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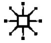

Confronting the Gray Market Problem

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Gray markets involve the sales of legitimate products by way of channels of distribution that are not authorized by the brand owners. Gray markets may benefit consumers and even brand owners under certain circumstances. On balance, however, gray markets are detrimental to brand owners because gray market traders access genuine product in both physical and virtual markets and reap profits stemming from the resale of goods owing to price differentiation between markets, thus depriving brand owners of those profits. In this study, we discuss the principal factors that encourage a gray market and the legal underpinnings that permit gray markets in the United States. We then summarize managerial tactics—both reactive and proactive—to combat gray markets.
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A gray market, as the term will be used in this paper, is the trade of goods or services through distribution channels that are legal but unofficial, unauthorized, or unintended by the original provider.[1] Gray markets are not counterfeits—the products are legitimate and involve the sales of trademarked products by way of channels of distribution that are not authorized by the brand holders [Duhan and Sheffet 1988]. The International Trademark Association [INTA 2014] clarifies this distinction for international trade:

> Parallel imports (also known as gray market goods) refers to genuine branded goods that are imported into a market and sold there without the consent of the owner of the trademark.[2] The goods are "genuine" goods (as distinct from counterfeit goods) in that they have been manufactured by or for or under license from the brand owner. However, they may have been formulated or packaged for a particular jurisdiction, but then imported into a jurisdiction other than that intended by the brand owner.

The trade represents a goods arbitrage situation where a gray marketer takes advantage of price discrimination both within a domestic market and across country markets to make a profit from buying and reselling the genuine product [Inman 1993].

In this paper, the problem of a gray market is addressed in the context of a trademark owner's perspective in situations where the firm negatively reacts to the trade and limits the distribution of its goods through unauthorized channels. At first glance, one could question whether the gray market is really a problem for the firm as the trade involves legitimate product—the firm is still selling its goods. In fact, the parallel trader may actually be opening untapped markets for the firm. Thus, we must first acknowledge conditions where a gray market may be beneficial for the company and/or the consumer. The focus of the paper, however, is on the effects on brand owners.

1. Beneficial Effects of Gray Markets for Brand Owners

The gray market can boost incremental sales of the firm, such as serving markets not in direct competition with its authorized dealers, providing access to products in a market with supply shortages, and allowing firms to assess market segmentation information [Anita

[1] There are also gray markets in securities, but these are not addressed in this paper.

[2] In this paper, the terms "gray market" and "parallel trade" are synonyms to describe the unauthorized sale of goods *across* and *within* markets.

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and others 2004; Xiao, Palckar, and Liu 2011]. The resale of luxury cars from the United States to China has provided a lucrative goods arbitrage situation for gray marketers like Automotive Consultants of Hollywood to serve the insatiable demand of Chinese consumers for Mercedes, BMW, and Range Rover vehicles [Goldstein 2014]. In 2009, Unilever faced a gray market situation in Jordan, Syria, and Lebanon—an estimated $4 million in unauthorized sales in this region. The firm decided to launch its Clear shampoo with media on the pan-Arab satellite networks to build a brand awareness of this new product in the region—even in markets like Jordan that were not part of the company's official channel of distribution. The managers at Unilever used the gray market sales of Clear to actually better understand the market, such as where the product was sold and the type of consumer purchasing the shampoo in order to *officially* launch the product one year later in Jordan [Mahajan 2012, p. 20].

The gray market can stimulate competition and benefit the consumer—the purchaser receives a lower-priced good and this benefits consumer welfare [Nolan-Haley 1983, p. 233]. In 2013, Pompei, a well-known gray marketer in the Hong Kong retail market, started selling its product online through Alibaba's TMall (formerly Taobao Mall), a Chinese-language website [http://www.tmall.com/]. Pompei Chairman Vincent Wong reported that their virtual sales of gray goods have increased around 20 percent each month at the TMall site [Chiu and Chu 2014]. Another gray marketer, Zhenpin.com, sources from distributors in Europe, such as Prada and Gucci, and resells the product in China at a 10–20 percent discount less than authorized retailers in China [Chiu and Chu 2014].

2. Adverse Effects of Gray Markets on Brand Owners

From a brand owners' perspective, adverse situations stemming from a gray market include problems related to upholding their brand reputation with consumers and maintaining a sound relationship with the firm's authorized distribution channel. For example, brand dilution can be a problem if the gray market resellers cannot provide after-sales service, warranty support, and/or replacement parts [Nakra 2006]. John Deere, at its company website, warns potential consumers of a gray market or "migrated" machine that, "Product warranty is tied to the specific region where a machine was originally marketed, and does not follow the unit if it migrates from one area to another" [John Deere n.d.]. Nikon, the Japanese camera manufacturer, used its "Peace of Mind" campaign targeted at consumers to stress the value of buying through a legitimate supply chain and even rewarded its consumers with an extended warranty for this type of compliance [Simpson 2012].

In addition to problems stemming from inability to support products sold in gray markets, another problem stems from the type of product information (repackaging) that occurs in the resale of the good, which can affect the consumers' perception of the branded product [Chaudhry and Walsh 1995]. Pharmaceutical firms have consistently questioned the legality of the poor quality presentation of repackaged gray market drugs sold in the European Union [Bird and Chaudhry 2010].

Finally, brand owners may seek to enhance profits by price discrimination between different markets where they control distribution channels. The arbitrage function of gray markets may thus have a direct, adverse impact on their earnings.

3. Confronting the Gray Market Problem for Brand Owners

The Alliance for Gray Market and Counterfeit Abatement (AGMA) claims that high-tech companies can lose approximately $1.4 billion in profits each year owing to gray markets [AGMA and Deloitte 2011]. The market fragmentation of the pharmaceutical market in Europe owing to very distinct national drug pricing schemes continues to create a lucrative market for gray marketers to "buy low–sell high" owing to distinct nationally regulated prices. Other illustrations of price discrepancies are widely reported in studies on the gray market for information technology products. For example, Gudigantala and Bicen [2011] report that authorized sellers lose billions of dollars to gray marketers involved in selling software, toner cartridges, processors, computer equipment, and network equipment.

The European Federation of Pharmaceutical Industries and Associations [2013] continues to warn that the gray market erodes the pharmaceutical firms of their innovation reward and depletes funding for future research and development. It estimates the value of the gray market in Europe at €5,000 million (ex-factory prices).

There are gray markets in all sectors ranging from tangible products (electronic components, heavy construction machinery) to intangibles (broadcast signals); and from ordinary consumer products (shampoo, light bulbs) to critical health care goods (pharmaceuticals, pacemakers). The three main contributions advanced of this paper involve: (1) a discussion of principal factors that encourage a gray market; (2) a brief

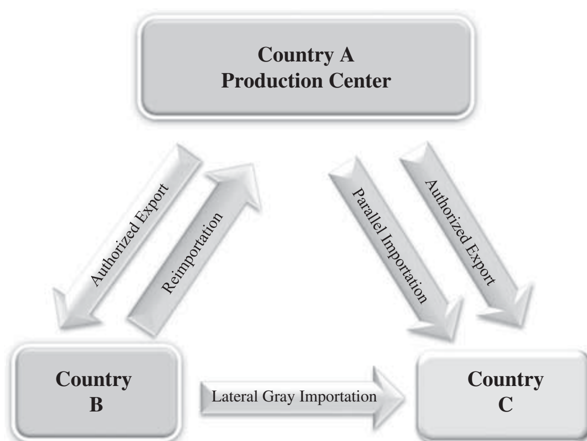
overview of the legal implications of gray markets; and (3) a brief discussion of an array of managerial tactics; both reactive and proactive, to combat gray markets.

4. Conditions for the Existence of Gray Markets

Overall, gray markets evolve with three underlying conditions: the gray marketers must be able to access goods in the distribution channel, the barriers to trade between country markets must be low enough to allow the traders to easily move products; and the price variation must be high enough to provide a profit incentive [Duhan and Sheffet 1988]. Figure 1 illustrates the types of trade diversion that occurs via a gray market [Assmus and Wiese 1995]. Assmus and Wiese define the three types of gray markets in foreign trade illustrated in Figure 1 as follows:

1. *Parallel Importation*. If a product is priced lower in the home market than in the foreign market, and if the cost of arbitrage is less than the price difference, a gray marketer can take advantage of the price difference by parallel importation from the country of production to the export market.
2. *Reimportation*. If a product in the foreign market is cheaper than in the home market, and if the cost of arbitrage is less than the price difference, then reimportation from the foreign market is profitable for a gray marketer.
3. *Lateral Importation*. If there are price differences between two countries, and the product is not produced in either one, the product imported by one country is exported to the other through unauthorized channels.

Figure 1. Gray Market Model



Source: Adapted from Assmus and Wiese [1995, p. 32]

AGMA [2014] reports that the most common sources of gray market activity result from the following situations in distribution channels:

1. *Overdiscounted buys*: Partners or customers purchase a large number of products when in fact they need a smaller quantity of products in order to achieve volume discounts. They then resell the extra products without the consent of the vendor.
2. *Differences in purchasing power*: Products sold in developing markets are often sold at lower price levels owing to low purchasing power on the part of buyers. These are often sold to brokers who import them back to developed markets in North America and Europe and compete against authorized distributors—often successfully owing to lower prices.
3. *Abuse of marketing offers*: Software licenses or other products are sometimes provided at higher discount or no charge as “try-and-buy” in developing markets or for institutional customers. These may be activated or sold elsewhere without the knowledge or consent of the OEM (original equipment manufacturer).
4. *Intervention in legitimate supply chain*: Some products destined for export via logistics providers never reach the intended destination.
5. *Secondary markets to sell off stock*: The inventory of excess, aged, or manufacturer-discontinued products may be sold by OEMs or distributors on the open market (usually as a lower product class—take as is, no return, no support—and equally discounted). These are often sold as new on gray markets to unsuspecting customers.

5. Nonlegal Factors that Stimulate a Gray Market

There are four primary factors: price differentials, market access, volume of demand, and legal status of gray markets that firms and policymakers can use to assess the emergence of gray markets. We discuss the first three factors below, but separate our discussion of legal factors in the next section.

Price differentials

The major reasons for price differentials are changes in the exchange rate, competitive pricing strategies of the firm, price discrimination, and regulated prices [Chaudhry and Walsh 1995]. A cursory review of foreign exchange rate movements for the past two years of the U.S. dollar vs. the U.K. pound, Euro, Swiss franc, Canadian dollar, and Japanese Yen illustrates the price discrepancies stemming from exchange rate movements that are necessary for a gray marketer to

seek profits incentive from arbitrage. Even a minor movement in currency exchange rates can attract gray marketers because even a relatively small difference in price can result in significant profits incentive through a high volume of goods sold [Bird and Chaudhry 2010].

The second major area related to price differentials is market segmentation strategies that result in price discrimination either among or within markets. CNNMoney reported that the reason U.S. consumers had to wait in long queues to obtain the iPhone 5 was that Chinese consumers were obtaining it through the gray market. This reason was a price differential of $197.75. An unlocked iPhone 5 could be obtained in New Hampshire for $649, but the consumer in Beijing (owing to an import tax) would pay $846.75 [Elmer-DeWitt 2012]. Thus, the gray marketers simply purchased iPhones in the United States and resold them in China. Apple responded to the gray market problem in China by opening more of its own stores there. The firm also strictly controls the supply of the iPhones to consumers, such as limiting the number of iPhones that can be charged to one credit card (10 in 2012); prohibiting mass purchases of iPhones with gift cards; and having the Apple employees in China unseal the box and activate the phone to lessen the resale value on the gray market.

Global brand owners have partitioned national markets by setting their prices according to conditions that prevail for a variety of reasons, most simply to match the price elasticity of consumer demand in the local market [Chang 1993]. The firm can also face a situation where their domestic sales region, such as the U.S. pharmaceutical market, experiences a lucrative gray market for opportunistic sellers that pass the product through the supply chain with additional price markups. The report, *Shining Light on the Gray Market* [2012], conducted for members of the U.S. Congress, highlighted the thriving gray market in pharmaceuticals and how various entities actually resold one drug for cancer treatment, Flourouracil, for an astounding 8,471 percent markup owing to product shortages. This report showed a chain of reselling the product in the United States that started with Priority Healthcare's (a Maryland pharmacy) purchase of the drug from a wholesaler, McKesson Corporation, at $7 per vial. This led to a chain of reselling the drug through five entities (Tri-Med America, Medcare Health, DTR, International Pharmaceuticals, PRN) before reaching its final end-user, Sonora Regional Medical Center in California for the final price of $600 per vial. The analysts who uncovered this drug shortage problem interviewed one manager at a U.S. hospital who claimed that, "(W)e have no other choice … We have to take care of our patients" in order to justify paying the significantly increased price.

Market access

The gray marketer must be able to purchase the product within the distribution channel. A vertically integrated firm—a company that controls the product from its manufacture, distribution, to retail outlet and ultimate sale is less likely to experience a gray market. However, where the company is not vertically integrated, an authorized dealer may provide market access to a gray marketer. Ironically; the authorized dealer may be the gray marketer [Chaudhry and Walsh 1995; Bird and Chaudhry 2010]. Gray marketers are opportunistic middlemen that seek profits outside of the distributor's assigned territory [Weigand 1991]. The primary themes related to market access include the reduction of barriers to trade and a gray marketer's ability to access the distribution channel. The industry report, *Effective Channel Management is Critical in Combating the Gray Market and Increasing Technology Companies' Bottom Line*, describes the situation [KPMG 2008, p. 10]:

> The gray market has many sources, i.e., unauthorized dealers obtain products from a variety of sources normally at discounted price either due to price arbitrage, abuse of incentive programs, or simply because the products are not what they seem. For example, an OEM may choose to discount products for a particular end customer to increase sales, especially if there is stiff competition for that customer. To obtain deeply discounted products for open-market speculation, a channel partner may deceive the OEM into deep-discounting products for non-existent customers and then divert those products to the gray market for possible greater gain.

A survey of OEMs, channel partners, and brokers was conducted to discern their involvement with gray market activity and discovered that authorized dealers (1) regularly receive offers from the gray marketers (38 percent); (2) freely admit to complicity in the gray market (66 percent); and (3) mainly deal with the gray marketers owing to a lower price and sometimes faster delivery [KPMG 2008, p. 23].

Volume of demand

In international trade, a primary reason for gray markets to develop is supply shortages in the importing country [Cavusgil and Sikora 1988]. Gray markets have exacerbated drug shortages for pharmaceuticals in the United States for life-threatening illnesses, such as cancer, owing to profit incentives of supplying

excess demand [*Shining Light on the Gray Market* 2012]. Overall, if the gray marketer seeks profits through volume of goods sold, a product must have a general appeal to local consumers who will not doubt the authenticity of the good [Howell and others 1986].

The gray marketers would prefer a homogeneous product presentation to provide an attractive gray market for the good as they must consider the extent to which the product resembles the original good (that is, the authorized product in the import market) and the extent of repackaging that is required to sell in the import market [Bird and Chaudhry 2010]. Would a U.S. consumer consider purchasing a camera with a warranty card and operators manual in Spanish, Japanese, or Urdu? The gray market camera is authentic; however, the packaging, warranty information, and the like will create uncertainty about the authenticity of the product. Therefore, we know that the greater the homogenous product presentation of the parallel good, the greater the probability of a gray market; but, in some cases, the gray marketer can re-package the good to provide a standardized appearance [Bird and Chaudhry 2010].

6. Legal Decisions that Govern Gray Markets

The debate regarding the legality of gray markets in the United States centers on trademark law, specifically (1) universality or trade identity and territoriality and (2) exhaustion.

Universality or trade identity and territoriality

A trademark signifies the origin of the product, not the channel of distribution of the product. Thus, if the gray market good is genuine and there have been no attempts to falsify the product's origin, the courts are likely to rule in favor of the gray marketer under the "first-sale doctrine." As the laws can be many and varied across national markets [Palia and Keown 1991; Weigand 1991; Chang 1993; Chaudhry and Walsh 1995; Bird and Chaudhry 2010; Conroy 2011], we highlight the legal ambivalence of rulings on universality and territoriality by using two U.S. court cases: *Kirtsaeng* v. *John Wiley & Sons, Inc.* and *Omega, S.A.* v. *Costco Wholesale Corporation.* We have selected these cases because judicial interpretation of the first-sale doctrine has yielded mixed results.

Kirtsaeng v. John Wiley & Sons, Inc. The U.S. Supreme Court's decision of the case *Kirtsaeng* v. *John Wiley & Sons, Inc.* involved judging the legality of Supap Kirtsaeng obtaining textbooks in Thailand and reselling them in the United States for a profit [Stohr and Asseo 2012]. Supap Kirtsaeng had originally been fined $600,000 in the lower U.S. courts to pay John Wiley & Sons for copyright infringement for this trade diversion. However, in 2013, the U.S. Supreme Court, in a 6–3 decision, ruled in favor of Supap Kirtsaeng with a landmark decision that upheld the *first-sale doctrine* [Jeong 2013]. This doctrine governs the legal principle that a copyright holder can only realize a profit from the original sale of the product [Stohr 2013]. This implies that a company cannot prevent the merchandise from re-entering the United States and being sold to consumers, despite the fact that in this case the book was manufactured as an Asian edition. The Supreme Court decision permits parallel traders to obtain products in other countries, such as Thailand in this case, and resell the merchandise on internet auction sites, such as Amazon and EBay, and retail stores in the United States [Dembosky 2013].

Omega, S.A. v. Costco Wholesale Corporation

The Supreme Court's decision on the John Wiley case basically overturned the *Omega, S.A.* v. *Costco Wholesale Corporation* case (2008) that had previously ruled in favor of the copyright holder, Omega, to prevent Costco (the gray marketer) from reselling its watches manufactured in another country into the U.S. marketplace. A review of this case reveals a zigzag of court decisions that first ruled in favor of Costco under the concept of the *first-sale doctrine*. Later, this decision was reversed by the U.S. Ninth Circuit Court; and Omega, the Swiss watch manufacturer, prevailed as the watches were manufactured outside of the United States. The case reached a stalemate in the U.S. Supreme Court with a 4–4 decision (Supreme Court Justice Kagan did not participate in this decision), and thus the Ninth Circuit Court's decision was upheld [Brooks 2010].

Exhaustion

Under the concept of exhaustion, the trademark owner loses all rights to the product after it has been sold to a channel member, such as a licensee or authorized distributor. In 1993, the case *Lever Bros.* v. *United States* resulted in what is commonly referred to as the *Lever Rule*. In this time frame, the litigation centered on trademark infringement relating to the problem of gray goods obtained overseas being resold into the United States that were *materially different* than the current goods sold in the U.S. marketplace. This court ruling requires a parallel trader to affix labeling on the product to warn the final consumer that the product is

not identical to U.S. products sold through authorized channels [Ladas & Parry LLP 2013].

7. Employing Strategies to Diffuse the Gray Market

There are few studies that offer universal strategies for firms to assail gray marketers [Lansing and Gabriella 1993]. In general, these strategies rely on the premise that pricing can be controlled to a certain extent by the firm, such as by instituting a "one price for all" policy [Howell and others 1986] or an "aggressive confrontation by means of price-cutting" strategy [Cavusgil and Sikora 1988]. A company can employ both *reactive strategies*, that is, ways to reduce the level of a gray market that already exists; and *proactive strategies*, that is, maneuvers to prevent a gray market from occurring in the first place. We provide a brief discussion of a few antigray market stratagems in the next section.

Reactive: Strategic confrontation

The firm must decide how to support its authorized channel members, such as through dealer education, in order to prevent the gray marketer having access to its supply chain. In the report, *When Channel Incentives Backfire: Strategies to Help Reduce Gray Market Risks and Improve Profitability* [AGMA and Deloitte 2011], the analysts honed in on the fact that many firms use a variety of incentives to sell their products through a large number of channel partners. These incentives can provide a means of access for gray marketers.

Table 1 illustrates the magnitude of "stacked" incentives given to sell the product—in this case a total of 55 percent off the list price. In this study, the respondents claimed to have given at least 25 percent in incentives for each product sale. Clearly, using this type of incentive scheme will make the product much cheaper in the markets targeted for the incentive, and a gray marketer can simply buy in the channel at a lower price and resell the product in another market where the price is closer to the list price. One successful gray marketer claimed his company (a reseller) profited from IBM's volume purchase agreement where customers were awarded large discounts for buying hundreds of terminals at a time—the firm literally bought and resold every machine through the gray market [Marion 2013]. The entrepreneurial parallel trader said that it took IBM several years to finally put in the contract that his firm was the end user in order to get the incentive—thus ending the company's ability to resell the machines [Marion 2013].

Table 1. Stacked Incentives in the Channel of Distribution

List Price	$1,000
Contractual discount (25%)	($250)
Channel partner accreditation (12%)	($120)
Programmatic (8%)	($80)
End user (10%)	($100)
Net revenue:	$450

Source: AGMA and Deloitte [2011, p. 7]

Thus, one strategy is to legally constrain reselling as a condition for channel partners to receive incentives for volume purchases.

Reactive: Supply interference

Another strategy relies on the manufacturer's ability to control the supply chain of the product at either the wholesale and/or retail level to effectively impede the access of its goods to the gray marketers. In essence, the manufacturer limits the amount of volume or creates erratic delivery dates to make the gray market a less lucrative source of supply for buyers. Apple has used an ad hoc supply interference strategy to clog the supply of its iPhones to thwart the grey market in China [Luk 2013]. The firm's initial solution was to temporarily close the doors (at its stores) in Beijing, triple the amount of security guards, and start an online booking system for appointments to allow a single purchase of just one phone per day.

Proactive: Strategic pricing

David R. Sugden, in *Gray Markets: Prevention, Detection and Litigation*, comments on the futile endeavor of a brand owner to have a worldwide pricing tactic as follows [2009, pp. 115–116]:

> The proposal that globally fixed prices will eradicate the gray market has two fundamental flaws. As an initial matter, it ignores the *de facto* price discrimination that will remain depending on the national or state taxes levied on products … Second, disparate pricing schemes are a mandated reality of business. It is naïve to suggest that brand owners can solve the problem by having their laptops sell for the same price in Manhattan as they do in Jakarta.

There will always be some form of price variation between country markets and the key (albeit to a difficult puzzle) is to deliberate how the company can *manage* price to the point where a gray marketer does not detect a profit incentive.

Proactive: Marketing information systems

Overall, predicting the size of a gray market is a difficult task, and a marketing information system should be developed that would monitor red flags that are key indicators of gray market activity: (1) pricing that is too low; (2) unreasonable spikes in orders; (3) unusual orders; (4) special discount requests; (5) warranty exchange requests; and/or (6) unusual delivery requests [Sugden 2009, pp. 123–129]. To scrutinize the gray market, Sugden recommends these methods of detection [pp. 131–142]:

- *Audits*—the brand holder should have written into the contracts with its distributors and resellers the right to conduct audits, such as random spot checks, and can use point-of-sale reports to gauge illogical sales activity;
- *Internet monitoring*—the Web provides a wide distribution channel for both counterfeit and gray market goods. The problem lies with the abundance of information that must be scrutinized on auction sites, such as Amazon or EBay. A firm can retain an outside service, such as MarkMonitor [www.markmonitor.com] or Channel IQ [www.channeliq.com] to perform this task.
- *Brand Protection Purchases*—the firm may elect to hire mystery shoppers to pose as legitimate customers, to covertly assess the gray market behavior of the authorized channel members.
- *Informants*—a gray marketer can work with an elusive identity, but the operation may be known to possible informants who can provide information to the brand owner. Paul Mitchell, a manufacturer of salon products, uses both its company website and toll-free phone number hotline as a means for informants to report diverted products [www.paulmitchell.com/Pages/ContactUs.aspx].
- *Dumpster Diving*—a firm can search a suspected channel members' trash to gather evidence (for legal implications of this measure, see *California* v. *Greenwood,* 2014). Through the employment of outside investigators, a firm may search through a channel member's paperwork in the dumpster to gather evidence of alleged trade diversion in the authorized channel.

8. Conclusion

The goal of this paper was to educate business economists, managers, and policymakers on the topic of gray markets. Price differentials, market access, volume of demand, and the legal status of gray markets will continue to foster this type of trade diversion. The increased level of global business and the decrease of barriers to trade, especially free-trade agreements, such as the North American Free Trade Agreement, will continue to help gray marketers move the company's product from one market to the next without insurmountable obstacles. The recent legal cases put forth in U.S. courts are a quagmire of different decisions that can be overturned in a relatively short time frame. The two separate cases involving John Wiley & Sons and Omega are testimony to this type of legal discourse based on divergent judicial interpretations of the "first-sale doctrine." An overview of a few antigray marketing strategies was provided to allow brand owners to start contemplating feasible ways to at least counterattack the parallel traders by working with authorized distributors and creating novel marketing information systems to circumvent the problem.

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