

Know IP – The Stockholm Network’s Monthly IPR Journal Volume 4: Issue 2. April 2008.

Contents

Commentary – On Risk, Market Failures and IPRs – Meir Pugatch and Helen Disney p. 2

Topic of the Month – The Secret Garden – Gulya Isyanova, p. 3

Experts’ Corner – Parallel Imports Are Not a Cure For America’s Prescription Drug Access Problem – Brian Ferguson, p. 4

New and Notable – EU Consultation on Online Creative Content, p. 6

Upcoming Event – The Process and Impact of the WHO Intergovernmental Working Group (IGWG) on Public Health, Innovation and Intellectual Property – An Assessment, p. 7

New Publication – *What’s wrong with royalties in high technology industries?* by Damien Geradin, p. 8

Newsflashes – Top Stories in the World of IP and Competition, p. 8

Commentary

On Risk, Market Failures and IPRs – Meir Pugatch and Helen Disney¹

The Stockholm Network is a market-oriented think tank. It therefore believes that market-based solutions are in most circumstances the best way to support and sustain the economy.

Yet we also recognise that market failures do occur, and that there are times in which central authorities should intervene in order to restore confidence in the market or to establish some ground rules that can help push the economy forward.

In this context, one can find some interesting similarities between the market failures that are generated in the absence of intellectual property rights (IPRs) and the market failures that have been identified during the current financial crisis.

In broad terms – the current financial crisis developed because the financial sector engaged in excessive borrowing and lending without ensuring there were sufficient guarantees to justify such activity (i.e. they did not adequately ensure their borrowers could pay back debt).

The financial sector has taken on too much risk (spreading it and even concealing it in some very sophisticated ways) in the attempt to boost profits and share prices. Operating like a herd, key players, such as investment banks, sacrificed economic fundamentals to create ever more enticing portfolios.

However, every wild party must end and, in this case, the hangover is characterised by cash flow shortages, risk of insolvency and instability in the property markets.

This is not a pretty picture. Central authorities, especially in the US, which is the epicentre of this financial earthquake, are now forced to intervene

in order to restore order to the system. Short term measures include bail-outs, financial backing, active intervention in the currency markets and reduction of interest rates.

Over the longer term, central authorities, together with the markets, will have to restore the system's credibility, increase its transparency and, most importantly, reduce risk by going back to basics with regards to lending and borrowing.

So what do IPRs (or their absence) have to do with this? Apparently quite a lot...

The IP system is also based on a mutual understanding between central authorities and the markets – like financial instruments, IPRs are aimed at reducing risk, creating trust and maintaining transparency.

Reducing risk – in the absence of IPRs innovators are exposed to the problem of 'free-riding'. An innovator faces the risk of not being rewarded for his efforts, as people would be free to use his innovation without having to seek his permission. IPRs significantly reduce this problem as they establish the concept of ownership (although the risk of free-riding still exists, e.g. in cases concerning counterfeiting and infringement of IPRs).

Creating trust - IPRs are not granted to just anyone for anything. Criteria have been established in order to identify which types of innovations and creations – such as for inventions (patents), artistic and literary creations (copyrights), or consumer information (trademarks) – merit the protection of IPRs. Moreover, exceptions have been instituted and timelines established in order to ensure that society is able to secure its overall objectives. All of these criteria and exceptions are aimed at ensuring a sufficient level of trust between society, the markets and the central authorities.

Maintaining transparency – the IP system is based on transparency. Under the protection of IPRs the relationship between owners and users is clearly defined. For some forms of innovations, notably patents, transparency is also secured at the technical level, as innovators have to disclose the particulars of their inventions in exchange for

¹ Helen Disney is CEO of the Stockholm Network. Dr. Meir Perez Pugatch, Haifa University, is Director of Research of the Stockholm Network.

IPRs. Finally IP owners are able to report on their intangible assets to the public and to their shareholders in a more accurate manner. For a company whose main intangible assets are based on IP protection (e.g. pharmaceuticals, software and music), the obligation as well as the ability to report on these assets is a fundamental element of its performance in the market.

The underlying fundamentals of the IP system and the financial system have a lot in common. Some argue that the IP system, much like the financial markets, is in a state of crisis (a notion with which we strongly disagree). Among those who share this belief, one can identify two extremes – those who hold the view that IPRs should be significantly weakened (and even abolished) in order to allow for ‘better’ innovation to take place, and those who believe the opposite, that making a far greater use of IPRs (using both existing instruments as well as new ones) is the right way to enhance innovation.

Since this debate is likely to continue, we ought to come back to the basics of the IP system and review its objectives. Here, much like in the case of the financial system, we believe that the economic fundamentals of the IP system are sound. And, much like the current debate on the architecture of the financial markets, the question is not about creating a new system but rather of enforcing its fundamentals and matching them to the current characteristics of the global economy.

Topic of the Month

The Secret Garden – Gulya Isyanova²

In the children’s novel *The Secret Garden*, a little girl is sent to live with her relatives in Yorkshire after the death of her parents. By accident she discovers a locked garden in the grounds of the house. When told that she must not play in it and that it must remain locked, she points out the absurdity of a garden which no one can enjoy. The same can be said for great ideas and

inventions – if no one can enjoy them or even know about them, what is the point? Perhaps a more pertinent question is what is the key to unlocking the ‘secret garden’ of ideas and inventions in the modern economic context?

Modern economies are complex and dynamic systems. If the Darwinian adage of survival of the fittest still rings true, then by virtue of their near-ubiquity it could be inferred that capitalist economies are the ‘fittest’. The reason capitalism dominates is that in short, the leaps and bounds made under this system – in terms of economic growth and progress, technological advancement, scientific discovery and ever-increasing standards of living for the general population *et cetera* – have simply made a market economy the most appealing option for societies in the global economic system.

Different schools of thought identify different drivers of capitalism. Here, we will pertain to Schumpeter’s view as he identified innovation as the source of capitalist propulsion. In his view, the capitalist system is restless and absolutely relentless – everything is constantly being re-thought and everything is ultimately superseded. In other words, no business or industry can become complacent about its success. It must think ahead and innovate or face the risk of dying out. One would think that this risk of falling to the sides in the race for survival would be enough of an incentive for companies to invest heavily in innovation. This is not the case, however. Why?

An important distinction needs to be made here between inventions as ideas and expressions of ingenuity and creativity, and innovation as the practical process of putting these ideas into practice. While the ‘secret garden’ of ideas may always be in bloom, organised innovation is something which requires time, effort and ultimately, money. In other words, innovation requires high input levels of finite resources and is therefore an endeavour characterised by high risk and uncertainty. Putting many eggs into one basket may, after all, be sometimes necessary but it remains a very risky strategy. So how does society convince inventors to pursue this risky strategy of innovation?

² Gulya Isyanova is a researcher at the Stockholm Network

Intellectual property rights (IPRs) have, in one form or another, been used as an incentive to entice inventors to disclose their secrets for over 500 years. Early copyright and patent activity, for example, could be found in the Renaissance-era Italian city-states of Venice and Florence. The function of IPRs is to minimise some of the risk associated with the innovation process by guaranteeing a temporary advantageous market position to the inventor. In other words, IPRs act as an impetus for the process of creation and innovation by enabling a trade-off to take place between the inventor and society – in a sense, a form of social contract.

There is some opposition to this type of contract from a political perspective. How can knowledge, which is indivisible and moreover, a public good, be subjected to conditions of artificial scarcity? In other words, why interfere with the market (which as we established above is the economy of choice) by creating artificial monopolies? Does this not stifle creativity as well as the innovative process itself?

Here we have to consider the context in which this trade-off takes place. With technological, scientific and economic progress comes great complexity of inputs and process. In the global economy of today, the bulk of innovation (the kind which propels the economy and leads to growth) is conducted by companies, the main reason being that only they have the capabilities and resources to conduct the kind of research and development (R&D) that is required in the modern setting. This applies to manpower, financing and brand reputation. The primary agent is no longer the lone inventor but the company – we live in an era of organised innovation.

If companies are indeed the main agents of innovation in the modern economy, then their inputs are accordingly of a much larger scale. Context is everything. In the pharmaceutical sector, for example, the cost of developing a new drug currently stands at \$800 million. This principle, however, applies to all sectors – machinery, applied technology, agriculture and so on. Without some form of downstream enticement (i.e. a temporary artificial monopoly), these kinds of R&D costs would be seen as

simply far too risky, and therefore, would not be pursued. What this effectively means is that IPRs act in the capacity of a *pre-condition* for creating a market – without this downstream enticement, these innovations would neither leave the realm of ideas nor become part of the economy.

Some critics may accept this line of reasoning, but still point to the argument that while the intention behind IPRs is to promote innovation, the current system has gone far beyond its original intentions. This point merits consideration. However, the wrong conclusion is often drawn – *occasional misuses* of the system are mistaken for a *characteristic* of the system. Yes, patents thickets exist (as well as so-called patent trolls) but surely this does not warrant the abandonment of the entire system. By that same drastic logic, banks would decide that the existence of a few bad creditors warrants the abandonment of the entire credit system. The IP system is dynamic and develops by responding to markets. It is a useful tool with which we can keep pushing forward. Dare it be said, it is a key to the ‘secret garden’ of inventive ideas and ambitions.

Experts’ Corner

Parallel Imports Are Not a Cure For America’s Prescription Drug Access Problem – Brian Ferguson³

Even though the recent appreciation of the Canadian dollar has dampened enthusiasm for it, the idea of re-importing prescription drugs from Canada as a realistic cure for the problem of many Americans not having access to affordable drugs is one which refuses to go away completely. While not yet as prominent in the current Presidential campaign as it was in the previous one, it remains an element in the candidates’ speeches. Were it to be implemented, we would be faced with the irony

³ Brian Ferguson teaches Economics at the University of Guelph and is Fellow in Health Care Economics at the Atlantic Institute for Market Studies.

of the clout of the American government being at one and the same time directed at protecting the intellectual property rights (IPRs) of the American movie industry *and* at violating the IPRs of the American pharmaceutical industry. The message would appear to be that if you want the US government on your side, stick to satisfying the more frivolous of the American population's desires.

The irony is enhanced by the similarities between the movie and pharmaceutical sectors. Both feature the following: long development delays from inception to release; risk that a competitor will pre-empt a market segment with a very similar product; uncertainty about how the market will respond to one's own product even if it is the first to reach the market; and, as a consequence, a heavy dependence on blockbusters to keep the entire industry afloat.

Even American critics of the re-importation idea get the economics wrong: they tend to talk about re-importation as importing Canadian price controls, apparently unaware that Canadian law has no writ in the United States. They also seem unaware that Canadian price controls apply only at the factory gate and not at the retail level, so that even if those controls did apply to parallel imports, the price which Americans would pay for their drugs would depend entirely on American market conditions. Indeed, the difference in price between the Canadian and American markets may be more a reflection of price discrimination – pricing to local market conditions - than it is of effective price controls. Danzon and Furukawa suggest that when countries' drug prices are properly standardised for purposes of international comparisons, differences in prices between countries roughly reflect differences in incomes.⁴ If the United States pays the highest drug prices on average, it is not because the rest of the world is 'free-riding' on American drug research, it is because

the United States is a very rich country. Danzon and Furukawa suggest that international price differentials in drugs approximate Ramsey pricing for the allocation of joint development costs across markets.

Economists generally favour free trade and the exhaustion of the manufacturer's property rights on first sale, hence the profession's support of used book and used car markets. The pharmaceutical sector, however, has special circumstances (beyond the obvious absence of a market in used drugs). In addition to long development times and a relatively short period of patent protection remaining after a drug makes it to the market, reduced tolerance on the part of regulators and the public for risk of side effects serves to make investment in drug development an increasingly risky financial decision. In this instance, allowing price discrimination is second best to an unattainable first best policy. Weakening the drug companies' ability to price discriminate by enforcing exhaustion of their IPRs would do considerably more harm than good.

Beyond that though, is the fact that as a device for cutting the cost of prescription drugs, re-importation from Canada to the United States would almost certainly fail. The European evidence, drawn from countries with a wide range of pricing regulations, suggests that it is very easy for the benefits of re-importation to wind up accruing to the re-importers and retailers, and not to consumers or government programmes. Canada's regulations on the pricing of generic drugs are regarded as a major reason why prices of generics are higher in Canada than in the United States, and a recent report by the Canadian government's Competition Bureau suggests that much of the benefit of generic competition accrues to pharmacies, for the good reason that those pharmacies, and not consumers, are the generic manufacturer's market. The Internet pharmacy market might well yield some benefit to individual American consumers (primarily un-insured individuals who are effectively priced out of the market at present), but the chances that re-importation would cut costs for, say, large state or local government insurance plans are slim at best.

⁴ Patricia M. Danzon and Michael F. Furukawa; "Prices And Availability Of Pharmaceuticals: Evidence From Nine Countries"; *Health Affairs*; 2003 Jul-Dec; Suppl Web Exclusives:W3-521-36 <http://content.healthaffairs.org/cgi/content/abstract/hlthaff.w3.521v1>

Ultimately though, the idea of re-importation as a cure for American health care problems is a cop-out. If anything, American problems of lack of health insurance are more important for pharmaceuticals than for, say, physician care, because physicians can and do price discriminate in terms of what they charge their patients, often (though not always) accepting lower fees from their un-insured than from their insured patients. While drug companies might price discriminate at the national level, it is a much more difficult policy for pharmacies to implement at the local level. The idea that shipping drugs north to Canada and then re-importing those very same drugs into the United States (thereby disrupting the Canadian market in the process) will somehow cure these health insurance problems is a notion which only a politician could buy into.

Indeed, at present it seems that the only people who are making a serious effort to tackle America's problem of access to pharmaceuticals are the folks at Wal-Mart who came up with the idea of \$4.00 generics. That is not a good omen for American pharmaceutical policy.

New and Notable

EU Consultation on Online Creative Content

This month, the Stockholm Network submitted its views on the issue of IP in the creative content online context to the consultation process currently being conducted by the European Commission.⁵ The consultation process was launched in January 2008 to help prepare a recommendation on creative content online to be adopted by the European Parliament and Council. It calls for a common legal environment for online content.

In particular, the Commission is proposing actions at the EU level for the following perceived problems:

- “Lack of availability of creative content and lack of active licensing of rights on new platforms...”
- “The online environment allows content services to be made available across the Internal Market. However, the lack of multi-territory copyright licences makes it difficult for online services to fully benefit from their Internal Market potential...”
- “Interoperability and transparency of DRMs [Digital Rights Management technologies] could allow management of rights in the online environment by enabling the content sector's digital shift and by encouraging the development of innovative business models...”
- “Piracy and unauthorised up- and downloading of copyrighted content remains a central concern. It would seem appropriate to instigate co-operation procedures between all stakeholders.”

The Stockholm Network does not believe that European policy toward DRMs is fundamentally broken. As a result, we are wary of attempts to introduce regulation into this area of policy that may have detrimental effects on European IP regimes, on innovative industry, and on European competitiveness as a whole. The Stockholm Network fears the introduction of policies which will damage Europe's already fragile IP system. In particular, the Stockholm Network makes the following recommendations:

- The European commission must reject policies which threaten the sustainability of creative industries and the innovating sectors of the European economy.
- As much as it is possible, intellectual property owners should be given a wide-ranging ability to protect their property.
- Neither national governments nor the EU can and should attempt to replace market forces and decide which DRM solutions are best for any business.

⁵http://ec.europa.eu/avpolicy/other_actions/content_online/index_en.htm

- Accordingly, the EU should not legislate to encourage or require interoperable DRM systems.
- Rights-owners should not be prevented from drafting End User License Agreements (EULAs) as they see fit. Market forces and the practicalities of enforcement provide sufficient incentive to firms to draft apposite EULAs.
- Piracy is a crime, not a problem deriving from variations in legislation. Authorities should try to tackle piracy at the systemic level, by stepping up enforcement efforts while liaising with stakeholders in creating a broad education campaign.
- All relevant parties must bear their fair share of responsibility for online piracy and copyright theft. This does not only include content creators and end users, but intermediaries including Internet Service Providers (ISPs) and online content mediators and aggregators.
- An effective anti-piracy campaign must inevitably involve some use of filtering methods. Though privacy concerns must be addressed if any such system is to be implemented, a balance can be struck that enables a more rigid enforcement of IPR without jeopardising privacy along the way.
- A due diligence clause on the part of ISPs and online content mediators needs to be included in any upcoming legislation to ensure responsibility for copyright violation is taken by all relevant parties. There should not, however, be a radical push to hold them responsible or liable for all illegal activities third parties engage in as this would surely limit their use by, and usefulness to, the public.

The full SN submission can be found at the commission website (see under 'S'):

http://ec.europa.eu/avpolicy/other_actions/content_online/consultation_2008/ngo/index_en.htm

Upcoming Event

Conference on 'The Process and Impact of the WHO Intergovernmental Working Group (IGWG) on Public Health, Innovation and Intellectual Property – An Assessment'

Date: Tuesday, 15 April 2008.

Time: 09:00 -17:00

Venue: Feestzaal of Maastricht University Faculty of Law, Bouillonstraat 3, Maastricht, The Netherlands.

The Maastricht University Faculty of Law and the Stockholm Network Intellectual Property & Competition Programme are jointly organising a forum and debate on 'The Process and Impact of the WHO Intergovernmental Working Group on Public Health, Innovation and Intellectual Property'.

The mandate of the WHO Intergovernmental Working Group (IGWG) on Public Health, Innovation and Intellectual Property is 'to prepare a global strategy and plan of action on essential health research to address conditions affecting developing countries disproportionately'. The resulting global plan of action will be presented to the World Health Assembly mid-2008.

The IGWG process and its outcomes are likely to have considerable implications on the extent to which the issues of public health, innovation and IPRs are being dealt with, both in the multilateral arena and domestically. The current discussions and debates over the IGWG process touch upon a multitude of issues, such as global governance, trade relations, industrial and innovation policies, evidence-based practices and access to medicines, as well as moral and ideological issues.

Join us to discuss these fascinating issues.

Speakers include (in alphabetic order): **Prof. Michael Blakeney**, Director, Queen Mary Intellectual Property Research Institute; **Prof. Anselm Kamperman Sanders**, Director Masters Intellectual Property Law and Knowledge

Management, Maastricht University Faculty of Law; **Mr Douglas Lippoldt**, Groupe d'économie mondiale, Sciences Po and Senior Trade Policy Analyst, Trade Directorate, OECD; **Prof. Gerald Mols**, Rector, Maastricht University; **Dr Meir Perez Pugatch**, Director of Research, Stockholm Network & Senior Lecturer, University of Haifa; **Mr Christoph Spennemann**, Legal Expert Intellectual Property Team Policy Implementation Section, Division on Investment, Technology and Enterprise Development, UNCTAD; **Mr Bart Wijnberg**, Senior Adviser, Department of Pharmaceutical Affairs & Medical Technology, Ministry of Health, Welfare and Sport, The Netherlands., **Dr Lee Feldman**, Chair & Chief Scientific Officer, Scian, The Institute for Scientific Policy Analysis and **Ms Helen Davison**, Senior Researcher, Stockholm Network.

To RSVP, please contact Dr Cristina Palomares, Chief Operating Officer, Stockholm Network.

Email: cristina@stockholm-network.org
T: +44 20 7354 8888, F: +44 20 7359 8888

New Publication

What is wrong with royalties in high technology industries? by **Damien Geradin**

In this paper, Professor Geradin addresses the issue of whether something has gone wrong with royalties in high technology industries. This paper seeks to answer the question by looking at a number of concrete scenarios where firms holding IPRs seek to obtain a return on their patent portfolios by licensing them. The paper shows that the behaviour of these firms essentially depends on whether they are vertically-integrated or non vertically-integrated.

Professor Geradin reviews four different hypothetical scenarios, illustrating common misconceptions and misinformation related to evaluating the royalties that are paid by standard implementers. He also shows that the focus of competition authorities analysing technology licensing agreements should not be so much on

controlling royalty rates, a complex task for which competition authorities are not well suited, but rather on ensuring that vertically-integrated firms do not restrict downstream competition through anti-competitive licensing practices.

<http://www.stockholm-network.org/publications/list.php>

News Flashes

Top Stories in the World of IP and Competition

Combating piracy

British Internet service providers will be required to monitor and punish piracy occurring on their networks or face legal sanctions, according to a new edict from Westminster. Culture secretary Andy Burnham said the deadline of April 2009 sent a "clear signal" of the government's intent to curb piracy. The UK follows in the footsteps of France, where similar legislation was introduced last year, instructing ISPs to cut off Internet services from online pirates.

http://www.ft.com/cms/s/0/26765228-e0c0-11dc-b0d7-0000779fd2ac.html?nclick_check=1

'Software' patents

Confusion continues in British legal circles over the patentability of computer programs. The High Court overturned a decision by the UK Intellectual Property Office to reject a patent application from mobile phone technology firm Symbian. Lawyers hope the case will resolve discrepancies between British and European patenting regulations.

<http://news.bbc.co.uk/2/hi/technology/7307375.stm>

New IP hopes in Russia?...

In his first interview since being elected Russian president, Dmitry Medvedev spoke of his

intention to improve his country's IP environment. Commenting on steps he would take to improve the rule of law, he said, "some of our people don't even think that when they buy pirate records that they are violating someone's intellectual property rights. We need to change the system of thinking, the mindset. In this sense we should try to create a new attitude toward the law in the country."

<http://www.ft.com/cms/s/0/f40629a8-f9ba-11dc-9b7c-000077b07658.html>

The Copyright term in the EU

European Commissioner for the Internal Market Charlie McCreevy announced last month that he would investigate extending copyright protection for recording artists. A proposed term of 95 years would maintain protection for works from the 1950s and 1960s whose protection will otherwise expire in the near future, including still-lucrative recordings from acts such as The Beatles and the Rolling Stones.

http://business.timesonline.co.uk/tol/business/industry_sectors/media/article3372115.ece

Commercial breaks and copyright violation

Sweden's Supreme Court has ruled that the nation's television stations must obtain permission from directors before inserting commercial breaks into their films. The ruling found that the practice violated copyright. While most directors have waived their right to veto advertising, the director who brought the case welcomed the ruling, saying "the decision has been left up to the director whether or not there should be breaks in a film".

<http://news.bbc.co.uk/2/hi/europe/7304096.stm>