 Pirates make use of all distribution channels



Pirates make use of all distribution channels (see figure 10). Counterfeiters find their way to the consumer either indirectly via “mobile” traders, wholesale and retail traders or directly via the internet.

“Mobile” traders are the preferred distribution channel for counterfeit accessories, clothing, cosmetics and personal care products. 41 percent of the companies surveyed have discovered counterfeit goods distributed in this way.

Counterfeit food and beverages are primarily distributed via the same channels as the original products. Hence, retailers are in second place in the list of sales channels accounting for 37 percent of counterfeit goods discovered. This figure includes traditional retailers as well as one-euro shops. In third place, accounting for 33 percent, are the wholesalers.

Even though the sale of counterfeit goods is very much the exception at reputable European wholesalers and retailers, piracy

is nevertheless an issue they must take seriously. Carefully examining goods and, in particular, their origin is of growing importance as counterfeiters become increasingly inventive at channeling their goods into the supply chain.

The internet is in last place as a distribution channel, accounting for 33 percent of goods. The risk from online trading is higher in industries which are increasingly geared towards internet sales such as accessories or clothing.

The internet

The internet offers counterfeiters huge opportunities while at the same time providing a risk for consumers. The main advantage for counterfeiters lies in the anonymity provided by the internet, allowing them to disguise their scheming and impede detection by the authorities. Furthermore, they have direct, round-the-clock contact with potential customers world wide.

A further benefit for pirates is that consumers are hard pushed to tell a counterfeit product from the genuine article on the internet. They have no way of feeling or properly seeing the quality of the products. Rather, they are only shown an image of the product, meaning that a copy can easily be passed off as the original. Properly checking the authenticity of

products is possible only to a limited extent, although consumers may be alerted to counterfeit versions by an unrealistically low price. However, price is not always a reliable indication, especially in the case of internet auctions where a low first bid is not uncommon, even for genuine goods. Without being able to rely on quality and price as clues on the internet, consumers are subject to a higher risk of unwittingly buying counterfeit goods.

Counterfeiters exploit the advantages of the internet and their brazenness knows no bounds. They do not even attempt to disguise the fact that goods are not genuine, for instance in the case of counterfeit watches which are offered on dedicated websites as high-quality copies. Loosely, what they are saying is: "We only use the highest quality materials and the counterfeit version can only be distinguished from the original by experts."

So how do counterfeit goods get into the individual supply chains? Counterfeiters make use of the global flow of goods and prefer container shipment. Only a tiny portion of the huge volumes of cargo transported by ship can be checked. This reduces the risk of counterfeit goods being intercepted. Pirates go to great lengths to disguise the illegal origin of goods. Counterfeit goods are sent on a long journey using forged consignment notes and involving transshipments and carriage through several customs territories. Another method being practiced increasingly is mixing original and counterfeit articles in the same consignment. In this way, the pirates hope to sail through the risk analysis and controls of the country of destination.

The big question is whom can consumers still trust? Where can they be sure of buying an original if counterfeit goods have flooded the market via every distribution channel? Traditional wholesalers and retailers of Europe play a major role in this and have a real opportunity to market themselves as offering authentic articles, guaranteed.



4. Damage from counterfeiting

The market for counterfeit goods results from the overwhelming demand from consumers on the one hand and the economic attraction of counterfeiting on the other. Thus, counterfeit goods are increasingly appearing on the markets. The damage caused to the consumer goods industry is estimated to run into billions.

We have attempted to estimate this damage by asking companies to what extent they are affected by counterfeiting and the damage caused.

4.1 Two thirds of companies are affected by counterfeit goods

The proportion of companies affected by counterfeit goods is alarming (see figure 12): of the companies surveyed, 56 percent report that their products have been the constant victim of counterfeiting in the past three years, while another 22 percent of companies report that they detect illicit copies of their products several times a year. This means that two in three companies are affected by counterfeiting.

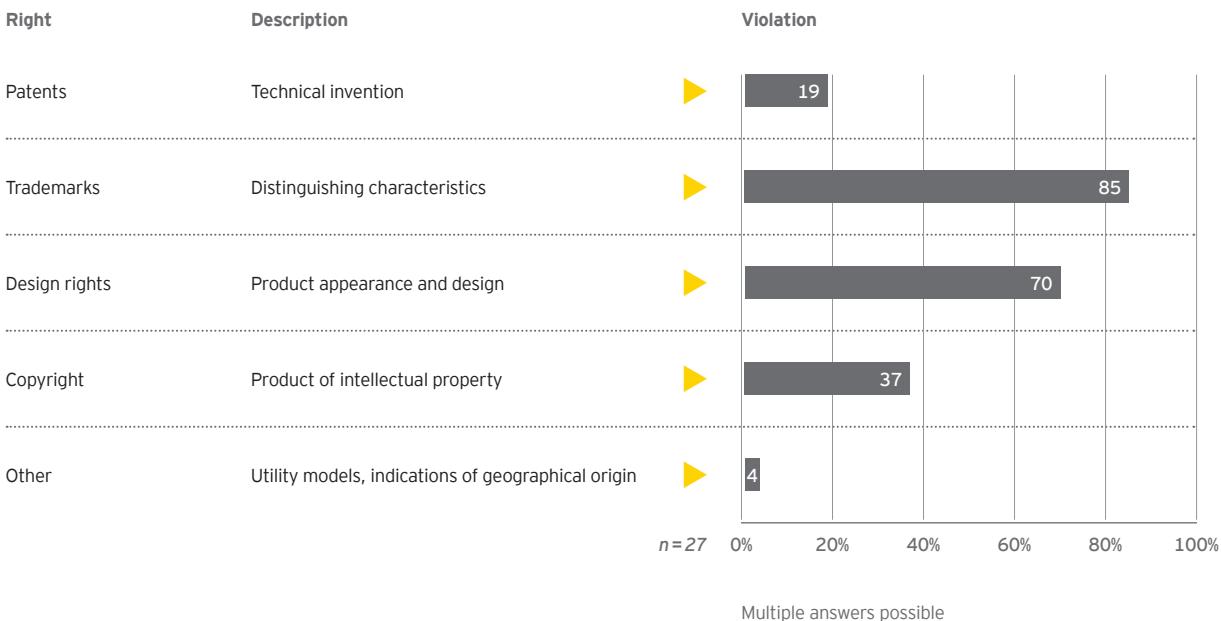
An analysis of the companies affected by product group reveals that luxury and consumer goods in the areas of accessories and clothing are not the only product groups targeted by counterfeiters, although at

100 percent they are hardest hit. Pirates are also targeting daily consumption products including cosmetics, personal care, food and beverages. Over 50 percent of companies serving that segment have registered counterfeits of their products regularly.

However, these figures represent the tip of iceberg as not all companies address the problem systematically. Most companies that take a closer look at the counterfeiting phenomenon do in fact identify imitations of their products. Consequently, a large number of counterfeit goods go undetected. Companies and customs officials need

Which rights are violated by counterfeiting?

Figure 11



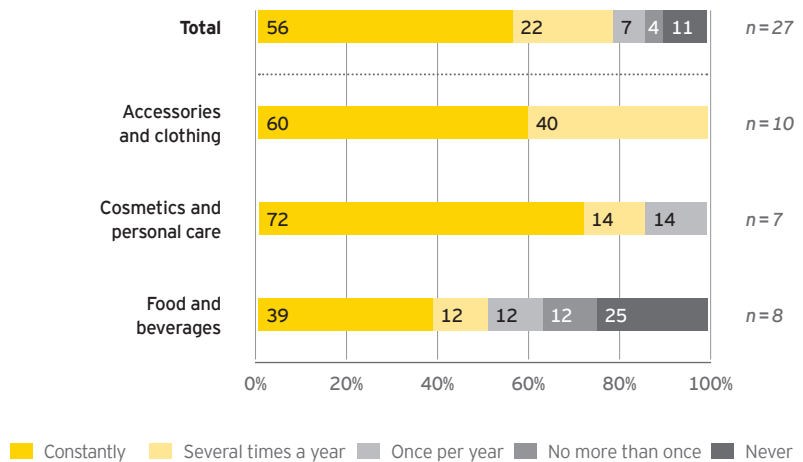
increasingly complex detection measures to identify the actual extent of the problem and to limit it.

Companies expect the risk attached to counterfeiting to increase in the coming years (see figure 13). None of the companies surveyed believe that the risk will decrease. The spoils of counterfeiting are simply too great. Nevertheless, 54 percent of companies hope to stabilize the degree of counterfeiting at the current level based on comprehensive countermeasures, while 46 percent expect the risk to rise.

The trademark is the most frequently breached intellectual property right of the companies surveyed (see figure 11). In total, 85 percent of the companies surveyed report that the trademark is breached by counterfeiters. Design rights ranked second of 70 percent, followed by copyrights at 37 percent and patents at 19 percent.

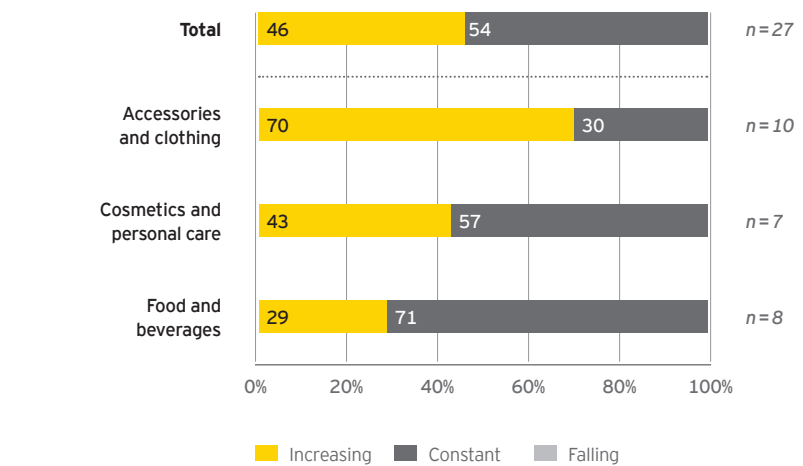
How frequently have your company's products been counterfeited within the last three years?

Figure 12



How do you think the risk will develop in the next three years?

Figure 13



4.2 The financial damage is not systematically assessed by the companies themselves

Companies have not implemented a system to evaluate the direct and indirect damage of counterfeiting, despite its prevalence (see figure 14). Indeed, only 19 percent of the companies surveyed evaluate the direct damage caused by counterfeiting, and only four percent attempt to estimate the indirect damage.

The direct damage concerns the costs directly incurred by a company due to counterfeiting (see figure 15). This includes the costs to combat counterfeiting and the related loss of revenue.

The costs of combating counterfeiting are incurred in the process of defecting and seizing or disposing of the counterfeit goods. Such costs are determined by 30 percent of the companies surveyed. Furthermore, 30 percent of companies

report that they supplement their estimate of the damage caused by counterfeiting by determining the litigation costs incurred. Finally, 22 percent contract the services of external providers in the fight against counterfeiters and include this cost in their calculation of the damage caused.

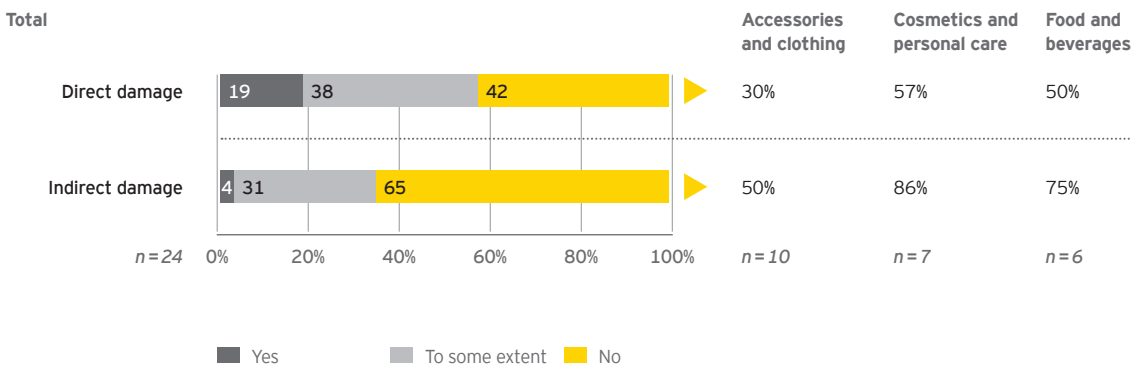
Another significant component of the direct costs is the loss of revenue attributable to counterfeiting. Of the companies surveyed, 41 percent measure the extent to which their original products are crowded out by the sale of counterfeit goods. One company operating on the Russian market was particularly hard hit and saw counterfeit goods gain a market share of 30 percent. Using a series of measures, the company was able to suppress the counterfeit goods within one year and increase revenue substantially.

Apart from direct damage, companies also incur indirect damage from the spread of illicit copies on the market, i.e., damage to a firm's reputation. Counterfeit goods skim off purchasing power. Moreover, the inferior quality of the counterfeit article is associated with the original manufacturer, causing damage to its brand. For instance, the aforementioned company active on the Russian market was forced to cancel the advertising campaign for its product because it would have caused more harm than good to its brand owing to the poor quality of the counterfeit goods in circulation.

Apart from the loss of brand image, a brand can also lose its exclusivity if counterfeit goods are widespread on the market. This happens if illicit copies of a firm's products gain a greater market presence than the

Have you calculated the damage as a result of trademark and product piracy?

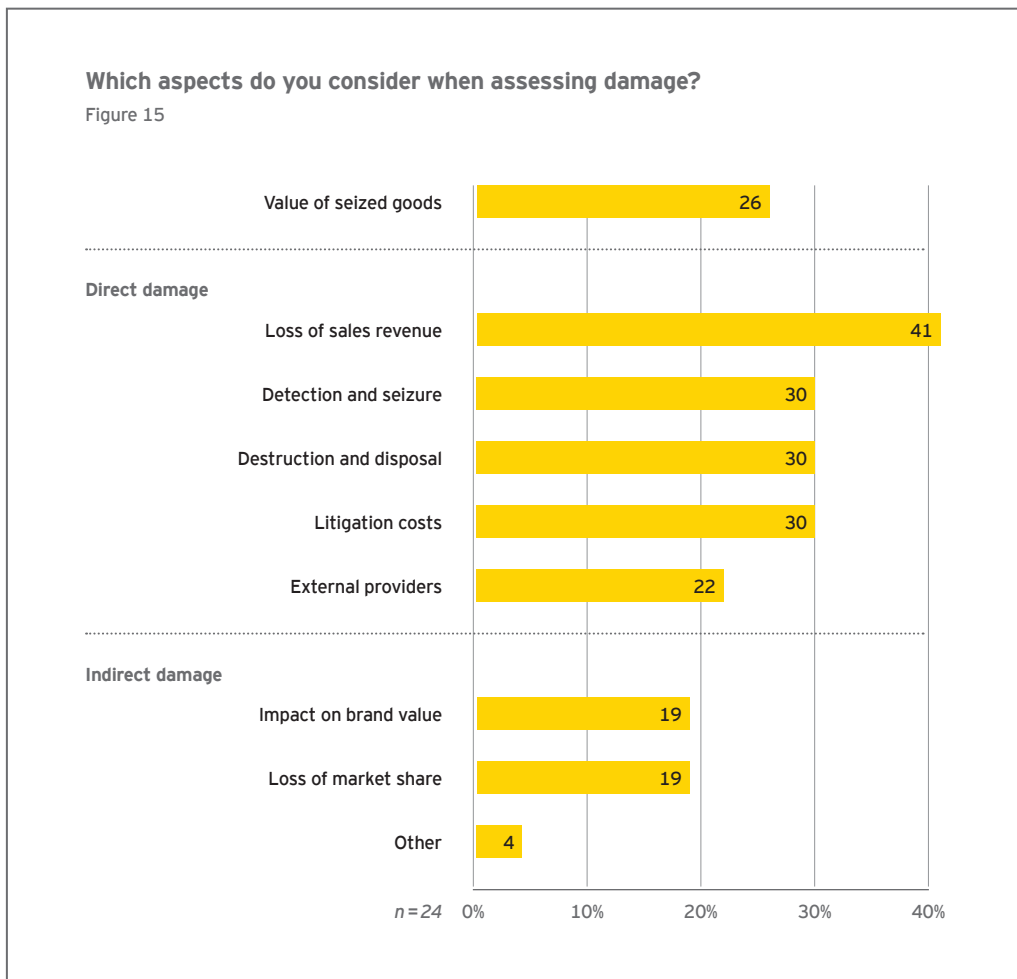
Figure 14



original, making the market accessible to all income levels. Even customers that are able to afford the original then lose interest in the brand.

The loss of image and exclusivity burden the brand's value. The loss of brand value due to counterfeiting is measured by 19 percent of companies.

A share of the companies affected actually do try to evaluate and describe the damage caused. However, a systematic approach is not apparent. The only notable point is that companies most affected by counterfeiting make a greater effort to determine the associated cost. For instance, up to 60 percent of the companies in the accessories and clothing product sectors fully, or at least partially, calculate the direct cost incurred. By contrast, only about half of producers of food and beverages determine the cost incurred. None of the companies surveyed was able or willing to disclose the damage in euro.



4.3 Drifting in treacherous waters



The lack of a systematic approach reflects the uncertainty prevailing among most companies as to how to evaluate the damage caused by counterfeiting (see figure 16).

While the direct costs are generally clear, i.e., the cost attributable to protecting brands, a reliable estimate of the loss of revenue is more difficult: would the buyer of a counterfeit product be willing to pay a higher price for the original and, if so, how much more would he or she be willing to pay? Which figure should be taken as a basis: the purchase price, the sales price or the contribution margin?

Of greater concern to companies - and even more difficult to measure - is the damage attributable to a loss in the brand's value. Valuing a brand alone is subject to uncertainty, but dwindling customer loyalty on account of counterfeiting is even more difficult to measure.

Companies could estimate the damage caused by counterfeiting based on customs statistics. Customs officials determine the value of seized goods in euro. Such values can be included as a lower limit in the calculation.

It is of paramount importance for companies to address measurement problems systematically and to find a solution that suits their specific circumstances. There are two main reasons for this:

1. *"You can't manage, what you don't measure,"* i.e., you cannot reliably determine the effectiveness of measures against counterfeiting if you cannot measure the financial loss attributable to counterfeiting. Continuous measurement of financial damage is essential if the success of measures is to be assessed (cost-benefit analysis).

2. *Internal communication of problems associated with counterfeiting:* at present, companies often have the following mechanism for drawing internal attention to the problem of counterfeiting: "To communicate the problem of counterfeiting, until now we have presented the counterfeit product together with the original. If the responsible departments cannot distinguish between the copy and the original, they realize that they have a problem on their hands." This is no doubt the right way of creating initial awareness of the problem. However, a monetary value can serve as a more straightforward and reliable basis for generating awareness in the individual departments in the long term that brand protection has to be incorporated in every decision.

A measurement of the damage caused provides companies a reliable indication of the risks attaching to counterfeit goods and a basis for successfully implementing and assessing measures. A measurement of damage provides an initial navigation aid in treacherous waters.

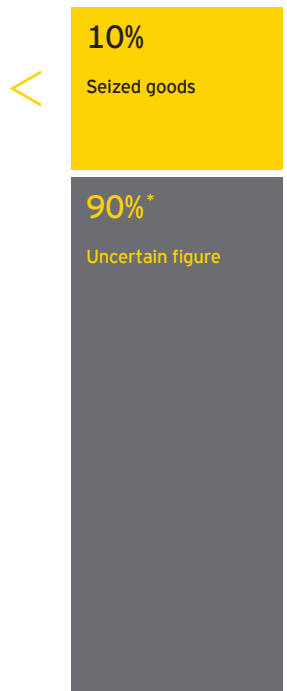
Components of damage caused by counterfeiting

Figure 16

Value of seized goods [EUR]

Valuation in euros applies to German customs authorities only. On European level only the number of protected goods is given owing to uncertainty in relation to

- ▶ Valuation of purchase/sales price
- ▶ Valuation of brand-inspired imitations



Companies

Costs of seizing goods

■ Discovery

■ Destruction and disposal

■ Litigation costs

■ External services

Loss of sales revenue

■ Customer sensitivity to price

■ Valuation of loss of sales revenue

Loss of image

■ Valuation of decreasing customer loyalty

■ Valuation of brand

Consumers

■ Risk of confusion

■ Health and accident risks

■ Financial risks

Economy

■ Tax revenue loss

■ Job losses

* Companies agreed unanimously that a maximum of 10% of counterfeit goods are discovered

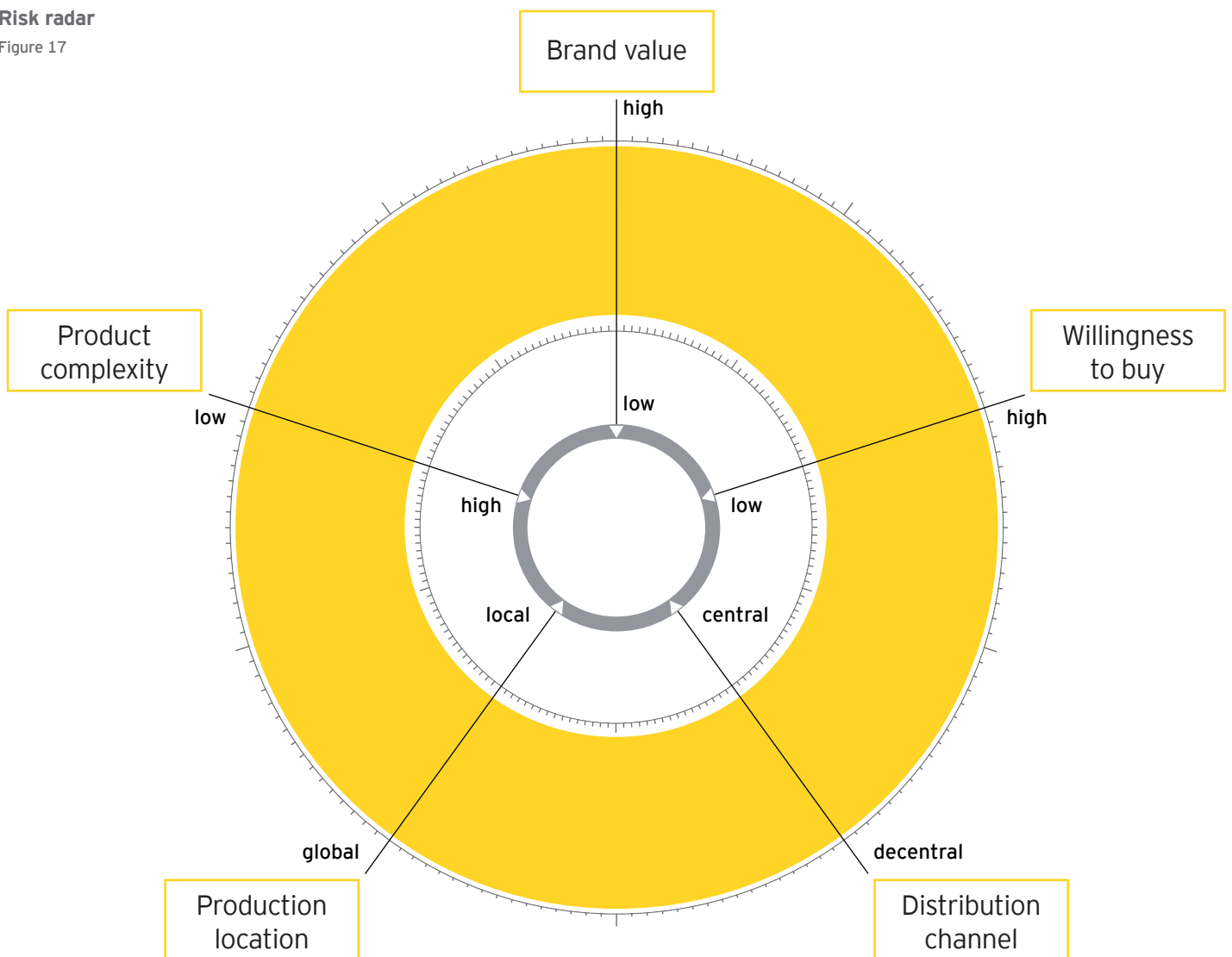
■ Definite figure

■ Value uncertain

4.4 A risk radar to navigate in heavy seas

Risk radar

Figure 17





The risk radar determines the risks attaching to counterfeit goods based on the following five dimensions (see figure 17):

1. *Brand value*
2. *Willingness to buy*
3. *Distribution channels*
4. *Production locations*
5. *Product complexity*

The first and undoubtedly most significant dimension is *brand value*. The risk of counterfeiting increases as the brand value increases. A high brand value invites free-riders because it can be transferred to a (good) copy. This frequently allows counterfeiters to obtain better prices for their copies, thus making counterfeiting particularly economically attractive.

Willingness to buy, understood as the willingness of consumers to consciously buy counterfeit products, continues to be very high for certain product groups. The risk of counterfeiting increases as the willingness to buy increases. The consumer survey reveals that the consumers' willingness to throw moral or even health concerns overboard and buy a counterfeit product increases as the price and exclusivity of a product increase. Consequently, demand for counterfeit goods is lower for the product groups food, beverages, cosmetics and personal care products, and higher for clothing and accessories.

The possibilities of protecting the *distribution channels* from being infiltrated by counterfeit goods decrease as the number of players rises. While the risk attached to illicit copies is still manageable in direct distribution structures, it rises steadily the more indirect distribution is used. The risks specific to online distribution have already been discussed (see box on page 24).

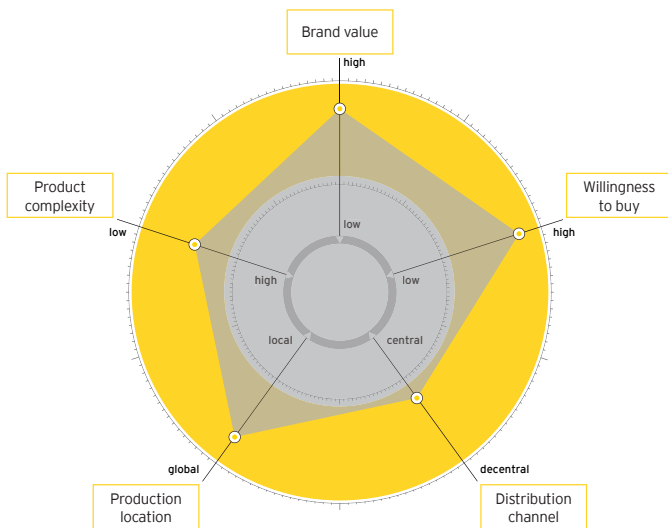
The *production location* influences counterfeiters' access to original products. Counterfeiters generally do not care if they have to obtain the information they need to copy products from Europe at a greater expense, or whether the information is available on their doorstep - the economic incentives are their only concern. Nevertheless, the counterfeiters are faced with lower barriers when the production locations are on their doorstep. The risk generally rises as the global distribution of production sites increases, and further still if manufacturing processes are sourced from contracted suppliers.

A final risk dimension is the *product complexity*. Although counterfeiters can deceive consumers with a good imitation of packaging in the case of some products, other products, such as elaborate bottles of perfume for instance, require considerable investment to produce a faithful copy of the original. Any special requirements of a product, such as compliance of frozen products with the cold chain, also discourage counterfeiters.

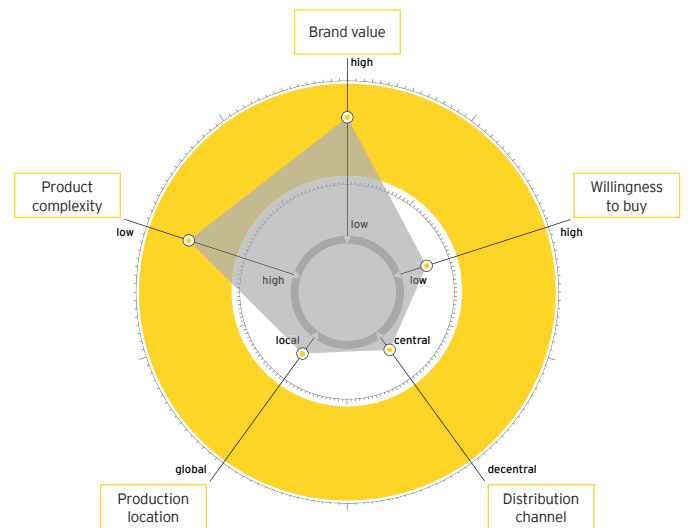
The risk radar for two segments

Figure 18

Clothing



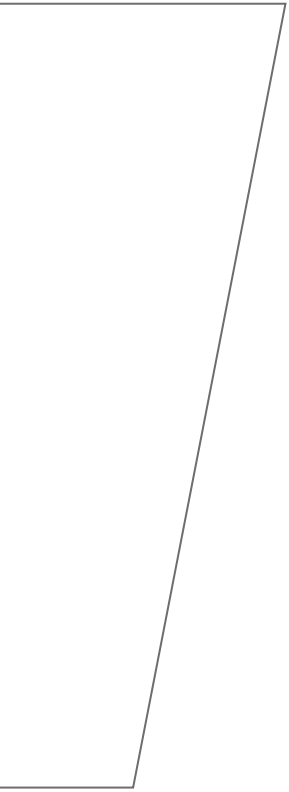
Food



The risk exposure of two segments to counterfeiting is illustrated in figure 18. Both supply and demand are high in the clothing and accessories product groups, especially in the luxury segment. The brand value is high, as is consumers' willingness to buy counterfeit goods. Production is usually spread around the world and products are distributed to consumers via a comprehensive range of distribution channels - including the internet. Finally, it appears that

the products' low degree of complexity makes them easy targets for counterfeiters. Consequently, the risk is high in all five dimensions.

The risk of counterfeiting is significantly lower in the food and beverages product groups. This is partly because demand is lower and partly because production is mostly performed locally in Europe with distribution in specialist retail stores.



5. Combating counterfeiting

Some of the companies surveyed have already adopted individual measures to combat the supply of counterfeit goods and to contain demand. The effectiveness of such measures mainly hinges on the correct integration of brand protection within a company's organization, particularly along the value-added chain. But calls by companies for support from the government and trade associations are also not falling on deaf ears.

5.1 Organizational integration of brand protection

Our survey sheds light on the current integration of brand protection activities in individual business units. An initial finding is that brand protection is a matter for the boss. Of the companies surveyed, 77 percent assign decisions relating to brand protection at top management level, while the top management plays a supporting role in the remaining 23 percent. Companies are thus well aware of the strategic importance of brand protection.

Operating responsibility for brand protection is usually anchored in the legal counsel department, which serves as the decision-making body in 58 percent of the companies surveyed. The marketing department makes decisions in 27 percent of the companies surveyed. In the majority of companies, namely in 65 percent, the marketing department merely plays a supporting role.

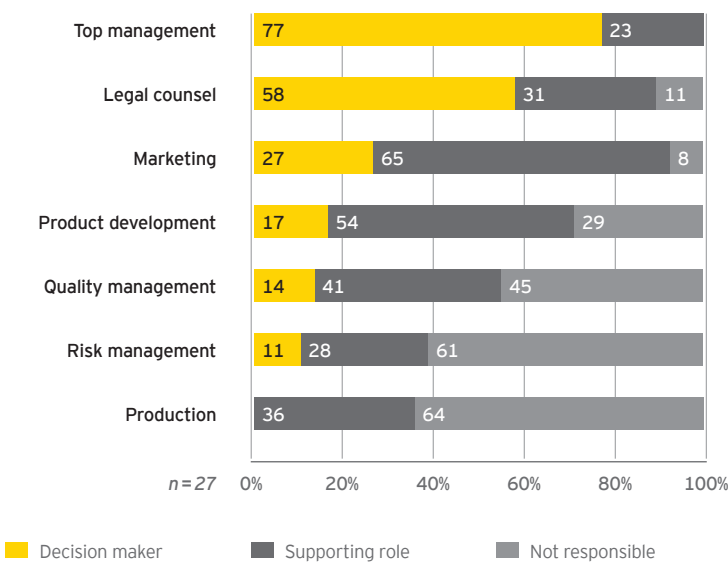
Other departments are generally excluded from decisions concerning brand protection. While the development department is involved in decision making in 17 percent of the companies surveyed, the quality management department is only involved in 14 percent of the companies, the risk management department in 11 percent while the production department is not involved at all. This department is mostly assigned a supporting role in brand protection. In other words, protecting the brand tends to be perceived as a singular, legal task rather than a holistic corporate task.

From an organizational perspective, some companies have anchored brand protection in a "brand protection steering team." Brand protection officers from the individual departments meet regularly in the steering committee and discuss the latest developments. This allows effective communication on brand protection between the individual business units.

Which business units are responsible for brand protection?

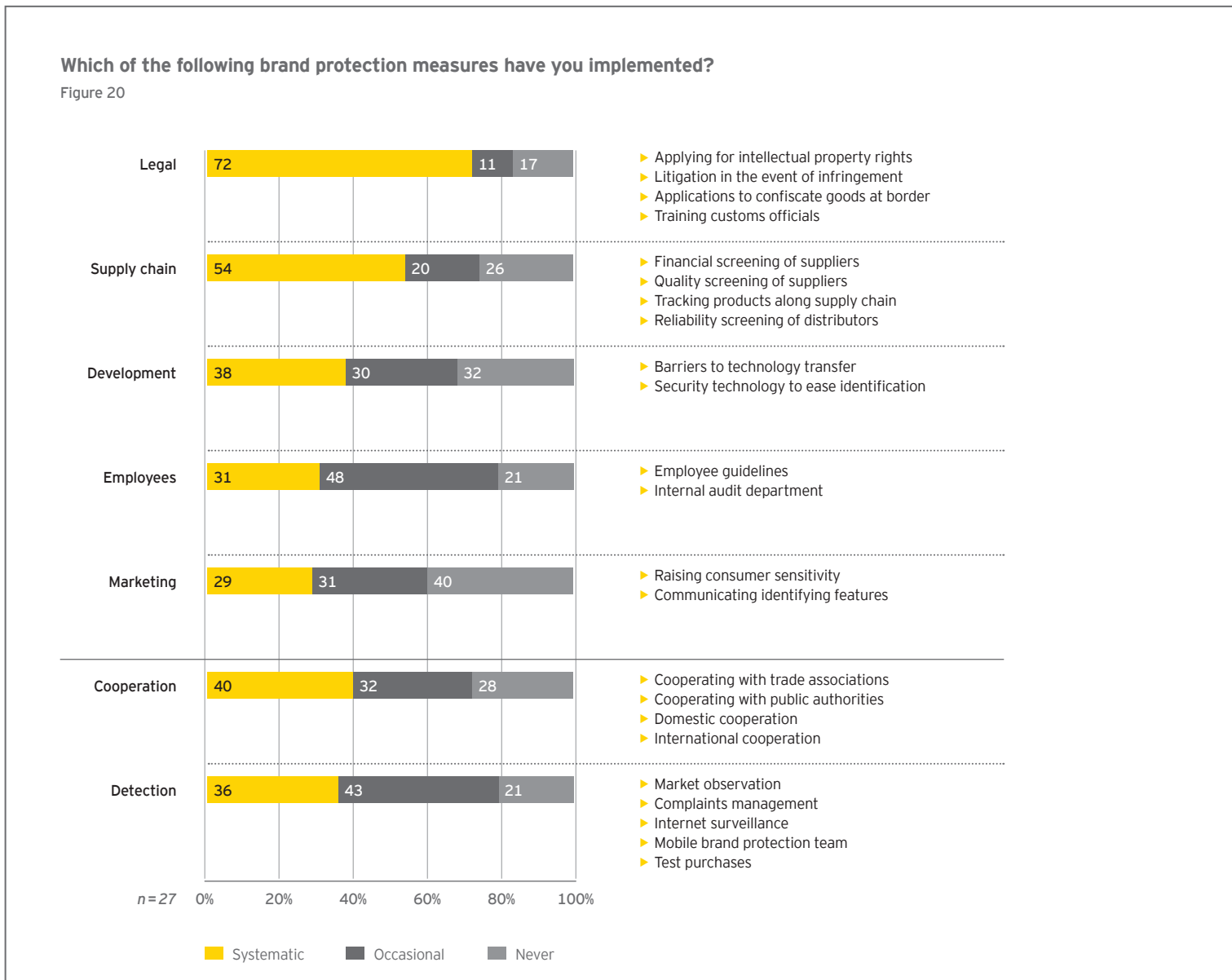
Figure 19

Total



5.2 Brand protection measures

Based on their integration in the company's organization, brand protection measures primarily focus on legal aspects (see figure 20):



Of the companies surveyed, 72 percent have systematically implemented *legal* measures in the markets concerned and 10 percent have performed a partial implementation. Application for intellectual property rights is the basis for brand protection, including trademarks, patents, utility models and design rights (see box on page 8), which afford the owner exclusive rights to market its goods and services in a specific region. Intellectual property rights enable companies a basis to litigate against the manufacture and sale of counterfeit goods and to protect itself at the border by filing application for confiscation.

To the extent possible, companies have adopted measures along their *supply chain* to hinder the infiltration of counterfeit goods into their logistics chains. On average, 54 percent of companies inspect the reliability, quality and credit standing of suppliers and distribution partners. In addition, products are tracked as they move down the supply chain where unusual movements can be identified. An additional 20 percent of companies concentrate such measures on markets and distribution partners subject to a heightened risk.

Targeted measures are designed to hinder counterfeiting at the *development* phase, including the placement of barriers on technology transfer. In addition, both open and hidden security technology is used to make products counterfeit-proof and to identify illicit copies quicker and more easily. Shorter

innovation cycles are intended to help stay one step ahead of counterfeiters. These measures are implemented systematically by 38 percent of the companies surveyed on average, a further 30 percent limit their efforts to critical products and markets.

On average, 31 percent of the companies surveyed provide special training on related guidelines to their *employees* and the internal review department oversees brand protection.

Only 29 percent of the companies surveyed consider brand protection a *marketing* task. Companies do not want the public to associate their image or name with counterfeit goods and wish to avoid unsettling consumers. Alternatively, the company can enter into positive communication with the consumer. Such a policy should focus less on the fear of an unwanted purchase of a counterfeited product and more on the advantages of the original.

The companies surveyed have largely implemented their brand protection measures throughout their departments. However, protecting the brand also requires external cooperation and of course specific measures to identify counterfeit goods.

On average, 40 percent of companies consider *external cooperation* advantageous in their efforts to protect their brand from counterfeits. Rather than implementing selective actions, they bundle their resources

in trade associations and in cooperation with public authorities. In response to the increasing international dimension of product and brand piracy, companies are cooperating at national and international level alike.

In a bid to *detect* counterfeit goods, 36 percent undertake market surveillance and perform test purchases. Some companies assign brand protection teams to problem markets. These teams investigate and re-search the origin of illicit copies using law enforcement methods - primarily on location. They thus increasingly tighten the dragnet around counterfeiters and make it more difficult to trade openly with illicit copies on the market.

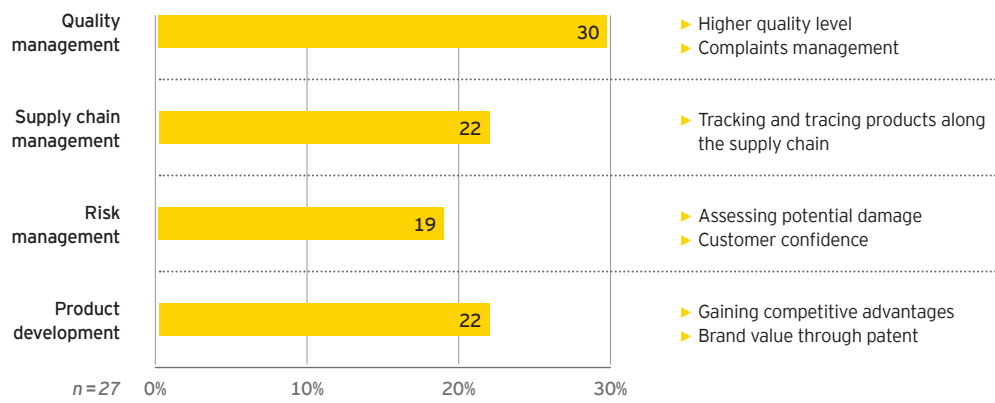
The survey shows that companies underestimate the positive side effects of measures to counter counterfeiting (see figure 21). Still, 30 percent of the companies surveyed see an added value for quality management: anti-counterfeiting measures reduce the number of low-quality imitations and in turn increase the overall quality level on the market. Only about every fifth company sees an added value for supply chain management, risk management and product development activities. However, brand protection can actually provide substantial benefits to companies. Apart from the competitive advantage gained from product development activities geared at brand protection, customers' confidence in the brand is also strengthened.

Do measures to combat counterfeiting have an added benefit for other business units?

Figure 21

Responded with yes

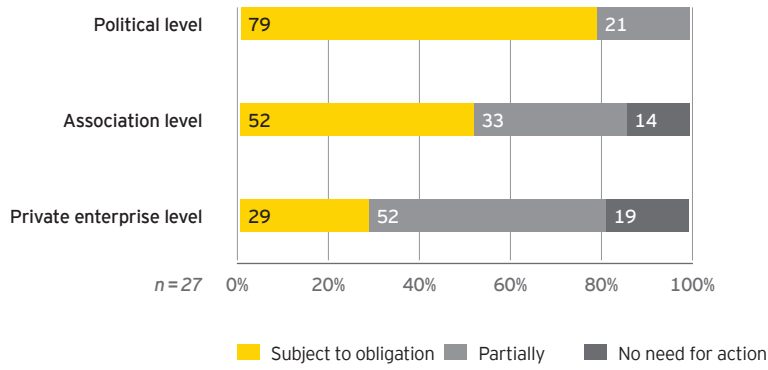
What is the added benefit?



5.3 Companies demand the support of government and associations

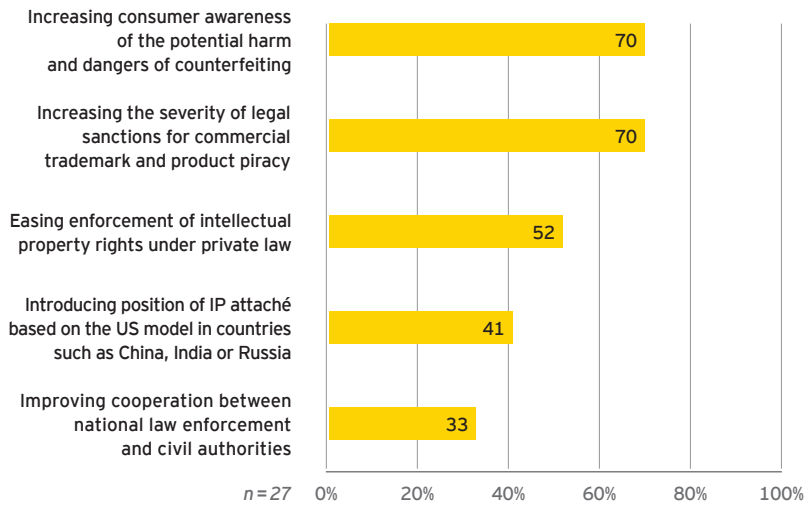
At what level do you see further need for action?

Figure 22



Which measures are urgently needed in your opinion?

Figure 23





Companies believe that the government has a duty to combat product piracy (see figure 22). Of the companies surveyed, 79 percent view counterfeiting as a global regulatory issue that can only be solved on a political level. Interestingly, the remaining 21 percent also see a need for political action. None of the companies surveyed excused the government from this responsibility.

More than half of the companies surveyed also allocate an important role to associations. At the same time, 29 percent of companies believe that they have further scope for action against trademark and product piracy, while 19 percent of the companies surveyed are of the opinion that they have exhausted their options.

This might well be the case as regards reducing demand. Companies' scope of action is restricted here if they are to avoid causing damage to their own brand. Here, they need "neutral" assistance - namely from the government and trade associations. On the supply side, companies are faced with both homegrown and regulatory problems. These can be addressed by the companies directly in the course of process-oriented brand protection.

What importance do companies attribute to the task of the government and associations (see figure 23)? For 70 percent of the companies, increasing consumer awareness is the most important measure. The companies surveyed believed that this is a task for a neutral agent. At the same time, 70 percent of companies demand that the

risk exposure faced by counterfeiters should be raised by imposing harsher sanctions under criminal law for commercial trademark and product piracy. Apart from sanctions, they also demand the enforcement of intellectual property rights to be made easier.

Companies see less potential in the introduction of the position of an IP attaché based on the US model to represent a country's intellectual property rights in countries such as China, India or Russia. This initiative is considered useful by 41 percent of the companies surveyed. At the bottom of companies' priority list is increasing cooperation between national law enforcement and customs authorities at a European level. Companies believe that cooperation at this level already works well.

Exposure to quality and security risks from counterfeit products: managing the phenomenon

The nature of counterfeit products can vary greatly. In 2003, for instance, counterfeit AMD Athlon XP processors allegedly appeared on the German market. It appears these processors infiltrated German retail chains as what is referred to as tray or OEM goods originating from the excess stocks of major PC manufacturers. Such deliveries of excess stocks are susceptible to infiltration by counterfeit products. In addition, counterfeiting is frequently reported in the food industry. In 2002, a seizure of counterfeit Johnnie Walker whisky was made in London that contained a large proportion of methanol. In 2004, twelve children died in China after consuming imitation baby food.

Last year, German customs officials confiscated 20 counterfeit Xbox wireless controllers in a delivery from China. They were apparently addressed to a private person in German. In the course of a customs check some 16 metric tons of imitation brand shoes were also discovered last year in a delivery from China to Poland. Four owners of intellectual property rights were affected. In addition, customs officials discovered another 16 metric tons of counterfeit brand clothing during a routine truck inspection. The delivery originated in Turkey and 31 owners of intellectual property rights were affected in this particular case.

In 2006, German customs officials confiscated counterfeit brands and products worth almost EUR 1.2 billion. If one considers that combating brand piracy is not one of the primary tasks of German customs authorities and that they do not conduct comprehensive investigations, it is safe to assume that these figures represent the tip of the iceberg. Although the present study focuses exclusively on consumer goods, other industries are also troubled by counterfeiting, including the automotive, aviation and the pharmaceuticals industries. Consequently, the spectrum of potential damage ranges from massive losses in the value of assets to life-threatening risks.

The cases illustrated above do however afford initial insights into the structures used by organized crime in brand piracy operations. Based on the information gained, deliveries have to be analyzed both upstream to the producer and its suppliers and downstream to the buyer and its distribution partners. In order to effectively combat brand piracy, complete knowledge of all parties and companies as well as production and distribution channels is essential.

For years now it has been indisputable that the companies concerned cannot rely on customs and law enforcement authorities alone. Brand manufacturers with global operations in particular

have in-house departments to combat brand piracy and to analyze grey markets. Markets are monitored for this purpose. Specialists also use special software to analyze the internet or use local investigators to shed light on the production and distribution structures described above.

The case-by-case analyses described above should however be complemented by analyses, or better still, monitoring of in-house production and distribution activities. Especially in light of the frequency of cases in which the in-house sales organization does not comply with the rules and the capacities in one sales territory are exported to another to embellish earnings figures. In addition, production companies might also use excess capacity to operate their own distribution channel on behalf of the manufacturer. It is therefore advisable to maintain the transparency of processes and structures of production and distribution using appropriate audits. These audits should be contractually agreed by the partners, and should focus on the analysis of quantity flows. They could also be extended to include qualitative aspects of course - such as positive side effects.

An extremely important aspect of brand protection is for companies to tag their products in order to obtain a clear view of their production and distribution channels. This also allows companies to distinguish between their products and counterfeits more easily. There are often cases in which products are not tagged in the production process or along the distribution chain due to efficiency or cost factors. This can make it impossible to track missing goods and thus result in considerable losses.

All these activities are of little use if brand protection cannot be legally enforced. This generally requires that the intellectual property rights are filed and infringements pursued under private or criminal law. Ernst & Young's forensic team (Fraud Investigation & Dispute Services) investigates and pursues brand piracy in close cooperation with lawyers specialized in brand protection. In this process, Ernst & Young creates the transparency needed to legally assert claims. In addition, Ernst & Young can help you design your brand protection activities.

Dr. Stefan Heißner
Lead Partner
Fraud Investigation & Dispute Services



6. Priorities in brand protection

Until now, most companies have taken various but rather selective measures to tackle the problem of counterfeiting. This applies both to the integration of measures in a company's organization as well as to the measures taken in individual departments. In order to successfully protect the brand from counterfeiting, two measures have to be pursued with great intensity. Firstly, greater efforts should be undertaken to inform consumers of the disadvantages of counterfeit goods and the advantages of the brand. Secondly, the isolated measures should be combined in a comprehensive process and integrated in the risk management system. This is the only way to ensure that brand protection activities in a company are implemented in full and that momentum isn't lost. These two measures are discussed further in the following.

6.1 Brand values must be communicated

A comparison of our survey of companies and our survey of consumers reveals the difference in value attributed to some product characteristics (see figure 24).

The chart compares the importance of various product characteristics from the company's perspective and the consumer's estimate of the importance of these characteristics for original and counterfeit goods. The height of the bars indicates the willingness of customers to lower their expectation levels when purchasing counterfeit goods rather than the original.

Quality is a significant characteristic of a brand for consumers and companies alike. Consumers are clearly aware that they have to accept lower quality standards due to the lower quality of the raw materials used if they choose counterfeit goods. This explains the size of the bar.

Brand characteristics like innovation, origin, emotion, prestige and tradition are of greater importance to companies than

consumers. An analysis of the height of the respective bars reveals that consumers readily transfer these brand values to counterfeit goods. However, this does not apply to origin.

Interestingly, safety and ethics are characteristics of great relevance to consumers. By contrast companies seem to tend to perceive these as hygiene factors and they are thus rated lower. The height of the bars indicates that consumers often consciously do without these characteristics when buying counterfeit goods, despite being aware of the frequent criminal aspects involved in the manufacture and distribution of illicit imitations.

A priority of brand protection should therefore be to increase awareness for the criminal and unethical aspects of counterfeiting while emphasizing the positive characteristics of the original product. This constitutes an initial step in weakening demand for counterfeit goods.

Perception of brand characteristics

Figure 24

1 Quality

- ▶ Important product characteristic for consumers and companies
- ▶ Consumers consciously cut back when buying counterfeit goods

2 Safety & Ethics

- ▶ Of high relevance to consumers when buying a brand product; possibly perceived as hygiene factors to companies
- ▶ Consumers lower standards when buying counterfeit goods

3 Core brand values

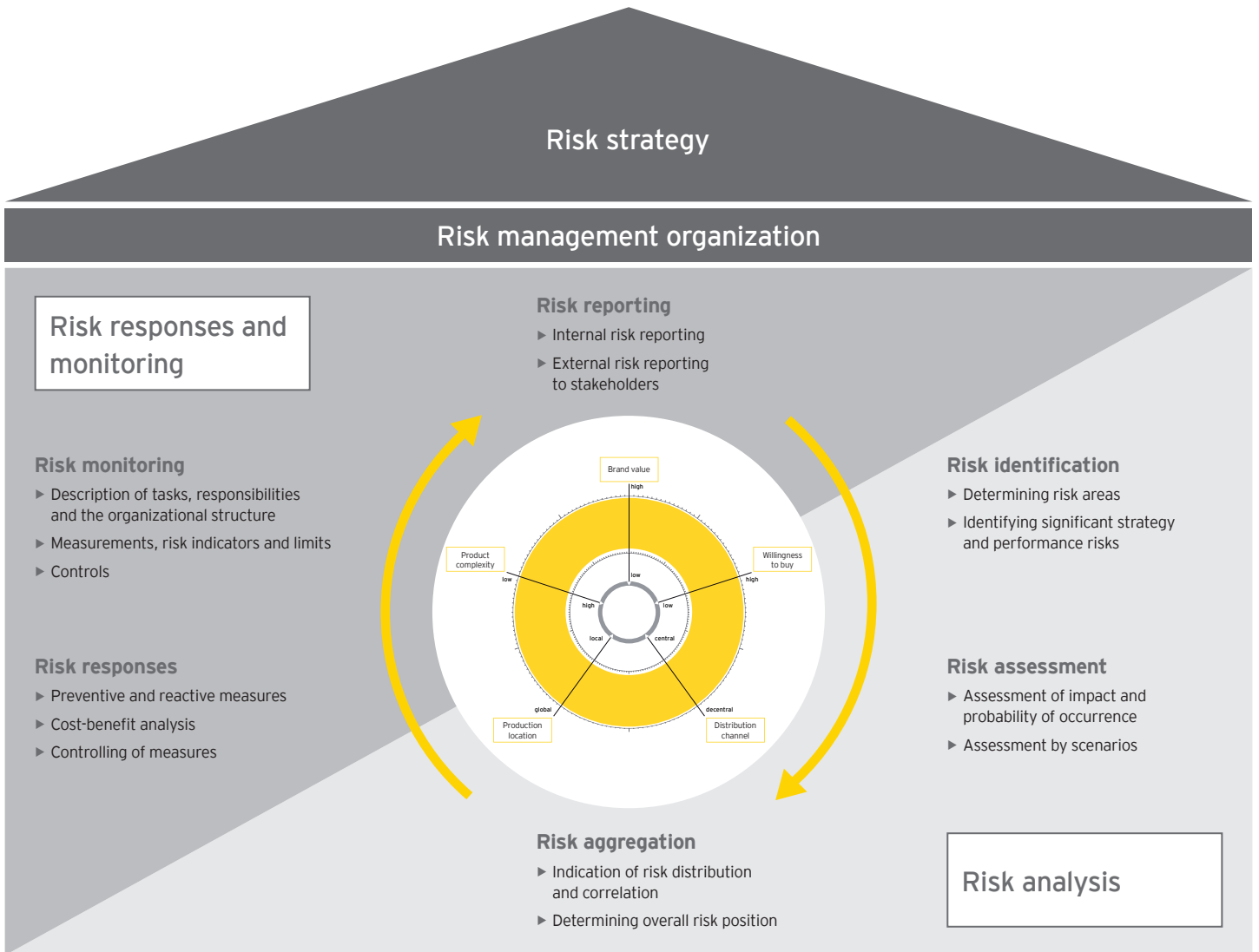
- ▶ Core brand values from companies' perspective but less important to consumers
- ▶ Consumers do not cut back when buying counterfeit goods (exception: origin)



6.2 Brand protection must be practiced as a continuous process

House of risk

Figure 25

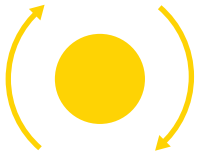


Combining individual measures at an organizational and administrative level into a process-oriented risk management systems stands at the center of successful brand protection. A standardized process with clear tasks and areas of responsibility is needed, as illustrated by the "house of risk" (see figure 25). This continuous process begins with risk analysis and is followed up with countermeasures aimed at managing the risk.

In the first phase, the risk analysis process, risks are identified, assessed and aggregated. This early phase provides a screening function for the risk management process that determines which risks arise (identification), their relevance (assessment) and how they can be classified to handle them (aggregation).

The risk analysis process is followed by the second phase, namely managing risks using countermeasures. The sustained success of this phase is supervised using a risk monitoring system and subsequently communicated as part of a suitable risk reporting system.

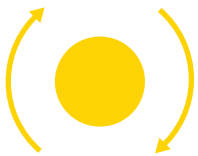




► Risk identification

Identifying risks is a first step

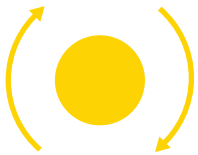
In order to use a risk management process to combat trademark and product piracy the risk of counterfeiting has to be identified first. The objective of this phase is the systematic localization of critical points along the risk radar in order to determine new dangers early. The individual dimensions of the risk radar describe the five critical conditions that can heighten the risk of counterfeiting.



► Risk assessment

Risk measurement is key

Any counterfeiting risks identified are measured based on two factors: the probability of occurrence and the impact. These factors are modeled in the risk portfolio. Our survey highlights the difficulties involved in systematically measuring the damage caused by counterfeiting. Particularly when determining the severity of loss, but also when determining the probability of occurrence of counterfeits, brand protection navigates in treacherous waters: overestimating risk can cause damage to the brand's image. By contrast, underestimating the risk can take the wind out of the sails of brand protection activities. If the risk attaching to counterfeiting cannot be determined accurately, it should at least be estimated on a qualitative basis, since measurement is the foundation for efficiently combating risks. Estimates can be used legitimately, provided that the premises are documented accordingly.



► Risk aggregation

The total risk is determined by aggregation

Individual risks are aggregated to risks clusters to simplify the process of identifying and measuring risks. Hence, the company's overall risk exposure to counterfeiting can be determined. Correlations between the individual risks and with corporate values highlight the level of risk. For instance, systematic piracy of a company's innovative or flagship products can undermine its innovative power.

Managing risk using appropriate measures

Appropriate measures to manage risk are defined along the dimensions of the risk radar. The objective is to produce a positive impact on the company's risk position. The individual measures are subjected to a cost-benefit analysis. The key issue here is to what extent a company achieves a balance between opportunities and risks through a specific measure. The aim is not to fully eliminate counterfeiting at any price, but rather to limit counterfeit goods to a level that the company can afford while ensuring the efficiency of measures. Breaking a butterfly on a wheel has never been a recipe for success.

Of central importance to the success of risk management is the implementation of measures targeting counterfeiting throughout all relevant business units. For instance, measures should not focus solely on legal aspects. Instead, they should also focus on the supply chain, production activities and marketing. Otherwise, the ship's hull might well be reinforced, but the pirates can gain access through the wide open gangway. Risk management has to have the necessary entrepreneurial vision to set the right course early and navigate safely.

Clear areas of responsibility have to be assigned

Risk management has to be located based on competence. Consequently, it has to be anchored in the organization's business processes. The objective within the company's individual business units is to protect the brand from counterfeiting and to actively manage the process if it does not take the desired course or if predefined thresholds are exceeded.

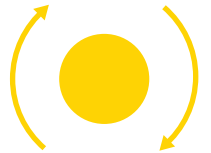
To ensure the sustained implementation of the measures adopted, responsibilities have to be clearly defined and complied with as part of risk monitoring activities.

Reporting provides a measure of success

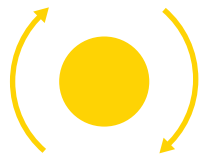
The success of the risk management process is measured in the course of risk reporting. Internal communication to management is of central importance. External communication is, however, also increasingly gaining in importance, for instance in the management report issued together with financial statements. In some companies, the risk report has already established itself as a permanent element of the annual management report. Its aim is to strengthen the confidence of analysts in the company.

Whether the strategy to combat product piracy is effective can often only be determined after a prolonged period of observation. The question is whether the pirates have been driven away for good or whether they are just regrouping? The degree to which the measures were successful or failed is then taken into account in the analysis of the next attack. This improves active prevention activities and allows companies to capsize aggressors early.

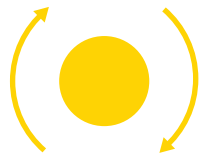
► Risk responses



► Risk monitoring



► Risk reporting



7. Summary and outlook



The fact that 78 percent of companies are affected today by counterfeiting across all segments - with an upward trend - more than underscores the extent of the counterfeiting problem. Nevertheless, companies do not have their hands tied in the fight against trademark and product piracy. On the contrary, intensifying communication to consumers about the risks of counterfeit goods and the advantages of the original brand can help reduce demand for imitation products. It is also important to establish a continuous risk management process in the company. This begins with the systematic measurement of damage and is followed by determining potential measures to protect the brand and a cost-benefit analysis. The company's objective must be to actively practice comprehensive brand protection.

Nevertheless, companies depend on support from the government and associations in the fight against trademark and product piracy. These can make an important contribution to reducing demand for imitation products by increasing consumer sensitivity and awareness. At the same time, the possibility of increasing the severity of legal sanctions as a deterrent should be considered.

A concerted effort from industry, government and associations is the most effective way to meet the challenge of brand and product piracy.

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