

Know IP – The Stockholm Network’s Monthly IPR Journal Volume 3: Issue 6. August 2007

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Commentary

The Patent Reform Act - Divided We Are, United We Stand – Helen Disney and Dr. Meir P. Pugatch ¹

To the policy community, the Stockholm Network included, the power-struggle and heated debate underpinning the US Patent Reform Act of 2007 may be more interesting than the Act's reforms. This is not because the 2007 reforms do not merit a serious discussion – they do, and admittedly much more than the brief overview that follows. But, the debate over the future of the US patent system is fascinating, not least because it involves a deep divide between various knowledge-based industry giants that, by and large, consider the patent system to be an integral part of the US economy and society.

The Reform Act in Brief

July 2007 may be remembered as a historic (or at least significant) milestone in the evolution of the US patent system - the Draft Patent Reform Act of 2007 (originally entitled H.R. 1908) was approved by the House Judiciary Committee (H.R. 1908, 18 July 2007) and the Senate Judiciary Committee (S. 1145, 20 July 2007).²

Everybody seems to agree that, once finalised, the Patent Reform Act will lead to some substantial reforms to the manner in which patents are applied, examined, enforced, and litigated in the US. The new Act will mark the end of the famously isolationist US position (dated 1869) which seeks to grant a patent to the person who proves they were the 'first to invent' the invention. The Patent Reform Act will now align the US system with the rest of the world by establishing that a patent be granted to the person that is 'first to file' an application for that patent.

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

² H.R.1908 was presented to Congress in April 2007:<http://www.patentlyo.com/patent/files/PatentReform2007.HOUSE.pdf>; The S. 1145 Bill: <http://www.patentlyo.com/patent/files/PatentReform2007.SENATE.pdf>

Similar to the EU system, the Patent Reform Act will now create a stringent 'post-grant review proceeding' that would allow third parties to petition for the revocation of the patent after it has been granted.

The Patent Reform Act also clarifies the means by which damages from infringements are calculated, as well as adding new methods for calculating damages.

Last but certainly not least, the Patent Reform Act presents new measures aimed at limiting 'litigation abuses' in patent cases. These include, among other things, establishing new rules concerning the jurisdiction in which patent infringement cases take place, as well as raising the bar on the ability of patent owners to initiate lawsuits.³

The debate

Coming back to the internal power struggle over this Act, past and present IP debates are usually portrayed as a struggle between the owners and users of knowledge. This time the debate over the Patent Reform Act was dominated by the owners of knowledge, who have found themselves fighting each other.

Supporters of the Patent Reform Act grouped under various umbrellas, such as the Coalition of Patent Fairness (<http://www.patentfairness.org>) – a broad coalition of software, hardware, IT and internet companies, such as Apple, Cisco, Dell, Intel, Microsoft, SAP, and many others.

Critics of the Patent Reform Act (or at least some of its components) have also formed their own alliances, such as the Coalition for 21st Century Patent Reform (<http://www.patentsmatter.com>) – which also fields big guns, such as 3M, Dow Chemical Company, DuPont, Motorola, several major pharmaceutical companies, Texas Instruments, and, again, many others.

³ See Cynthia Beverage, Morrison & Forester LLP Patent Reform Act (August 2007), <http://www.venulex.com/articles/tabid/66/docid/6281/Default.aspx>

It would be somewhat irresponsible, as well as simplistic, to divide these groups into black and white categories in terms of their views about the Patent Reform Act. Nor is it easy to capture the common denominator of each group in terms of their technological characteristics. Nevertheless, it is worth highlighting three elements that shed some light on the debate between these US giants.

Views about the need to reform the US patent system

Both sides understand the need for reforming the US patent system. (Very) simply put, there are two views about the issue – one that advocates the need for significant reform and the other that believes that the system requires more balanced, moderate changes.

To illustrate this we can cite the opening statements of the websites of the two groups mentioned above.

The Coalition for Patent Fairness argues that "the current patent system is in need of reform. Over-broad patent grants stifle future innovators, while unjustified lawsuits that aim to extort settlements without regard to the merits of underlying patents clog the courts. Enactment of targeted patent reforms is necessary to ensure the future competitiveness of America."¹

On the other hand, the Coalition for 21st Century Patent Reform argues that "while it may need some revision, the system works... We recognise the need for patent reform and we have identified several steps we feel will lead to responsible actions and treat all business sectors fairly."²

Litigation abuse – both sides are concerned about the same issue but disagree on the solution

Knowledge based industries and companies expressed serious concerns about the future of US innovation and productivity as a result of

either keeping the patent system or reforming it. The damaging effect of 'litigation abuse' in patent cases is perhaps the most painful issue, an issue that was raised by both groups.

Those that support the Patent Reform Act in this current form expressed serious concerns about the abuse of patent litigation under the current system: "Abuse of the patent system results in extremely high costs to consumers and business. Rather than having to fend off these abuses, American companies should be spending time, money and manpower on innovating and growing, creating jobs and delivering more value to consumers and shareholders. Under the current system, American innovation suffers."³

The same concerns were expressed by those who believe that the Patent Reform Act will increase the tendency of litigation abuse rather than minimising it: "These bills would allow an endless loop of legal challenges after patents are awarded that will make it more difficult for U.S. patent holders to prevail against frivolous challenges – often initiated by our foreign competitors. Companies with deep pockets could prevail against such challenges, but not the small manufacturers, universities and tech start ups upon which our innovation leadership depend."⁴

The 'Divide' – same objectives, different business models

Why do companies that share a strong belief in the importance of IPRs, and patents in particular, disagree so fundamentally about the changes needed in the system?

One reason for this is that although all of these companies are in the business of producing knowledge and IPRs, they do not necessarily share the same business model (something that

¹ <http://www.patentfairness.org>

² <http://www.patentmatter.com>

³ Coalition for Patent Fairness. The Case for Reform (2007), http://www.patentfairness.org/CPF_White%20paper%20v3.pdf

⁴ United Steel Workers, (July 2007), http://www.patentmatter.com/issue/pdfs/USW%20to%20Rep's%20Conyers%20Smith_patent%20reform%20073107.pdf

has become particularly visible during the recent decade).

The high-speed, high-tech companies (such as internet based, and software companies) focus on rapid technological developments, expanding market needs, and product diversifications. For these companies can bring a new development and a new product every day. Accordingly they are concerned that patents may be acquired and used by various abusers (often labelled as “patent trolls”) for the sole purpose of 'extortion'.

Blue-chip, manufacturing-oriented companies focus on long-term structured models of product research and development, in which bringing new products to market is a process both lengthy and costly. For these companies patents are the main tool to deter free-riders and copycats from copying their products at almost cost-free price.

Regardless of who is right – the US will prevail once again

History will judge who is right and who is wrong in the current debate.

But what is great about the US is that these debates are taking place in a very open and transparent manner and that, more importantly, they will lead to reforms.

This is hardly the case in the EU, where the discussion about the future of the EU patent system is circular and ineffective at best. Nor is it the case in some developing countries that seem to focus on selective reading and manipulative quotes of some of the US debates as a means to justify their own industrial policy, rather than encouraging their own domestic debate.

Topic of the Month

Cause or Coincidence? Some Empirical Findings on the Link between IP and Innovation – Kristian Niemietz¹

At a first glance, and peculiarly, arguments both for and against intellectual property rights can sound intuitively convincing. The theoretical case for protecting knowledge-creations from imitation is clear: Nobody would till a field if he expected his neighbours to reap the harvest. Why should the incentive structure be different when it comes to the production of intangible goods?

But there are differences between physical and intellectual property. Whether or not somebody is trespassing on somebody else's estate can be found out relatively easily. Whether or not an invention borrows from another one, or is to be considered as an invention in its own right, is seldom as obvious as this. While borders around property in, say, land, are clear-cut and observable, the same is not true for borders in the idea space. Therefore, some have argued that in a system of IPRs inventors must constantly ensure their ideas do not violate ideas already reserved by others. Critics of IPRs have likened them to a minefield, in which every step holds the danger of a costly patent suit. IPRs would therefore not stimulate innovation but stifle it, by imposing large costs on potential innovators.

Where theory gives ambiguous answers, because both innovation-enhancing and innovation-hindering effects exist, empirical studies can help in assessing which of these effects are stronger. The Rapp-Rozek-Index, the first statistical measure of IPR-strength for cross-country comparison, revealed a close correlation between IPR-strength and economic development² (and obviously, developed

¹ Kristian Niemietz, Research Officer, Stockholm Network

² Pugatch, Meir P.: “Measuring the Strength of National Pharmaceutical Intellectual Property Regimes: Creating a New Pharmaceutical IP Index” p. 367-368

economies produce more innovation). But correlation alone says nothing about causality. Developed countries tend to have more sophisticated legal systems in general, IPRs being only one of multiple layers.

So it could well be that strongly defined IPRs are simply a companion phenomenon of economic development, not a causal factor. There could even be a reverse causality: When knowledge-based industries emerge, their actors acquire the ability to voice their economic interests and push legislation in their favour. In other words, perhaps it is the growth of knowledge-based industries that causes the protection of IPRs, not IPRs that cause the growth of knowledge-based industries.

In an econometric panel data study, Sunil Kanwar tries to adjust for these two error sources. The author measures the link between innovation and IPR, but corrects for other factors associated with innovation, such as general economic conditions, human capital, domestic capital funds and the cost of borrowing. As these are abstract concepts, Kanwar expresses ‘innovation’ as the share of R&D-expenditure in GDP, ‘IPR’ as the Ginarte-Park-Index of patent protection¹, ‘economic conditions’ as the growth in GDP per capita, ‘human capital’ as the average number of schooling years, ‘domestic funds’ as last year’s savings rate, and the ‘cost of borrowing’ as the real interest rate. To correct for a potential reverse causality, Kanwar adjusts for the dependency of IPRs on the level of economic development, human capital, a governments’ ability to protect IPR, the institutional climate, and the openness of the economy to trade. Again, this involves abstract concepts. The author approximates ‘economic development’ by GDP per capita, ‘government’s strength’ by the weight of tax revenue, the ‘overall climate’ by the Fraser Institute’s Index of Economic Freedom, and ‘openness’ by the difference between the official

forthcoming in *The Journal of World Intellectual Property* Vol. 9 No. 4 (2006); pp. 373-391

¹ The Ginarte-Park-Index is the most commonly used index for the strength of IP-regimes. It only includes patent protection, but it is assumed that countries with a defective patent protection are highly unlikely to simultaneously exercise a rigorous protection of other types of IP, such as copyright.

and the black market exchange rate. Having thus accounted for sources of biases, Kanwar estimates the impact of IPR for a data set comprising 44 countries and 20 years (1981-2000). He finds a strong positive impact of IPR-strength on R&D-investment.²

It might be objected that even if such a relationship exists, it merely describes an average for a large sample of countries. An overall positive average could conceal large losses to individual countries within a sample. Indeed, this is the point made by critics such as Carlos Correa and Frederick Abbott. According to them, developed countries depend on innovation and therefore benefit from IPRs. Developing countries, in turn, depend on imitation. They should therefore introduce IPRs only very gradually³. But there are factors pointing in the opposite direction. Without reasonable protection of their IP, technology-intensive companies could be reluctant to invest in or trade with a specific country. Therefore, the flow of technology and the subsequent sharing of knowledge between developed and developing countries could be impeded, resulting in a widening of the technological gap.

Just as above, where the theoretical debate is ambiguous, empirics may be useful. Andreean Leger (2006) has conducted a study similar to the above, but with a separate estimation including developing countries only. The author estimates the connection between innovation and IPR, and corrects for other main determinants of innovation such as market demand, past innovative activities, economic conditions, political stability, human capital, financial capital and openness to trade. Most of these abstract concepts are measured in a similar manner to Kanwar’s study. ‘Past innovative activities’ are approximated by last year’s R&D-investment, ‘political stability’ describes a distinction between countries with and without a coup d’état in a specific year and a measure for ‘openness to trade’ is derived from the Penn World Tables.

² Kanwar, Sunil: “Innovation and Intellectual Property Rights”; Working Paper No. 142 of the Center for Development Economics; Department of Economics, University of Delhi (2007)

³ Correa, Carlos et al: “EU in danger of breaking its promise to the poor”; Financial Times, May 24th 2007

Comprising observations from 36 developing countries and 26 years (1970-1995), a strong positive impact of IPR on innovation can be observed¹.

Leger's study confirms the intuition that IPRs encourage the transmission of technology to developing countries and thereby boost innovation there. It does not, however, show in which precise way this impact is exerted. Technological knowledge from outside can infiltrate an economy via three channels: Foreign technology-intensive companies can export to that economy, set up production facilities there, or sell the right to employ a protected technology to a local company.

Douglas Lippoldt and Walter Park have attempted to assess the effect of IPRs on all three channels, also disaggregating countries according to economic development. They find that the impact of IPR on FDI is stronger in the subgroup of the developing countries than in the sample as a whole, and greatest in the sub-subgroup of the LDCs. Of course, there are large variations between economic sectors. Some sectors are more IP-intensive than others, and some are more able than others to rely on self-help measures such as trade secrets. But other things being equal, FDI is the main channel by which IPRs exert their impact on innovation in developing countries.²

To summarise, an adequate system of IPRs may not be the single most influential factor for economic growth, but there is reasonable empirical evidence that the gains from IPRs more than outweigh the costs. That is true both in high- and low-income nations. In the latter, the most important channel via which IP affects

innovation is FDI.³ Econometric models are always subject to rough simplifications and can legitimately be criticised. But it should be up to the opponents of IPRs to prove their cause using a more fine-tuned model. Emotional arguments may be fashionable but they provide little help for economic development.

Views

The real threat to European R&D – Alec van Gelder⁴

These days, almost everybody understands how important science and technology can be for economic growth. So when the European Commission (EUC) produces a report on innovation that paints a portrait of declining levels of research and development (R&D) in Europe, policymakers will take notice.⁵

Yet if they follow the report's conclusions, things in Europe could get even worse.

R&D activity is increasingly taking place outside of its traditional home in America and Europe, and is playing an ever increasing role in the global economy. As economic growth lifts people from poverty to prosperity, particularly in Asia, the changing international division of labour is creating more demand for high-skill jobs.

But R&D in Europe is not in decline because of the pressures of globalisation and increased competition. Greater levels of research conducted in China or South Korea do not mean that there is less demand for it in other parts of

¹ Leger, Andreeanne: "Intellectual Property Rights and Innovation in Developing Countries: Evidence from Panel Data"; Verein für Socialpolitik, Research Committee Development Economics (2006)

² Lippoldt, Douglas: "Can stronger Intellectual Property Rights Boost Trade, Foreign Direct Investment and Licensing in Developing Countries?" forthcoming in Pugatch, Meir P. (Ed.): "The Intellectual Property Debate – Perspectives from Law, Economics and Political Economy" pp. 44-61; Edward Elgar Publishing, UK (2006)

³ An interesting question for further research could be the assessment of possible complementary effects. When other influential factors of economic development are improved simultaneously with IP-protection, is the combined effect of these improvements greater than the sum of the individual effects?

⁴ Alec van Gelder, Research Fellow, International Policy Network

⁵ "Key Figures 2007 on Science, Technology and Innovation; toward a European Knowledge Area", European Commission, 11 June 2007.

the world. Europe still possesses a large and well-educated workforce and highly developed infrastructure. However, Europe's declining share of R & D is a direct result of the EUC's failure to take advantage of these assets, combined with a policy mindset that actively discourages innovative activity.

The EUC's relentless pursuit of Microsoft has been well documented on these pages. While some may dismiss the importance of the case, given the software giant's market position, it has consequences that reach far beyond Microsoft and the interoperability of a scaled-down Windows. In fact, the case is more widely demonstrative of the EUC's lack of respect for private property – one of the most important safeguards of liberty, prosperity and innovation. The EUC's goal of forcing the company to license the source code behind Windows to its competitors (on terms the Commission must first approve) would be described as theft, if it weren't perpetrated by a government

A more recent and equally disturbing example is Apple, whose alleged sin is that its online music store, iTunes, sells only to owners of Apple iPod products and that this music is protected by digital rights management (DRM) encryption. iTunes is now the world's most popular online music store. So the EUC and various European governments are seeking to remove DRM from iTunes, thereby allowing competing media players to play iTunes tracks.

The fundamental messages these cases send to entrepreneurs is that too much success and innovation is a bad thing. This kind of populist policy and erosion of property rights frightens and undermines entrepreneurs, who may consider other countries to be more hospitable to their efforts. Emerging economies have taught us that good ideas can emerge from anywhere but sustaining R&D over time requires that these good ideas be exploited and commercialised on a level playing field.

Rather than simplifying and clarifying the protection of property by, for instance, harmonising European patent policies, reducing the costs of filing or litigation, or approving a

single language patent, Europe appears to be moving in the opposite direction.

The legality of DRM in the US has been clear since at least 1998 with the Digital Millennium Copyright Act. There, creators are free to explore the possibilities of digital protection for their property. The results have been astounding both for the industry and the consumer, as an elaborate and legal market in digital music has evolved considerably over the past five years.

It is perhaps no coincidence that the US has been the leader in this innovative field. In Europe, with weakening property protection for software or music, it is the pirates – who account for up to 65% of music downloads in some EU countries – who prosper.

Little wonder, then, that creators and innovators who have so much to offer to Europe's economic and cultural landscape seem to be venturing elsewhere to succeed. Disguised in Europe's small decline in overall R&D spending (1.95% of GDP in 2002 to 1.91% of GDP in 2005) is the glaring fact that US firms decreased R&D spending in Europe over the same time period from €51 billion in 2002 to just €17 billion in 2005.

The EUC's solution to these problems is to push governments to spend more in order to meet R&D targets set in 2002 – that each European country should spend 3% of its GDP on R&D. The Commission boasts that 38% of the publications appearing in scientific journals are from European researchers. But less and less of this research is actually being turned into useful products. Public spending may improve figures for publications, but this is not as productive an investment as it could be – nor is it sustainable.

More than likely, increased public spending will further undermine markets in R&D, resulting in even less innovation. Public funding for nanotechnology was by far the highest in Europe, but foreign firms – having attracted private funding demanding high returns – are proving most successful in this area. In 2003, US firms registered 1200 nanotech patents as compared to just 400 in Europe – and the gap is widening.

Politicians bemoan the fact that Europe has no equivalent to America's Google or Yahoo!. Yet the route to a successful high-technology industry is not targets, bureaucracy and public cash. Silicon Valley did not emerge because the state of California went on a spending spree. It grew and continues to thrive today because good ideas are welcome and entrepreneurs had strong incentives to build upon them – free from government meddling.

Europe's politicians must learn to stop interfering if technology and innovation are to flourish.

Book Review

Le Droit Français de la Concurrence (French Competition Law) by Aurelien Condomines – Dr Meir P. Pugatch

Except for merger control, French competition law is based on an *ex ante* control of prohibited practices by both traditional courts and a specialised authority, the Competition Council ('*Conseil de la concurrence*'). French competition law is very responsive to the evolution of economic theory, which is increasingly causing competition authorities to assess matters that are referred to them on a case by case basis.

This is why the approach chosen by Condomines is based on the most up-to-date case law. Throughout the book, most recent decisions of the Competition Council and of French courts are discussed and described. Most types of prohibited behaviour are addressed, with the objective of providing concrete answers to questions that arise frequently in practice. Hence, this approach will be particularly useful to practitioners, lawyers and in-house counsel.

The author begins his book by describing conduct prohibited by French competition law in three distinct chapters: anti-competitive agreements, abuses of a dominant market position and abuses of economic dependency. Through an analysis and description of case matters, he exposes the method used by the French Competition Council to assess and prosecute anti-competitive behaviour. The influence of the EC law and, in

particular, of block exemption regulations on French competition law is analysed throughout these chapters.

The fifth chapter focuses on the circumstances in which anti-competitive practices may benefit from an individual exemption from prohibition, in particular when their contribution to economic progress outweighs their negative impact on competition.

The final chapter is devoted to the procedure applied before the French Competition Council and to the growing development of private litigation before French courts in the field of antitrust law.

New and Notable

Stockholm Network Expert's Series on IPRs and Competition - A Statistical Analysis of the Gowers Review – Simon Moore

In December 2005, then UK Chancellor of the Exchequer, Gordon Brown, commissioned an independent review of the UK's intellectual property framework. In December of 2006, the former editor of the *Financial Times*, Andrew Gowers published his findings. In the seven months since the report was published, its recommendations have begun to be implemented by the British government.

Between February and April of 2006, the review process initiated a call for evidence, to which there were over 500 total responses, over 250 of which were organisational responses. It is these organisational responses which form the basis of our study.

In the call for evidence, Gowers stated that submitted evidence would "form a key part of the evidence base that the Review team can use to develop its analysis... alongside a range of other evidence sources, including quantitative data; surveys and views of representative groups; visits; seminars; and interviews". The question is, how much attention did Gowers pay to the

evidence he requested? Did his findings address the concerns of the UK IP community? Or was the call simply for show, with the results already set in stone?

Our analysis has shown that, by and large, the viewpoint of the Gowers Review is aligned with the submissions that were made to it. While some divergence of interest is to be expected, on almost all the significant matters, Gowers' decision equates with the prevailing opinion among the submissions.

Other findings included:

- A meagre 6.7% of submissions provided significant statistical data. Bearing this in mind, is agreeing with a majority viewpoint sufficient justification for adopting a recommendation, when that majority viewpoint lacks the evidence to back it up?
- There was very little dispute as to the need for some kind of IP system. Indeed, only six submissions were categorised as being anti-IP, and five of these concentrated principally or solely on the issues of digital rights management (DRM) and open-source software
- Fair dealing and exceptions to IP rights, were the most discussed topics, appearing in 40% of all submissions. Those areas are, the submissions suggest, the least clearly defined areas of IP policy.

With any investigation, the evidence is the largest determinant of success. However, when the quality of the evidence varies to the degree it did in the Gowers submissions, assessing the balance of quality and quantity is a highly precarious task. Gowers tended to align his findings with those of the majority of submissions, but not necessarily the weight of submissions backed up by economic or statistical analysis. Whether this approach is reasonable or rational is a matter of personal preference. But without recognising the discrepancy between quantity and quality, any future policy reviews are likely to suffer the same problems.

News Flashes

Top Stories in the World of IP and Competition

1) In a landmark case in India, Chennai high court has upheld national patent law which denies patentability to incremental improvements in medication. A case was brought by Swiss pharmaceutical manufacturer Novartis, maintaining that the law, which blocked an application for a patent for leukaemia treatment Glivec, was unlawful and in breach of WTO regulations. While deferring to the WTO over legal issues on that side of the dispute, the presiding judge dismissed Novartis' challenge, effectively clearing the way for generic competitors.

<http://business.guardian.co.uk/story/0,,2143067,00.html>

2) The record patent infringement settlement we reported on a few months ago, where Microsoft was fined US\$1.53bn for using the MP3 music file format without permission of MP3 group partner Alcatel-Lucent, has been overturned on appeal. Citing an existing license agreement Microsoft has with the other member of the MP3 ownership group, the Fraunhofer Institute, Judge Rudi Brewster overturned the original verdict, on the basis that, under US law, co-owners are obliged to sue jointly in infringement cases.

<http://www.ft.com/cms/s/c0f37fdc-4477-11dc-90ca-0000779fd2ac.html>

3) BMR's 4th annual Digital Music Survey has found piracy rates to be increasing, after a year of modest improvement in 2006. 43% (compared with 36% in 2006) admitted to having downloaded tracks illegally, while 18% (up from 8%) said they intended to do so again. The report claimed price structures were the principal cause of these regressions, but the music companies blamed the government and Internet service providers for failing to quell the tide. The survey also found that of the people who knew what

DRM was, 61% thought it invaded their rights and was thus a bad thing.

<http://business.guardian.co.uk/story/0,,2137465,00.html?gusrc=rss&feed=technology>

http://www.entertainmentmediaresearch.com/reports/EMR_Digital_Music_Survey2007.pdf

4) A lawsuit claiming Facebook's inventor stole code from friends while at Harvard has been postponed. Judge Douglas Woodlock gave the plaintiffs until 8 August to flesh out the evidence supporting their case or face its dismissal. Meanwhile, Facebook has again withdrawn applications supporting music uploading, after discovering it to be in breach of the Digital Millennium Copyright Act.

<http://www.businessweek.com/ap/financialnews/D8QJSIG01.htm>

<http://www.allheadlinenews.com/articles/7008075789v>

5) A distorted form of Harry Potter mania was evident in China this month as fans released pirated copies and unofficial translations of the latest and last in the series onto the Internet. While far from the first time this has happened, the release, some 10 days before the global launch, refocused the international spotlight on China's appalling intellectual property record.

<http://www.iht.com/articles/2007/07/31/news/china.php>
