

GREY MARKETING A CAUSE FOR ANALYSIS OF PRICE AND DISTRIBUTION CHAIN DEFICIENCIES

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ABSTRACT

The vast majority of grey marketing cases are not discovered until the matter is brought before courts of law or arbitrage tribunal. Because of this, it is hard to build the dynamics of an average case and draw conclusions on the phenomenon in general. This paper observes a real life grey marketing case from its inception to the eventual winding down. This case shows the effects of the grey marketing do not only inflict damage to the bottom line of the original manufacture. They also set consumer expectations for lower product prices. Grey marketing pricing strategy appears to serve as a guideline for pricing policies of makers of competing products entering the market.

JEL: M16, M19, M31

KEYWORD: Grey Marketing, Pricing, Distribution Chain, Price Strategy, Competitive Pricing

INTRODUCTION

Grey marketing refers to the process of selling legitimate trademarked goods through the non-authorized channels. According to (Pikard, 1996) “Grey marketing occurs when one party possesses the exclusive right to sell a certain product designated by a trademark in a certain area, and another party sells similar products in the same area under the same trade name.” This definition requires the presence of two conditions: (1) The existence of the agreement of exclusive rights to sell a certain product in the territory, (2) The existence of a strong registered trademark, which is recognized in a territory where a potential grey marketing activity may occur.

Despite the relative ease with which they may develop, the appearance of grey marketing is not frequent. For grey marketing to exist the product must be superior to others in the category, like Porsche cars or Rolex watches. (Schuster, 2010) describes a recent case of grey market sales of Omega watches. The product is perceived as significantly overpriced by a relatively large group of consumers.

Grey marketing usually appears because of the combination of aforementioned conditions. In many cases, grey market goods appear in the retailer’s hands through a maze of semi-legal operations, which can generate a legitimate interest from the authorities. The progress of international trade and increases in the number of multinational and global organizations around the world have spurred the creation of a large number of distribution channels and equally large number of entities. The purpose of these entities in the trade cycle is to act as an intermediary between the source, which is not necessarily a manufacturer, and the destination, which is not always a retailer or a consumer. These organizations have formed a rather impenetrable supply chain for each element of a non-productive entity generating its own profit. Through this chain, the price of goods can increase three or even fourfold without any measurable changes in a product itself. It is possible for small entrepreneurial companies to purchase the goods legitimately in one part of the world, move them to the other part of the world, sell them at a markup generally acceptable in the destination country. They are able to do this by setting the price well below the same product price in the legitimate distribution chain. The combination of these four conditions forms a viable opportunity for the creation of a grey market for any product.

This paper starts with a literature review that describes the state of today’s research on grey marketing and related topics. It follows with a description of grey marketing. The next section discusses the finding

and shows the methods of fighting grey marketing strategies. The last section of the paper draws conclusions and presents further research suggestions.

LITERATURE REVIEW

Grey marketing is regulated by the country of import. Each country has its own process of settling grey marketing cases. In the USA the definition and clauses of grey marketing are regulated by the Lanham Act, which accordingly to (Curley & Ferry, 2006) and (Schonfeld, 2010) gives the trademark owner full rights to decide who will sell the goods in the USA. However, with the advent of the Internet and e-commerce the definition of sale became even more blurred. The retailer of goods may reside in one part of the world and the buyer can potentially reside anywhere else. The Internet sale transaction may be executed in the country where Lanham Act or similar legal norms are not applied. The delivery of the product to the customer appears from the legal standpoint as the sending of a simple legal mail parcel from one country to another. In the case of grey marketing, the importer of goods does not break any import laws of the country they reside in. The surface legality of grey marketing allows them to persist over a long period since it takes time for the manufacturer to detect the illegal sales (Mendelsohn & Stanton, 2009).

(Chen, 2002) argues that persecuting grey marketing efforts of importation and selling goods yields an unfair advantage to legal distributors of goods thus creating a monopoly for selling the products. Entrepreneurs see grey marketing as an opportunity to sell goods at a lower price based lower costs during the acquisition and importation process (Brooks, 2010). Grey marketing largely constitutes a response by the market to the creation of a rigid distribution structure by the manufacturer of the goods or the trademark. Clarke 3rd and Owens (2000) and Beard, Kaserman & Stern, 2009 discuss dependency between the efficiency of the organization itself and efficiency of the underlying price structure.

As stated earlier grey marketing is only possible if the product is of excellent quality, it is sought by consumers and is perceived as overpriced. Grey marketers would endeavor to import and sell the product in the target country only if the product cost of delivery to the market would be significantly lower. Hence, the grey marketer still makes a profit by selling the product at a lower price. (Mathur, 1995) (Carrigan, 1999) explore the relationship between older (50+) consumers and retailers and shows that poor treatment of customers can also pave way to the appearance of the grey market for a certain product.

The main cause of a grey market is the division of responsibilities inside the product distribution chain. When the product first appears and is sold locally the product manufacturer undertook marketing and distribution efforts in order to deliver the product to the retailers. As the enterprise of making the product grows, the manufacturer attempts to segregate them from the distribution process and concentrate all efforts on R&D and manufacturing. At this stage of product development, the manufacturer seeks the alliances with companies, which would take over distribution of the product in a certain territory (Lee, 2006).

According to (Huang, Lee, & Hsiao, 2008) the distribution company does not strive to improve the product or fit it to the needs of the consumer. It simply owns the trademark for the territory of distribution, which gives it exclusive rights to deliver the products to retailers. In some cases, the manufacturer retains the right to influence price policies. However, in the vast majority of instances the distributor has exclusive rights to set the product price for the territory it operates. When the market is perfectly competitive, the distribution company has no other choice but to compete on price with distributors of similar products. In this case, the distribution operates by installing a market acceptable markup over the overall product cost. When the market is monopolistically competitive, distributors may apply a higher markup to a high quality product, which in the perception of the consumer has no analogs to the market (Argenton, 2010).

Monopolistically competitive markets usually create perfect conditions for product overpricing. If the product is mass-produced and sold in many places around the world, this approach to pricing can create conditions for the emergence of a grey market. (Frentzen & Nakamoto, 1993) underscore the importance of information flows in any market. Consumers make purchasing decisions based on the options presented to them by the operators of the market. (Gal-Or, 1988) states that incomplete information may seriously hurt the ability of market players to make a correct decision. (Livnat, 1986) shows that market equilibrium can shift based on the appearance of information to buyers and sellers. Grey markets appear in part because consumers lack information on the proper value of the illegally sold product and on the availability of substitutes of equal quality.

(Felten, 2010) notes that the appearance of grey marketing shows the possibility for price arbitrage similar to that observed in currency trading. However, it can be argued that in the market for tangible goods the ability to extract gains from alternative routes of product delivery is much smaller than in foreign currency trades. Despite the fact that financial damage to the company might not be large, (Eagle, Kitchen, Rose, & Moyle, 2003) argue that the value of brand equity can be seriously diminished by grey market activities.

CASE DESCRIPTION

The market for knitting needles has always been a two-tier market. The first tier contains needles of premium quality, which are coveted by consumers. These needles are made out of chrome plated aluminum tubes, high quality bamboo, wood such as birch or beech, bones and dairy byproducts. The price of these needles rarely reflects the costs of manufacturing and is set based on the estimation of the price consumers are willing to pay. Customers buying these products are aware of their superior qualities.

The second market tier is comprised of low quality bamboo needles as well as needles made of inexpensive steel and plastic. These needles are often made in countries with less expensive labor and sold all over the world under different brand names. Inexperienced knitters buy these products mainly because they are not sure if they would want to practice the craft or move on to other endeavors.

Knitters must make a significant investment into good quality premium-tier needles in order to satisfy their needs. It is customary for an average knitter to have 8-10 sets of needles of different diameters. Professional knitters usually have multiple sets of needles of the same diameter which they use on a knitting project or multiple knitting projects simultaneously. Many cases of grey marketing are reported when the process of illegal import and sales of goods is detected by the owner of the trademark. Because of this, many cases lack both continuity and dynamics when reported in the mass media and are examined in scholarly papers. The case described in this paper was a staged experiment, which was observed from its inception to the time the grey marketing efforts were shut down.

The case under review is a real world example of grey marketing, which happened in Canada in 2004-2009. The owners of the company involved favor Russian Style (Vilensky & Pustylnick, 2009) of knitting, which have a very smooth surface. One of the owners acquired this habit while using Russian manufactured steel needles with chrome-plated surface. After serious consideration, the Russian needles were deemed not suitable for import because Russians do not produce needles thicker than 5 mm.

Taking into consideration the requirements of the Canadian knitting market, which has a demand for needles of 2 mm -12.5 mm and sometimes even thicker, the company decided on using similar chrome plated needles produced in Germany, (called Product A in this paper). However in North America the same needles were distributed by another company which was not a division of the manufacturer, and was granted an exclusive right to distribute and sell these needles anywhere in North America including Canada.

The distributor stroke the agreement with a distribution partner in Canada, which had a right to represent itself as a Canadian affiliate of the major North American distributor. Information on the real cost of Product A for both distribution entities is private and confidential. This paper uses the estimated price based on certain assumptions for illustration. Table 1 represents the transformation of price as the needles are passed through the distribution channels. It is assumed that the Canadian distributor used Canada Post services to deliver the needles. If they use a courier, the retail price might have differed.

Table 1: Distribution of Price in Supply Chain

Step	Price of the Product
Main Distributor	\$8.00 USD
Canadian Distributor	\$12.00 USD
Transportation Cost	\$2.00 USD
MSRP (Ontario)	\$24.00-26.00 USD

This table displays a gradual accumulation of price value of a pair of Product A as the product moved along the supply chain.

The price of the products consists of the cost of manufacturing, delivery to the consumers and an acceptable profit margin. The manufacturer can use a marginal cost model as they are in control of the manufacturing process. Distributors are more used to the cost-plus or full-cost models which gives them control over the fluctuation of currency rates and manufacturer costs. It is also common in North America to use the “double cost MSRP”, which suggests that MSRP (or DSRP in the case of a distributor being a price setter) should be set as double the wholesale product price. This formula would cover all costs incurred by the buyer as well as the collateral costs of advertisement and stale stock. This pricing scheme also takes into consideration that no more than a half of all products would be sold at the suggested price and that the retailer would conduct dump sales of stale stock at significantly lower prices.

Product A, Bamboo and Dairy needles presented in Table 2 represent a premium product segment, whereas the rest of the competition represent low-end needle brands. Product A clearly dominated the premium market segment because of product versatility and superior quality. Besides the excellent quality chrome-plated surface, its circular variety also had a very flexible non-cringing cord, which is extremely useful in knitting socks using the Magic Loop technique.

Table 2: Needle Product Market Shares

Type/Brand	Percent of Market Share
Product A	13%
Competitor A	20%
Competitor B	40%
Competitor C	20%
Bamboo (All Brands)	6%
Dairy (All Brands)	1%

This table displays percentage of market shares for various types/brands of needles at the time when grey marketing case started

The product sold as a grey market product usually causes changes in the structure of the market. The consequences of grey market differ based on the extent to which the grey market retailer has access to the product consumers. In order to keep a low profile as well as to keep prices as low as possible, a grey market retailer does not advertise the product on the same scale as the original manufacturer or distributor. The most common marketing approach for grey market goods is viral marketing (Dasari & Anandkrishnan, 2010). Knitting is a social hobby and many knitters assemble into guilds or collectives in order to spend few evenings a month indulging in their hobby.

These groups usually discuss the product prices and share information about bargains and below market prices for yarns and needles. At the same time, the grey market retailer has to assume full responsibility for faulty products including the costs of replacement or repair of faulty products into their price model.

The market for the premium product exists as long as the product remains relatively expensive and relatively unaffordable to large numbers of consumers. Grey markets for the same product may decrease the longevity of the original market. In this case, grey market retailers would not be able to sustain the level of sales they enjoyed originally thus decreasing the viability of the grey market for a product. In the knitting needles market there are two trends which play role in the original appearance of the grey market: (1) The buyers and the potential buyers of the premium product see the opportunity to buy a premium product for lower price; (2) The buyers of the second tier products can be convinced that the difference in price is much lower and that the premium quality product yields other tangible benefits to the user.

As a result, the initial acceptance of the grey market price scheme was high and the grey marketer reaped tangible benefits causing the legitimate distributor a significant loss in revenue. In time, the grey market retailer saturates the segment of the market most susceptible to bargains and the amount of sales naturally drops. Hence, this market appeared relatively short lived. Table 3 illustrates this trend by using the sales of Product A of the grey marketer.

Table 3: Sales of Product A per Year

Year	Quantity Sold (100s)
2004	627
2005	950
2006	930
2007	615
2008	497
2009	176

This table displays distribution of sales of Product A (in 100s) per each year of the grey marketing case.

As Table 2 shows peak sales are reached soon after the company made a decision to import the goods through the alternative channel. Despite relying only on the viral marketing the grey marketer reached the peak sales in the second year. During the third year of grey market operations, the primary distributor and manufacturer, who made every attempt to stop grey market sales, detected the company’s efforts. These efforts together with the relative market saturation caused drops in sales with subsequent decision to exit the market by the grey marketer. This case clearly suggests that grey markets even if they are not targeted legally with “cease and desist” orders are not sustainable in the long run because they target only those consumers who are willing to find the lower priced goods and are not interested in the potentially illegal character of the sales.

DISCUSSION

A small entrepreneurial company would consider involvement in the grey market based on the perceived possibility of the price arbitrage. For the arbitrage to exist there should be a glaring discrepancy between the costs of the products in different parts of the world. This inconsistency in costs must offset the costs of delivery, the costs of sales and the costs of upholding the warranty and replacements by a grey marketer in order to create a consideration for the price arbitrage. The grey marketer must also take into consideration the short life span of the grey market and the possibility of both injunctions and barriers created by the owners of the legal distribution channels. (Champion, 1998) admits that simulations of grey marketing schemes indicate that these schemes are bound to be short-lived which is supported by the findings of this case.

While considering the possibility of arbitrage, potential grey marketers must also consider that involvement in the grey market of any substantive size would require a large initial investment. Regular distribution in North America uses a net 30 price model for the distribution of goods to retailers. By using this model, any retailer has 30 days of sales of the merchandise before they are required to make a

payment to the distributors. The relationship between the paying distributor and the manufacturer is even more relaxed and net 60 or 90 models are often used.

Grey market distribution requires the company to buy the goods outright by paying the full price at the time of purchase. One of the reasons for this lies in the fact that the grey market retailer and the catering distributor want to stay under the radar and reduce interactions to the absolute minimum in order to maintain a business relationship for an extended period. On the other hand, the channels of goods acquisitions for a grey market are often located in parts of the world that do not accept any form of payment other than cash on purchase. The company considering grey market retail must include the cost of capital invested in the purchase of goods in order to create a full arbitrage picture.

For consistency we consider the manufacturer of the good is the owner of the original trademark. Although a distribution company can own a trademark on the certain territory, the overall ownership of the trademark belongs to the manufacturers. Quite often independent distributors of the product attempt to secure the distribution rights for a long period. This policy is based on the consideration that introduction of the product to the market of a significant size such as North America may take a fairly long time and will be met with sizable resistance by the consumer community.

This existing order of things locks a manufacturer out of the price setting process. The distributor becomes the only influential price setter on a certain territory. Agreements between the manufacturer and distributor often dictate only the volume of product which distributor must purchase or order from manufacturer in order to continue the relationship. Quite often, the distributor decides to set the price artificially high in order to maintain the status of the product as a premium purchase.

E-commerce creates significantly more transparency in any market of consumer goods including the market for knitting needles. The manufacturing company attempts to use the same price scheme for all its distributors in order to avoid conflicts which can potentially result in a legal action especially in the USA. In the USA unjustified price discrepancy is explicitly forbidden based on the Robinson - Patman act (Beard, Blair, Kaserman, & Stern, 2009). In this case, it is the responsibility of the distributors of the product to set the prices in a manner to exclude the possibility of an arbitrage within their distribution territory. In the described case of Product A, there were several attempts other than the one by the grey marketer discussed here to sell the needles in North America via Internet at prices significantly lower than the price set by the major distributor.

Hence, the manufacturer of the products has only two viable options. One possibility is to set a price which would deny the possibility of the arbitrage. A second possibility is to fight the grey marketing of its products through injunctions. The deficiency in price strategy can be attributed to the excessive independence given to the distributor over setting the price in a certain distribution territory. It can also be attributed to the improper positioning of the product. Pricing a luxurious and premium product would attract grey marketers much faster than when the product is priced to sell. Hence, in the case of positioning the product as a luxury item the product manufacturer must have more control over the product distribution (ex: luxury cars).

(Lin & Lin, 2010) state the appearance of substitutes in monopolistically competitive markets is highly probable. The feature differentiating a leading brand of products is always a target of copy by white labels and competition. In the case of grey market products, we consider products as substitutes which have similar features, comparable quality and the price, which rivals the price set by the grey market retailers. There is no visible connection between the appearance of a grey market for a certain brand and the appearance of substitutes. However, in some cases the price setting strategy of grey market retailers can spur the creations of equally priced substitutes of comparable quality. Unlike grey market goods, the

substitutes are legal. The manufacturer of the product can change its features in order to differentiate from the substitutes or reduce the price in order to make substitutes less viable.

After the grey marketer in this case entered into the market for Product A, several substitutes of comparable price and quality appeared on the knitting needle market. All these needles are made out of chrome plated aluminum tubes. They all sport flexible non-tangling cords, which make them as versatile as Product A. Company X made the first entrance. The original retail price of their needles was set at \$10-15 but have since been lowered. Since 2008, two companies: Distributor A from China and Distributor B from Germany entered the North American market. The MSRP of the needles vary from \$10 to \$15. In 2010 despite being considered, the best in the industry, Product A was priced out of the competition. Table 4 shows the pricing by the competitors.

Table 4: Comparative Sales Prices of Premium Needle Products

Company	Price
Company X	\$7.00 USD
Distributor A	\$11.00 USD
Distributor B	\$7.00 USD
Product A	\$15.00 USD

The table shows Manufacturer Suggested Retail Prices for each of the products in the Product A-like needle market.

Out of three competitors, Company X does not wholesale the needles. Because of its size, the company manufactures its own needles and has an obvious advantage on the internet market. On the retail market both Distributor A and Distributor B, have products with prices lower than Product A. The quality of the needles become virtually identical and the customers are switching to the more affordable product.

Manufacturers of premium products must always consider the product may be out-priced or even outright replaced by substitutes. The manufacturer cannot control the quality of substitutes as compared to their own products. A grey market sets the new acceptable price for the products. Elimination or reduction of the grey market can give a manufacturer temporary relief from the onslaught of the grey market retailers. However, the price set by the grey market is the price that will be targeted by the manufacturers of substitutes entering the market. By the time substitute products enter the market the manufacturer of the original product being targeted must be ready to come out with a product containing new features to differentiate the product while maintaining the price.

This paper does not consider distribution channels, which are fully dependent on the manufacturer for its price setting policies. However, it is important to discuss the channels which have a large degree of autonomy over price setting in their territory. According to (Myers & Griffith, 1999) tightening control over the distribution channels' policies is one of the most effective ways of fighting grey market attempts. Grey market retailers use legal channels in order to deliver goods to the consumer. They pay the applicable tariffs and duties and charge all applicable taxes as well. In many countries, these activities are considered legally entrepreneurial. The laws of the USA allow the owner of a trademark to get a court injunction related to the sales goods, considered part of a grey marketing scheme. However, the onus lies on the trademark owner to prove that the trademark infringement indeed occurred.

In the case of Product A, the North American distributor marketed the needles under a different trademark. They used a different color scheme for packaging in an attempt to distance itself from the manufacturer thus concealing its identity. In the attempt to fight grey market sales, the North American distributor had to change the packaging to resemble the original used in Europe. They also had to display the original trademark to make sure that the infringement is easily traceable. It is the goal of the grey marketer to piggyback on the name and the reputation of the product sold. Hence, the distributor owning

the trademark has to abandon the attempt to re-brand the product and stay as close as possible to the original product trademark to be successful in fighting grey marketing efforts.

Grey marketing is an indication of deficiency in the price policy of a manufacturer or distributor of a product. There is no single set of rules applicable to all products anywhere in the world. However when, as in the case of Product A, the price of the product sold by the distributor is almost double the grey market price, there is early indication that the price of the product is not justified by market conditions. The owner must realize that customers, spoiled by grey market prices will not be willing to return to the original pricing even if the grey market retailer ceases to exist. Another reason for price adjustment is potential saturation of the market at a lower price through grey market sales. If the distributor is not willing to adjust prices they may face reduced product demand by the time they finished fighting the grey market retailer in court. It would be much more efficient to fight the grey market using the market mechanisms of price adjustment. As stated earlier any grey market retailer must make a substantial upfront investment into the potential grey market goods. They must see a clear potential for an arbitrage, which would allow them to return their initial investment and earn a profit. Reducing the price of the product sold over legal channels may stop the grey marketing scheme at its inception and protect the legal distributor of the goods.

In many cases a distributor attempts to secure the largest possible territory for their distribution efforts in order to achieve maximum gains from their endeavor. Sometimes the distribution mechanisms are not properly aligned with the transportation mechanisms available in the territory of distribution. This causes larger transportation costs which are inevitably used in forming the retail price. The appearance of the grey market indicates that the overall retail price is too high and that the transportation factor may be to blame for the price escalation. In the case of Product A, both North American and Canadian distributors are located on the Pacific Coast. While both companies enjoy ease of communication with each other in the same time zone, the price of transportation through the territory of Canada, especially to the large Eastern markets of Ontario, Quebec and to the lesser extent the Maritime Provinces, is extremely high. To fight grey marketing in the East, it would be more prudent for the primary distributor to set up a distribution centre in Eastern Canada, which would cater to the aforementioned regions. The reduced retail price of the original product would offset the damage done in the East by the grey marketing efforts.

CONCLUSION

The main goal of this paper was to observe a real life grey marketing case from its inception to winding down. The observations are valid only for the case under review. The case shows that grey marketing indicates deficiency in the price strategy (the grey marketed product was significantly overpriced). The paper suggests two potential causes for overpricing: (1) overestimation of positioning of the product, correlating with (Thompson, 2009) and (2) potential poor structure of the distribution chain (Lim, Lee, & Tan, 2001). However, it is important to underscore that although grey marketing has a damaging effect for the company price strategy and especially the bottom line, the company can use it to its own advantage. Long and well-established businesses sometimes become oblivious to changes appearing in the market for a certain product. It is important for the manufacturer to have a good feel for how their distribution chain performs. Even without tracing the full chain of delivery of goods forming a grey market, the manufacturer can detect and potentially correct the pricing strategy of the original product. This correction would eliminate or reduce the threat of grey marketing.

Price setting schemes set by grey marketers are dangerous to the original product manufacturer's bottom line. By employing reduced prices, grey market retailers prompt consumers to expect lower pricing. The makers of substitutes use the price set by grey marketers as a benchmark for entry prices of their products. As a result, the manufacturer of the original product faces a threat from new entries to the market in addition to the one they face from grey marketing. Any market is based on the market laws set by

microeconomics. Grey marketing is a manifestation of these laws showing the price setting strategies of a product have to be corrected. The outcome of this study is consistent with the findings of (Lee, 2006), (Thompson, 2009) and (Antia, Bergen, & Dutta, 2004). The owner of the price strategy must treat grey marketing as an indicator of existing faults in their own price strategy rather than an illegal menace (Berman, 2004).

Further research on the subject should include the comparison of multiple grey marketing cases. We could observe in the described case the short lifespan of the grey marketing suggested by using the market simulations (Champion, 1998). Comparison of the dynamics of several cases may yield proof of the quick deterioration of sales by the grey marketer. This practical observation would add solid support to the conclusions made in the research.

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