

A MULTIFUNCTIONAL FRAMEWORK TO ADDRESS THE GRAY MARKET THREAT

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ABSTRACT

Gray market activity is the result of the sale of branded goods through unauthorized channels. The gray market activity reduces profits for authorized distribution channels, damages brand image and reputation, and creates conflicts among partners in supply chains. In many industries, the gray market activity is causing billions of dollars of lost revenue to manufacturers. Unfortunately, not many firms are well equipped to address the gray market threat. In this paper, we present a framework, which constitutes business, marketing, legal, and information systems related approaches to address the gray market threat.

INTRODUCTION

Gray markets emerge when genuine and sought after goods are sold or resold through unauthorized distribution channels. For example, when iPhone 4G was released in the USA, some Apple fans in Hong Kong could not wait for the official launching of iPhone 4G, and a few of them spent in excess of \$ 3,000 to buy a gray market iPhone 4G [10]. Unfortunately, gray market goods are not limited to cell phones; a number of tangible and intangible products such as automobiles, heavy construction equipment, watches, cosmetics, prescription drugs, software, broadcast signals, etc. suffer from the gray market activity [4]. The gray market activity in information technology (IT) industry alone is estimated to be \$ 58 billion, with IT firms suffering losses in profits up to \$ 10 billion [1].

But how do gray markets emerge? Firms sell their products to end customers either directly or through a network of authorized partners. Typically, the authorized channel members are provided with substantial discounts as incentives to make profits on the sale of the goods, but are also restricted by agreements to sell the goods only to genuine end customers. However, when authorized channel members sell the branded goods to *unauthorized* dealers, gray market goods emerge. But how do unauthorized dealers make profit? These dealers typically purchase branded goods at a discount from authorized sellers and sell them at a price lower than the prevailing market price and make profits in the process.

Recently, Hewlett and Packard (HP) alleged Maxicom PC Inc., one of its own authorized channel members, of selling the PC equipment to unauthorized dealers, and reached a settlement to recover more than \$4 million offered as pricing discounts [9]. The difference in prices of the same product in different countries is also a strong incentive for the emergence of gray market activity. In these cases, an unauthorized distributor in country A, where the prices are higher can simply import the products from country B, where the prices are lower, and if the costs of the arbitrage are lower, can make a profit in country A by selling the products at a cheaper rate. For instance, Omega, a Swiss-based watch manufacturing firm is currently fighting Costco on a copyright infringement case [11]. Omega sells its Swiss-manufactured watches through a global distribution chain. Recognizing that Omega watches are sold at cheaper rates in some countries compared to their US prices, some unknown intermediary

purchased the watches and sold them to a New York based company, which in turn imported the watches and sold them to Costco. Neither the New York based company nor Costco was authorized by Omega to sell the watches. Omega alleges that Costco sold the watches for \$ 1,299, well below the Omega's US retail price of \$ 1,999 [13].

If gray market activity is not efficiently countered, firms face threatening consequences. Gray market sales, on many occasions, dominate the authorized sales. For instance, the sales of gray market personal computers (PC) in India outnumber the authorized PC sales by two to one [4]. Because a number of gray market goods originally intended for high-end customers appear on low-end stores, the brand reputation suffers. Also, because the gray marketers rarely offer the kind of warranties offered by the authorized dealers, customers face problems with service requests. Overall, gray market activity is proving to be a grave threat to the bottom lines of many multinational companies and a number of these companies are not yet ready to face the threat.

Previous research in countering the gray market threat presented options available to firms through individual business functions such as marketing [4] [5] and law [8] [12]. To the best of our knowledge, this work represents the first attempt to prescribe a framework to counter the gray market threat using four individual business functions: business, marketing, information systems, and legal. We believe that each of these functional areas presents effective options to address the gray market threat and it is up to the individual firms to select a set of options best suited to address their case of gray market goods. In the next section we present the framework.

A MULTIFUNCTIONAL FRAMEWORK TO ADDRESS THE GRAY MARKET THREAT

This section discusses a multifunctional framework to address the gray market threat (see Figure 1). The conceptualization of the framework is based on the idea that an effective strategy to counter the gray market threat requires a combination of four approaches: business, marketing, information systems, and legal. A business approach represents a set of options available to the top management, where as marketing, information systems, and legal approaches represent options available to individual business functions within a firm. While an effective strategy might require the integration of many approaches, we also recognize that firms vary in terms of the resources that they can allocate to address the gray market threat, and therefore are advised to select a suitable approach that best equips them to limit the incidences of gray market activity.

Business Approach

Business approach requires the top management to set a strategic plan to counter the gray market threat. This plan should elaborate policies and action plans to determine the options available to proactively counter the gray market threat. We recommend four options as part of the business approach: establishing compliance policies, conducting proactive check on prospective channel members, performing periodic audits of channel members, and training employees.

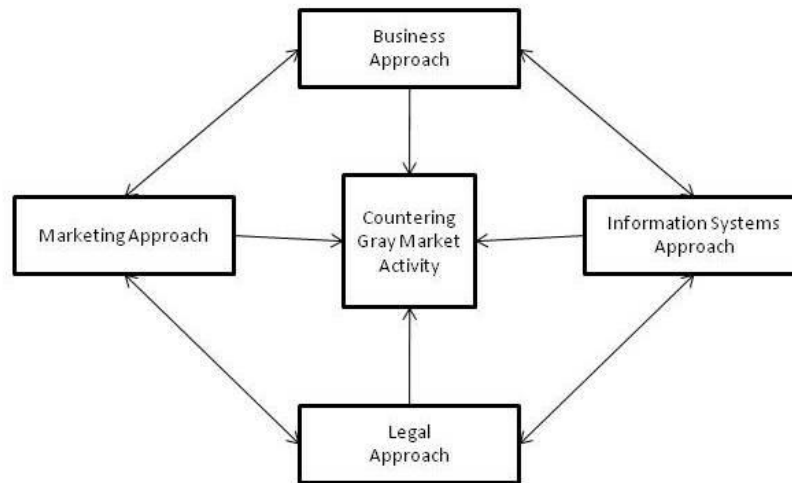


Figure1. A Multifunctional Framework to Address the Gray Market Threat

The top management should establish a compliance policy, which should elaborate acceptable behaviors for channel members concerning resale restrictions and penalties that accompany any violations. However, having a compliance policy alone is insufficient. The top management should provide a clear signal to the channel members that the enforcement of the compliance policy will be certain, swift, and severe in the case of a violation [3] [6]. For instance, both HP [9] and Cisco [15] provide extensive information about their intent to curb gray market activities on their websites; thus, discourage any potential gray market activity by signaling their commitment.

Another proactive option to limit the incidence of gray market activity is to perform a check on prospective channel members [1]. Conducting check involves ascertaining if a prospective channel member is a legal entity not involved in any criminal and civil cases. This option requires firms to conduct due diligence with an intent to only attract partners with clean records, which is likely to minimize the incidence of gray market activities.

Detecting gray market activity is a difficult task and one of the important resources in detecting gray market goods is employees. The employees who are most likely to detect gray market goods work in sales and distribution channel management and customer service [1]. The top management should identify these employees, train them concerning reseller agreements and compliance policies, and incentivize them to identify any gray market activity. Another way to detect gray market activity is through unannounced periodic audits of channel members. Audits also provide a means to incentivize compliant channel members and punish violators.

Marketing Approach

As price differences in branded goods across different nations act as incentives for the emergence of gray market activity, a multinational firm can engage in “price coordination” to minimize gray market activity. Assumus and Weiss (1995) discuss four options to coordinate prices. These options are: economic measures, centralization, formalization, and information coordination.

Through “economic measures,” the multinational firm can impose a “tax” on the branded product sold to a low-priced country, which is suspected of exporting the products to a high-priced country. The second option concerns “centralization” of price setting. Most multinational firms let the country managers set prices. However, if such decentralized price setting strategy results in gray market activity, then firms can adopt a “centralized” pricing approach, in which the headquarters directs country managers to set a specific price. Using “formalization,” the headquarters may prescribe a price setting process for country managers. For instance, the headquarters may find a lead nation – a nation most important in terms of profits and sales, and may direct the remaining country managers to set the same price. Finally, “informal coordination” makes price information transparent to the country managers and allows them to set prices in a way that is expected to reduce the gray market activity. The selection of a price coordination option depends on the availability of local resources and environmental complexity [5]. Overall, multinational firms can employ price coordination as a control mechanism to curb gray market activity.

Information Systems (IS) approach

Often times, gray market goods get diverted because firms do not track the flow of goods from manufacturing facility to point of sale location. This is an area where information systems can be very effective. Through the use of RFID, product serial number tracking systems, and web-based agents, information systems can help detect the gray market activity including the sellers of gray market goods in some cases.

RFID (Radio frequency identification) helps wirelessly track and identify an RFID tag attached to an object. An RFID reader presents advancement over simple barcode readers in that it can remotely read and write data to the RFID tag. RFID technology is used by a number of multinational firms to manage their inventory efficiently and to reduce inventory costs [7]. RFID technology has shown to be effective in tracking products through the distribution channel. For an instance, G&P Net, an Italian clothing company used RFID technology to track its inventory and also to identify the source of their gray market sales [14]. By creating a system that connected the RFID tag on each product with the orders from channel members, G&P Net was able to successfully determine the sellers of their gray market goods.

Another way to track the flow of goods is to employ product serial number tracking systems. The serial numbers if tied with order numbers can not only help the firms identify the source of gray market sales, but can also help consumers look up the warranty information on the Internet. But the key idea is to create an effective serial number system, which for instance, can allocate different serial numbers to goods produced in different countries, or unique serial numbers to subcomponents in such goods [2].

A number of gray market products are known to be sold on popular websites such as EBay and Amazon, although these websites take extensive care in protecting the intellectual property rights of firms. One way to detect websites that sell gray market goods is to employ web-based agents, which are software programs that uncover unauthorized websites. These agents work by comparing the URLs of websites selling the branded products with the URLs of authorized websites, and in the process identify and report the unauthorized websites [4].

Legal approach

In cases in which firms detect the seller of gray market goods and intend to sue them, they can use trademark law. The application of trademark law uses first sale doctrine, which rules that upon the first authorized sale of a product within a region, the owner of the copyright loses all rights to further control the product within that region. Though some countries apply the first sale doctrine within the borders of their country, the United States largely applies first sale doctrine to worldwide sales. According to the US first sale doctrine, once the branded item is sold anywhere in the world, the trademark owner loses all the rights to further control the product, meaning that the brand owner cannot stop the import of gray market products into the US market for resale. However, if a firm manufactures a product for a country other than the US, and after it is sold in that country, the trademark owner can stop the import of such product in to the US market for resale as long as such product is “materially different” than the product marketed in the US [12].

On the Use of Framework

In the preceding discussion, we presented a multi-functional framework to address the threat of gray markets. We believe that these approaches are neither mutually exclusive nor collectively exhaustive. Rather, these approaches present firms with tools, if effectively applied by individual business functions, help limit the incidences of gray market activities. Though all the approaches are effective, we particularly believe that the business approach should be the one to execute first. Initiated by the top management, business approach presents a set of proactive options, if executed well, sets an environment for effective implementation of other approaches. For instance, if the top management sets an enforceable compliance policy, checks prospective distribution channel members, trains employees, and conducts unannounced periodic audits; such steps are likely to minimize the incidence of gray markets. In the event of any gray market activity, price coordination or the use of information systems can work effectively to detect or curb the gray market activity. Legal means can be used to thwart gray market activities and send a signal to the unethical distribution channel members and unauthorized dealers to refrain from the gray market activities.

CONCLUSION

Multinational firms are concerned about the threats posed by the gray market activity for a long time. However, the advent of Internet has opened new avenues for the gray market activity to thrive and expand. Bothered by the extent of losses due to gray market activities, Motorola, HP, DuPont, and 3M employ full-time managers and staff to address the gray market threat [4]. In addition, a non-profit strategic alliance known as AGMA (The Alliance for Gray Market and Counterfeit Abatement) has been initiated by a collaboration of high-tech companies to address the gray market threat. As the gray market activity expands and thrives, so should be the ways to address the gray market threat. Firms can no longer just rely on marketing or legal departments to address the gray market threat; they require an integrated approach from business, marketing, information systems, and legal departments to fight it. By proposing a multi-functional framework, we hope that firms realize that they have access to new tools (more functional approaches including the use of technology) to solve an old problem.

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