Before the
UNITED STATES COPYRIGHT ROYALTY JUDGES
Washington, D.C.

In the Matter of	)	
MECHANICAL AND DIGITAL PHONORECORD DELIVERY RATE ADJUSTMENT PROCEEDING	)	**Docket No. 2006-3 CRB DPRA**

REBUTTAL TESTIMONY OF

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RIAA Trial Ex. 84

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My name is Andrea Finkelstein, and I am Senior Vice President, Business Affairs Operations and Administration at SONY BMG MUSIC ENTERTAINMENT. I previously filed written direct testimony and provided oral testimony in this proceeding. My background and qualifications were set forth in my written direct testimony.

I am submitting this rebuttal statement to respond to various claims made by the music publisher and songwriter ("Copyright Owners") witnesses in this proceeding and in support of RIAA's rebuttal case. I begin with the Copyright Owners' proposed rates and terms. Not only are their proposed rates very high by historical and international standards, but also by the standard of what writers and publishers are currently able to obtain for mechanical uses of their songs in the marketplace. Moreover, the rate structure proposed by the Copyright Owners would be disruptive, and their terms are unwarranted. I then turn to RIAA's proposed rates and terms. Contrary to attacks made by the Copyright Owners, RIAA's proposal is administrable and not unreasonably disruptive. Finally, I respond to an assortment of other issues raised by the Copyright Owners, noting that –

- there are substantial transaction costs associated with negotiating mechanical licenses below the statutory rate;
- SONY BMG does not pay commissions or fees to The Harry Fox Agency ("HFA");
- declining mechanical royalty payments through HFA may be at least in part simply a reflection of an increase in direct payments to music publishers; and
- discounted rates under controlled composition clauses in contracts entered into after June 22, 1995 do not apply to digital phonorecord deliveries, which in turn puts a

premium on this Court's adopting rates that serve the important role of controlled composition clauses in promoting the availability of works to the public.

I. Copyright Owners' Proposed Rates and Terms

A. The Copyright Owners' Proposed Rates Are Higher Than Market Rates

I cannot discuss the royalty rates proposed by the Copyright Owners (as set forth in their written direct case) without stating clearly at the outset that they are extraordinarily high. The U.S. mechanical royalty rate has already increased steadily through five years of falling CD prices and flat download prices. As a result, the U.S. statutory mechanical royalty rate represents an unprecedented percentage of the wholesale price of recorded music products, and a cents rate that is significantly higher than what is often voluntarily accepted in the marketplace for mechanical uses both within and outside the scope of Section 115:

- Under controlled composition clauses, artists routinely and voluntarily accept significantly discounted mechanical royalty rates, caps on our mechanical royalty expense, and free goods provisions that effectively grant a further discount, because they understand that is what the marketplace demands if they are going to get the significant advantage of having their songs and performances recorded, marketed and distributed by a record company. Nonetheless, our controlled composition clauses are often heavily negotiated.
- Outside writers (i.e., pure songwriters who collaborate with recording artists in writing one or more songs for an album) regularly partner with artists and accept the same controlled rates because they understand that is what the marketplace demands if they are going to have their songs recorded, made available to the public and

transformed into income-producing assets that can generate varied revenue streams for the writers for years to come.

- Publishers regularly license at discounted rates, whether as a result of controlled composition clauses or otherwise. Publishers sign writers knowing that those writers already have entered into recording contracts containing controlled composition clauses,[1] and even when the publishers sign a writer first, they typically will accept a controlled composition clause when that writer subsequently enters into a recording contract. They regularly issue voluntary licenses within the scope of Section 115 at or below the statutory rate. They license use of "samples," which are outside the scope of Section 115, typically by their taking an ownership interest in the new song and allowing the record company to pay only a single mechanical royalty covering both the new song and the samples of old songs included in it. They license first uses and dramatico-musical works, which are outside the scope of Section 115, on the same basis as uses within the scope of Section 115 – at or below the statutory rate.
- Finally, they historically have licensed record clubs at three-quarters of the statutory rate.

What Dr. Landes calls a "modest" increase proposed by the Copyright Owners[2] would, at the beginning of the rate period, represent a 37% increase in physical rates, a 65% increase in download rates, and in the case of ringtones about four times the current statutory rate and a 67% increase over the rates provided in our New Digital Media Agreements ("NDMAs"). Taking

[1] Indeed, it is my sense that publishers tend to pay higher advances to writers who have already signed recording contracts (which would include controlled composition clauses) than they do to writers who have not signed recording contracts. This indicates that publishers value knowing that a record company will invest in producing and marketing a writer's work more than they value the mechanical royalty rate discount they give up.

[2] CO Trial Ex. 22 (Landes WDT) at ¶43.

into account the Copyright Owners' proposed CPI adjustments, the rates would be even higher by the end of the rate period. Yet over that period, CD prices seem certain to continue falling, it looks like ringtone prices and subscription service prices may fall, and it is certainly not clear that average download prices will rise. Thus, the Copyright Owners' proposed rates will increase as a percentage of wholesale at an even faster rate than they increase in absolute terms.

Moreover, quite apart from the rate levels, the complex greater-of rate structure proposed by the publishers would be disruptive, and the Copyright Owners' terms are unwarranted. I address those points in the remainder of this section.

B. The Copyright Owners' Proposed Rates Would Be Highly Disruptive to SONY BMG's Administration of Mechanical Royalties

The rate structure proposed by the Copyright Owners has three very significant defects, each of which would make it hard to administer: (1) it is fragmented, (2) it is not comprehensive, and (3) the three and four subpart rate structures proposed for limited downloads, interactive streams and ringtones would be particularly difficult to administer.

In principle, it makes sense to have as few as possible distinct categories of products with unique royalty rates, because the core of the music business – signing artists and writers and producing and marketing recordings – and its basic economics applies equally across all types of products and services. In addition, the more rate categories there are, the more likely it will be that (1) we will have disputes about which uses fall into which categories, and (2) differences in rates will skew the marketplace by encouraging record companies and digital music services to pursue methods of distribution having lower mechanical royalty rates even if they are otherwise less efficient or attractive. However, the desire for fewer categories needs to be balanced against the desire to have rates that are appropriate to each distinct type of use.

The Copyright Owners' rate proposal offers the worst of both worlds – five categories of rates, each of which has a high cents rate or cents rate minima. Cents rates (and cents rate minima) are insensitive to price, and physical product prices have fallen and continue to fall, download prices are stagnant, and prices for ringtones and subscriptions services may be declining. When prices fall, high cents rates make lower-price uses uneconomical for record companies, and thus prevent writers and publishers from realizing income from those uses.

The Copyright Owners' rate proposal also suffers from being under-inclusive. It only covers five types of activities common in the marketplace today (physical products, permanent downloads, conditional downloads, ringtones and interactive streaming). It does not even purport to cover the full range of activities subject to Section 115, and does not specify any rates for new as-yet undeveloped delivery technologies. I understand that in responding to an interrogatory served by the RIAA, the publishers stated that "To the extent that any additional products or services licensable under Section 115 that do not fall within these categories either exist or are introduced into the marketplace during the period for which rates are to be set in this proceeding, applicable royalty rates and terms can be determined through negotiation between the parties or between individual Copyright Owners and copyright users, as contemplated by Section 115, which negotiations may or may not be informed by the rates applicable to existing, related recorded music products and services."[3]

Thus, under the Copyright Owners' proposal, there would be no statutory mechanical royalty rate for new products and services as they become available in the marketplace, merely an aspiration on the Copyright Owners' part that the parties will reach accord on applicable rates

[3] *See* Responses and Objections on Behalf of the National Music Publishers' Association, Inc., the Songwriters Guild of America and Nashville Songwriters Association International to the Recording Industry Association of America's and Digital Media Association's First Set of Interrogatories, at 9 (Response to Interrogatory No. 2) (Sept. 7, 2007).

through negotiations even though they have to date been unable to do so concerning the subject matter of this proceeding. However, it just is not possible to negotiate rates with thousands of music publishers, so we could not clear all of our repertoire, and history tells us that negotiating with even a handful of publishers over a new format can substantially delay the format's introduction.

As the person who is responsible for administering SONY BMG's licensing under Section 115, I understand the importance of this Court's mandate to "determine reasonable rates and terms of royalty payments for the activities specified by [Section 115]," 17 U.S.C. § 115(c)(3)(C) – all of those activities and not just some of them. The five years of the coming rate period is a long time, and unlike Section 114, Section 115 does not provide for a mid-term proceeding to set rates for a new type of service. Accordingly, adopting a rate structure – like the publishers have proposed in this proceeding – with gaps into which new types of products and services might fall could ensure that those products and services never are commercialized successfully. During the last rate period we saw repeatedly the effects of (1) the introduction of new products and services that did not fit into the existing cents rate structure, and (2) not having the possibility of a mid-term proceeding to address them. That unfortunate combination of circumstances caused the marketplace to grind to a halt while record companies and their distribution partners struggled to address musical work clearance issues, delaying the launch of subscription services, mastertones and other new formats.

In three of their rate categories – limited downloads, interactive streams and ringtones – the Copyright Owners have proposed complex three and four-subpart rate structures, each the greater of a percentage of revenue, a percentage of "total content costs," a per-song cents rate and (except in the case of ringtones) a per-minute cents rate, with the latter two subject to

adjustment at unspecified times based on changes in some unspecified version of the consumer price index. If this Court were to adopt the rates and terms proposed by the Copyright Owners, SONY BMG would not be able to administer mechanical royalty payments without first making substantial adjustments to its royalty accounting systems. While this rate structure is somewhat similar to the ringtone rate structure under our NDMAs, given the relatively limited number of ringtones, we have been able to meet our obligations by including in our royalty accounting system the minimum functionality necessary to administer ringtone transactions. The Copyright Owners' proposal adds additional complexity to the ringtone structure, with five different rate categories, including for each a playing time component and CPI adjustments.

The additional complexity of the Copyright Owners' rate proposal and applying it to a broader range of songs and uses would require significant time and effort for reengineering our royalty accounting systems, the testing that is required whenever changes are made to these systems, and additional time and effort to convert and validate the necessary data. If the Copyright Owners' proposed rates and terms were adopted, I estimate that SONY BMG would need a transition period of approximately one year before we could pay royalties under the new structure for any release, and at least an additional year to convert and validate all the data necessary for payments for limited downloads and interactive streams under the publishers' rate request.

C. The Copyright Owners' Proposed Terms

The Copyright Owners proposed terms are unwarranted and duplicative, and largely appear designed simply to boost their already high rate request even higher. I understand that RIAA has filed a brief arguing that this Court does not have jurisdiction to adopt the Copyright

Owners' proposed terms. However, I describe each briefly in case this Court reaches a contrary conclusion.

1. Late Fee

The Copyright Owners propose a high fee for late payments. This is a transparent effort to get paid more, and is inappropriate, for several reasons:

- Writers and publishers are the cause of most late payments. SONY BMG is not holding back mechanical royalty payments in an abusive way. The cause of most payment delays is the inability of publishers and writers to promptly advise SONY BMG of the split ownership interests in new songs. Early in the commercial life of a song it usually has not yet been finally decided who owns what share of the song (i.e., what the "splits" are), but everyone wants to get the song to market quickly. Record companies can't pay the publishers who claim to own pieces of a song until the writers and publishers agree among themselves who owns what shares, and publishers will not accept an overall royalty payment and the accompanying duty to account to co-publishers. Even though record companies do not have an interest in the publishing splits, I have heard suggestions that record companies could somehow do a better job of getting the writers of songs (who are typically the artists and producers of recordings) to work out ownership arrangements among them faster, such as by forcing agreement in the studio. However, if the writers and publishers want to be paid more promptly, the solution is simple – they should reach agreement among themselves on splits more quickly. It also must be understood that today recordings do not typically come together in one studio session. Songs are generally created and recorded together, in a process that can extend over a long period and involve

numerous participants who may never all be in the same room together, including the artist (which is often a group with several members), a producer, outside writers and others. In many instances, it is not until long after the recording process began, when post-production and mixing end, that the final version of a song emerges and it can be determined who made creative contributions to the song. Moreover, writers often include in their songs samples of other people's songs without first obtaining consent, requiring the relevant writers and publishers to later sort out the consequences of that action. Record companies currently can and do try to encourage and accelerate these kinds of negotiations, but there is little we can do to make writers and publishers come to agreement faster. Since writers and publishers could not get a return on their money from a bank, in the stock market or anywhere else that is nearly as high as the 1.5% per month proposed, the late fee will just encourage them to drag out their negotiations to get paid more by the record company.

- The marketplace already addresses this issue through advances. Because late payments occasioned by protracted negotiations among writers and publishers are commonplace, the marketplace long ago evolved a solution: record companies pay advances to HFA to cover these late payments. At SONY BMG we pay HFA advances on a rolling basis, and have millions of dollars in outstanding advance payments, to cover just the situation that the publishers would address with their late fee. Adding a late fee into the mix is unnecessary.
- The Copyright Owners' proposal is contrary to marketplace norms. Even though virtually all mechanical licenses are issued on a voluntary basis, often on a form determined by publishers, late fees are only provided for some of the time, and

contractual late fees are rarely, if ever, imposed. For example, the largest single source of our mechanical licenses is HFA. HFA uses a boilerplate license for bulk digital download licensing and takes the position that all our digital download licenses from HFA are subject to the terms set forth therein. The boilerplate digital download license does not include a late fee.[4] HFA's current standard form of license for physical products contains language regarding late fees on "statements rendered hereunder."[5] However, the late fee is 7% per annum – not 18% as the publishers have sought in this proceeding – and I do not understand the late fee to apply before splits are worked out. In any event, in practice, the 7% late fee is rarely sought.

- Unlike Section 114, Section 115 permits termination for late payment. I understand that this Court has provided a fee for late payments under Section 114. However, Section 115 is different from Section 114 in that Section 115 already provides a remedy for late payment – termination of the license (see 17 U.S.C. § 115(c)(6)) – while Section 114 does not. Thus, the justification for adopting a late fee in the context of Section 114 does not apply in the context of Section 115.

2. Pass-Through Licensing Surcharge

The publishers seek a surcharge on top of their extraordinarily high proposed rates for cases where a record company assumes responsibility for mechanical licensing for DPDs made by a digital music service. (This practice is sometimes referred to as granting an "all-in" license, or as "pass-through" licensing.) As if a 65% increase in the download rate was not enough, this is just a thinly disguised way of asking for a 70% rate increase. SONY BMG would prefer not to be in the business of handling mechanical license clearance for digital music services. Pass-

[4] *See* RIAA Trial Ex. 29.
[5] *See* RIAA Ex. 134- RP.

through licensing is administratively complex and labor-intensive, and we bear the administrative expense but receive no direct financial benefit. Pass-through licensing would not be necessary if the United States had a more streamlined mechanical licensing process like that in most other countries. Indeed, we have been willing to support federal legislation to create a single designated agent so that the need for pass-through licensing could be eliminated.

However, SONY BMG wants to distribute its products as widely as it can. Time and again mechanical licensing has proven to be a major impediment to the launch of new types of products and services. We are in the business of handling mechanical license clearance for digital music services because that is the best way to ensure the availability of our recordings and the associated musical works to the public. When a new service is about to launch, it has a choice: (1) build a mechanical royalty administration system like SONY BMG's and hire a staff like the approximately 50 people we have working on clearance, licensing and payment (or outsource those functions to a third party vendor), and delay launch until licenses can be obtained from the thousands of publishers that control the rights to a million or so tracks; or (2) ask the record companies to do it. Not surprisingly, many choose the latter. Aggregation of mechanical rights is a vital service that record companies perform to enable digital distribution of music. We should not be penalized for performing this service.

The justification offered by the publishers to support this surcharge doesn't hold up. I understand that the publishers have asserted that the justification is late payment. However, as described above, the publishers have other remedies for late payment -- advances and license termination.

3. Attorneys' Fees

The Copyright Owners propose that they be allowed to recover attorneys' fees in all collections actions. This proposal just does not seem like a payment term. Indeed, I understand that payment of attorneys' fees is already addressed in Section 505 of the Copyright Act. In any event, in my experience it is not a reflection of the terms on which mechanical licensing is conducted in the marketplace.

4. Reserve Accounting

The publishers have made vague and unsubstantiated statements that record companies have abused the reserve accounting rules under 37 C.F.R. § 201.19.[6] Without knowing what specific abuses are alleged, or whether they are alleged to have been perpetrated by my company, it is difficult to respond. On behalf of SONY BMG I can say that we make a good faith effort to comply with the reserve accounting regulations. Even without knowing what perceived abuses the publishers might have in mind, however, I can explain that the reserve accounting rules address a very important issue and should not be eliminated.

Under Section 115, a phonorecord is not considered "distributed," and hence a mechanical royalty is not payable for the phonorecord, until the licensee "has voluntarily and permanently parted with its possession." 17 U.S.C. § 115(c)(2). Physical products distributed through normal retail channels are usually provided to retailers with a privilege of return. That is, the retailer can return them to the record company for credit if the products do not sell. Because the record company does not permanently part with possession of them when it ships them to the retailer, no mechanical royalty should be payable on the units that ultimately will be returned. The reserve accounting provisions of 37 C.F.R. § 201.19 address this circumstance by

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[6] *See* CO Trial Ex. 11 (Israelite WDT) at ¶44.

striking a balance between the interests of record companies and publishers: publishers are paid on the majority of units before they sell to the consumer at retail but the record company does not pay immediately on all the units it ships, because it estimates some share of them are likely to be returned. In accordance with these provisions, the record company maintains a reasonable reserve, as it is required to do under Generally Accepted Accounting Principles, for some fraction of units estimated to be returned, and "trues up" the reserve against its actual experience.

The Copyright Office's existing reserve accounting regulations already address potential abuses. Under those provisions, licensees are barred from maintaining reserves when, within the preceding three years, "the compulsory licensee has had final judgment entered against it for failure to pay royalties for the reproduction of copyrighted music on phonorecords, or within such period has been definitively found in any proceeding involving bankruptcy, insolvency, receivership, assignment for the benefit of creditors, or similar action, to have failed to pay such royalties." 37 C.F.R. § 201.19(d). In view of this provision, it would be completely unwarranted to eliminate these very important provisions for other licensees. Any proposal by the publishers in this regard is just an attempt to be paid high royalties on units that are ultimately returned and generate no revenue for the record company.

5. Configuration-Specific Licensing and Reporting

Finally, the publishers propose that licensing and reporting be performed by specific configuration. I am mystified by this proposal. In the case of licensing, Section 115 prescribes when and how a license is to be obtained, *see* 17 U.S.C. § 115(b); a notice of intention to obtain a compulsory license is required to "comply, in form, content, and manner of service, with requirements that the Register of Copyrights shall prescribe by regulation," 17 U.S.C. § 115(b)(1); and those regulations specify that a notice is to identify "[t]he types of all

phonorecord configurations already made (if any) and expected to be made under the compulsory license." 37 C.F.R. § 201.18(d)(1)(v)(D). In the case of reporting, the Copyright Office's regulations specify that "if necessary [reports] shall be broken down to identify separately . . . [e]ach phonorecord configuration involved." 37 C.F.R. § 201.19(e)(3)(ii); *see also* 37 C.F.R. § 201.19(f)(4). I do not understand what additional reporting the publishers could possibly want, but any additional reporting seems unnecessary and burdensome.

II. RIAA's Rate Proposal

The publishers have suggested that the implementation of RIAA's rate proposal will be unduly burdensome. Contrary to such attacks, RIAA's proposal is administrable, consistent with the treatment of similar issues in the marketplace, and not unreasonably disruptive.

A. Royalty Base

RIAA has stated all of its royalty proposals as a percentage of the licensee's all-in wholesale revenues. In the case of agreements with digital music services, this appears to be the same royalty base as what the publishers have called "total content costs" – the amounts paid by third parties to the record company for rights to sound recordings and mechanical rights to musical works. This royalty base is used in SONY BMG's NDMAs, and I understand it was also used in other NDMAs that the publishers have pointed to as benchmarks.

This royalty base is appropriate because virtually all mechanical licensing of physical products is to record companies that sell their products at wholesale (incorporating both sound recordings and musical works); almost all mechanical licensing of permanent downloads is through record companies that authorize distribution through digital music services on an all-in basis (e.g. through wholesaling); and some other mechanical licensing (e.g., of on-demand

streams and limited downloads through subscription services) is also through record companies on an all-in basis.

Applying a percentage rate at wholesale makes defining the royalty base relatively straightforward, and susceptible to few of the definitional and operational problems that one might encounter in defining which revenues of an internet-based portal or other service should be attributed to its music service. In the case of physical products, SONY BMG like other record companies sells its products to retailers. We invoice for the sales we make and in due course receive payment, accounting for the revenues recognized in accordance with Generally Accepted Accounting Principles ("GAAP"). The revenues proposed to comprise the royalty base for physical products are simply the gross sales as reflected on the applicable invoices, less returns and applicable sales discounts (since obviously our revenue is reduced by any discount that is taken from the list price).

Revenues realized from services are equally easy to identify. We may have an elaborate agreement with a service concerning which of its revenues should be taken into account in computing its payment to SONY BMG. In entering into such agreements, our interests are aligned with those of the publishers – we both want to generate as much revenue as possible from the distribution of our music. However, ultimately the service provides us sales reports and accountings, as well as payment. The payments to which we are entitled from services are the royalty base RIAA proposes to use in calculating its mechanical royalty payments for digital phonorecord deliveries ("DPDs").

As a result, RIAA has been able to propose a definition of revenue that is patterned on the definition recently adopted by this Court in the SDARS case (37 C.F.R. § 382.11), but is much simpler. The definition proposed by RIAA here is fundamentally "revenue recognized by the

licensee in accordance with Generally Accepted Accounting Principles." RIAA's definition need not provide additional detail concerning subscription and advertising revenues, because they are not applicable at wholesale. Instead, RIAA's definition describes broadly the revenues record companies receive from distribution of physical products and DPDs. Like the definition adopted in the SDARS case, revenue creditable to the licensee but paid to an affiliate is included. The number of exclusions is minimal because the exclusions adopted in the SDARS case by and large do not apply at wholesale. This definition is consistent with existing practice. Our revenues are the basis for payments we make to royalty artists and the musicians unions, and to music publishers in the case of payments for ringtones under our NDMAs.[7]

That leaves two cases requiring special treatment that today represent a very small part of the mechanical licensing marketplace:

- Direct licensing by services. In theory, any digital music service could do its own mechanical licensing. In practice, however, few services are willing to undertake the huge clearance burden borne by record companies; they generally insist that record companies extend rights to both sound recordings and musical works ("all-in" or "pass-through" licensing). As a result, it is my understanding that only the subscription services generally take responsibility to do their own mechanical licensing (and some of them may hire a third party vendor to handle the necessary administrative effort). Under the rubric of "total content costs," the publishers have proposed that they receive the same percentage of the total payment for sound recordings and musical works whether both sets of rights are provided

[7] The NDMAs are not an appropriate rate benchmark for a number of reasons, including the package of trades we made concerning rates for different configurations. However, the definition of the wholesale royalty base and some of the definitions and other noncontroversial implementation details of the NDMAs are indicative of our administrative practices.

together by the record company or they are acquired separately by the service. RIAA adopts this approach to providing an equivalent payment when the service licenses directly.

- Direct retail distribution by record companies. Today I am aware of very little direct retail distribution by record companies. It consists primarily of promotional streaming through artist and label websites, although record companies may sell downloads directly through websites too. Because of the additional costs of retail distribution (e.g., operating a web store, bandwidth, credit card fees, and other fulfillment costs), it would not be fair to apply the same royalty percentage used for wholesale revenue to the higher revenues received at retail. To achieve an economically equivalent result, the rate should be lower to offset the higher base. In the interest of simplicity, RIAA proposes that in the case of direct retail distribution by record companies the applicable percentages be reduced by specific percentages representing approximate wholesale/retail splits for the relevant product category, with that percentage being applied to all the relevant revenues from such distribution. Thus, for example, in the case of a record company that sells downloads from an artist website, the basic rate would be multiplied by 70% (a typical wholesale/retail split for downloads today) to yield approximately the same payment as if the sale had been made at the same price by a third party service.[8] It might be possible to devise other ways to calculate an

[8] RIAA has proposed applying the same 70% split to physical products. There is no such standard retail markup for physical products, because retail prices vary widely among retailers. Retail prices also are not reported to us. However, it historically has been understood that on average, physical product wholesale prices are probably more like 60% of retail. RIAA's

economically equivalent royalty in this situation. However, given the tiny fraction of the market represented by direct retail sales, the administrative burden of a more computationally-intensive approach cannot be justified.

B. Rate Categories

As described above, it would be desirable to have as few as possible distinct categories of products with unique royalty rates, although rates need to be appropriate for each distinct type of use. As compared to the Copyright Owners' rate proposal, RIAA's proposal has significant advantages relative to both of these goals. It includes only three unique rates, for: (1) physical products, downloads, limited downloads and other DPDs in general, (2) ringtones, and (3) on-demand streams and other incidental DPDs. Where necessary to draw a line between categories, RIAA has provided definitions reflecting existing practice between record companies and publishers in the marketplace. For example, RIAA's definitions of the terms "subscription digital music service" and "on-demand stream" are similar to corresponding definitions in the 2001 agreement between RIAA, NMPA and HFA that provided a framework for the mechanical licensing of subscription services. Because RIAA proposes percentage rates in each category, its proposal automatically adapts to the economics of each use. And because it covers physical products, general DPDs and incidental DPDs without any gaps, it covers all "the activities specified by [Section 115]." 17 U.S.C. § 115(c)(3)(C).

C. Bundles

As consumers have grown less and less interested in purchasing traditional audio-only album products, and increasingly migrated to low-value digital singles (or simply stolen music through infringing sources), record companies have tried hard to maximize consumers' spending

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proposal thus in effect probably offers to overpay for direct retail distribution of physical products.

on recorded music. An important piece of those efforts has been offering products that bundle one category of audio-only content with another, or with other value-added content. Bundles can take many forms:

- An example that is a pure physical product would be a disc product like a DualDisc or DVD-A consisting primarily of audio-only tracks with some additional audiovisual material (where any use of musical works would be separately licensed and compensated).
- Examples of pure digital products would be a ringtone bundled with one or more permanent downloads, or a subscription service offering primarily on-demand streams and limited downloads with the ability to retain permanent downloads of a limited number of favorite songs.
- An example of a hybrid bundle combining both physical and online products would be a CD bundled with the right to download the same tracks, or a bonus track. Recently, I have heard discussion of bundling LPs with downloads so that audiophiles will be able to experience analog music with the rich sound of vinyl and still enjoy the easy portability of digital downloads.

Because the Copyright Owners' rate proposal requires payment for use of each musical work in a bundle at the full price as if it were a stand-alone product, it tends to make it uneconomical to offer bundles that are priced at less than the sum of their parts. However, selling a bundle for less than the sum of its parts is precisely what is necessary to entice consumers to buy such bundles rather than just a part of them, and thereby to generate more revenue in which record companies, publishers and writers can share. RIAA's proposal solves this problem by using a percentage of revenue. It addresses allocation of revenues among the

different types of elements in a bundle with a straightforward rule based on existing marketplace practice. In general, where possible, revenue is to be allocated based on the published prices of the individual components. This is consistent with the approach taken in SONY BMG's NDMAs. If there were no published price for the individual items, a reasonable and non-discriminatory allocation methodology would need to be applied consistently. It is sometimes necessary for SONY BMG to make allocations like this in accounting under our artist and producer contracts.

D. Allocation Among Works

One reason a percentage rate is so desirable is because the amount payable from the sale of a product depends on the revenue that can be generated from sales, not the number of tracks. Thus, for example, the royalty would not depend on whether the artist wishes to include 12 tracks on his or her album or 14; it would depend upon the price at which we can get it into distribution. As a result, it is necessary to allocate the revenue-based royalty among the tracks of a product. This must be the case for some of the publishers' percentage-based royalty structures as well (e.g., for limited downloads of albums), although I am not aware that they have proposed a way to do this allocation. RIAA proposes dividing the revenue equally among the relevant tracks, which is how we pay artists and producers already. Thus, if an album had 13 tracks, each track would be allocated 1/13 of the revenue generated by the sale of the album. Other options are certainly possible. For example, one could take into account long works. However, doing so would be much more complicated. Doing so would not clearly be fairer, since among the tracks on a typical album, the difference in length among the tracks is probably not a very good indication of either the commercial value of the song or the effort that went into creating it. For

example, our controlled composition clauses typically do not call for extra payment for long works.

E. Transition Period

If this Court adopts a percentage rate, it will take a certain time to implement the new rate structure in the computer systems SONY BMG uses for royalty distribution. If the rate structure is relatively straightforward, like RIAA's rate proposal, it should take no more than about six months to complete the necessary programming. If the rate structure were more complex, like the five rate categories and several three or four-part greater-of rate structures proposed by the publishers, it would take longer and cost more. Once our royalty system was programmed for the new rate structure, we could immediately begin calculating royalties based on the new structure (and paying royalties for which we had done the necessary calculations) for all new releases. However, it would take additional time to convert the data in our databases for all our past releases.

RIAA's rate proposal includes a transition provision designed to permit the foregoing. Because virtually all of our accounting is on a quarterly basis, RIAA proposes that the new rates be effective on the first day of a quarter. Having rates effective on the first day of a month that is not the first day of a quarter would in essence require two separate accounting cycles for the quarter.[9] RIAA proposes that the effective date be the first day of a quarter more than six months after this Court's decision is final, if RIAA's percentage rate proposal is adopted, to provide time for all parties to adjust their systems to reflect the new rate structure. (If the Court

[9] The Copyright Royalty Judges have the discretion to set an effective date for the first day of a quarter. Section 803(d)(2)(B) of the Copyright Act states that mechanical royalty rates set by this proceeding will take effect "on the first day of the second month that begins the after the publication of the determination of the Copyright Royalty Judges in the Federal Register, except as otherwise provided in this title, or by the Copyright Royalty Judges."

were to adopt a more complicated rate structure like that proposed by the Copyright Owners, I estimate that approximately 12 months would be required for implementation.) To permit data conversion for record company catalogues, RIAA also proposes that record companies have the option of paying for older releases under the old rate structure for a further 12 months. The opportunity to pay under a percentage rate will certainly motivate us to proceed with the conversion process promptly, particularly if rates go down as we strongly believe they should, but we still must modify and extensively test our computer systems and convert and validate a very large set of data to handle any new rate structure. We want to make sure that we make the necessary conversions correctly, so it is important to provide a reasonable transition period to undertake all the necessary data conversion.

I should be clear that despite the need for an information technology project to convert to a percentage rate structure, I very much favor such a structure and do not view it as disruptive when viewed from a long-term perspective. I also do not believe that it should be viewed as disruptive to publishers, because (1) publishers receive mechanical royalty payments abroad on a percentage basis, and (2) to the extent that, for purposes of their writer contracts, publishers need to know how many cents per track record companies are paying them, our statements provide the total number of units sold and our total payment for a song, which enables publishers to do the simple math of dividing our payment by the number of units of the song sold. A percentage rate is very important to the long term health of the music industry. The one-time nuisance of conversion should not stand in the way of what is clearly the right thing to do.

F. Alternative Rate Request

RIAA has provided an alternative rate request with cents rates for all existing product types of any consequence. I do not favor this alternative cents rate proposal. A percentage rate

is the better rate structure. I understand that RIAA has provided this alternative only in case this Court determines that it is not appropriate to adopt a percentage rate structure.

RIAA's alternative proposal identifies a number of rate categories, and for physical products and a la carte downloads several price bands. Within each price band, I understand that RIAA has specified a cents rate royalty that is approximately equivalent to its percentage rate proposal. Importantly, RIAA's alternative proposal includes a percentage rate for subscription services and other categories of new digital uses that constitute a small portion of the market with uncertain economics.

RIAA's alternative proposal also has special rules to address two problems we have encountered under the current cents rate structure. These problems would not exist under a percentage rate structure. However, if this Court adopts a cents rate structure (or cents rate minima), it is important that these issues be addressed specially:

- Locked Content. One mode of distribution with which there has been some experimentation, and that could become more common over the coming rate period, is distribution of locked content, either preloaded on a device or by means of DPD. Locked content is a recording that has been encrypted or degraded so as to be accessible in non-degraded form only for limited previewing absent a purchase transaction. For example, a computer hard drive or an MP3 player might ship with a thousand or more locked recordings that would be available for the consumer to buy and unlock. If a full physical mechanical royalty were payable when the locked content shipped, this model would be impossible to pursue, because the mechanical royalty on a thousand locked recordings would be $91 at today's rate. Nobody could possibly afford to pay $91 to ship a thousand locked recordings that have not been

paid for and that might not ever be listened to. It only makes sense for the royalty to become payable when the content is permanently distributed (i.e., when it is unlocked), and RIAA's proposal so provides.

- Multiple Instances. Publishers delayed the introduction of multisession physical products such as DualDisc by claiming that under the current cents rate structure they are entitled to be paid multiple times when the same recording appears on a disc multiple times to enable the disc to be played on multiple devices or at different levels of sound quality. We think that is wrong as a matter of law, because the mechanical royalty is to be paid for each phonorecord distributed – not each session on a phonorecord. Nobody ever thought the law required separate payment for the left and right stereo channels on an LP or CD; there is no reason the various sessions on a DualDisc or SACD that are included to enable play on different types of platforms should be treated differently. Certainly the economics of these products would not warrant paying a multiple of the usual royalty. RIAA's proposal addresses this problem by making clear that it is only necessary to pay once for the use of a particular recording on a disc.

RIAA's alternative rate proposal has some of the flexibility and fairness of a percentage rate structure. However, it is a poor substitute for a percentage rate royalty. That said, it certainly would be preferable to a cents rate structure with no sensitivity to differences in product types and pricing.

G. Terms

RIAA has proposed four terms in the hope that they would make the compulsory license more useful than it has been:

- Clarification of Covered Reproductions. As part of this first proceeding to determine royalty rates for DPDs, this Court should clarify that DPD licenses, and the rates the Court sets, include all reproductions necessary to deliver a DPD to the end user - including server and buffer copies. SONY BMG believes this to be the case under current law, and this should not be controversial. NMPA/HFA agreed to this proposition in their 2001 agreement with RIAA to provide a framework for launching subscription services. The specific language of RIAA's proposal is based on legislation NMPA supported in 2006 that, among other things, also would have clarified this point – Section 2 of the Section 115 Reform Act of 2006 (H.R. 5553) and Section 102 of the Copyright Modernization Act of 2006 (H.R. 6052). However, because occasional questions along these lines arise from time to time, it would advance the online market to resolve them once and for all.
- Accounting for DPDs. The current reporting period under Section 115 is too short to be practicable for accounting for DPDs. The twenty day payment cycle simply does not allow services enough time to complete their month-end accounting cycle, report to record companies, and then for record companies to do the same to report to publishers. RIAA has proposed treating the DPD as distributed when reported. This refinement is more consistent with marketplace practice, which almost always provides a 45 day payment cycle for mechanical royalties. This refinement could materially enhance the usability of the compulsory license for DPDs.
- Signing Statements of Account. If SONY BMG were to use the compulsory license, we would need to have an officer of the corporation sign hundreds or thousands of

accounting statements each month. Permitting these statements to be signed by any authorized agent could materially enhance the usability of the compulsory license.

- Audit. The compulsory license presently requires a burdensome certification of annual statements that is duplicative of other audits. SONY BMG, like other companies, conducts its own annual audit, and we are also regularly audited by publishers. While we try to and generally do respond to publishers' broad and often duplicative requests for information promptly, such audits are very demanding on the time of our staff. The often-unreasonable demands for additional royalties that publishers make can sometimes hang over our heads for years, and it can be very difficult for us to get to closure on an audit. Anything that can be done to reduce unnecessary burdens in this area would be a very good thing. The compulsory license certification process is redundant and a material impediment to use of the compulsory license. As in the case of Section 114, an independent audit should serve as a sufficient verification procedure.

III. Responses to Other Arguments Made by the Copyright Owners

A. There Are Substantial Transaction Costs of Negotiating Mechanical Licenses Below the Statutory Rate

I understand that witnesses for the music publishers have testified that the transaction costs associated with negotiating mechanical licenses at rates below the statutory rate are low. Those claims are inconsistent with my experience overseeing such negotiations at SONY BMG. HFA does not have authorization from its publisher-principals to grant reduced-rate licenses in the ordinary course. Each such license requires specific consent to the reduced rate from each publisher who controls a share of the composition. As a result, for there to be any negotiation, we must contact the publishers directly ourselves. That process is usually very time consuming,

because multiple publishing interests are typically involved in a single composition. For example, in the case of an album with thirteen tracks, there may be several writers on each song, which means that we might need to obtain 20 - 30 licenses for that one album. Typically some publishers would control pieces of multiple tracks, but it would not be unusual to work with more than 15 publishers on the licensing of an album.

Simply reaching appropriate people at over 15 publishing companies can take time, but that is not the end of the process and is not always successful. Because it is a negotiation, there are often multiple rounds of communication back and forth. Publishers do not always respond to our inquiries, or respond promptly, and it can take numerous telephone calls just to get a single publisher's consent. For example, in the case of our release of Barry Manilow's "The Greatest Songs of the Sixties," an album of 14 cover songs for which we needed to secure 25 licenses from 14 different publishers. SONY BMG tried to negotiate a rate of 75% of the statutory rate and offered an advance based on 250,000 units, which we ultimately increased to 300,000 units. One publisher accepted our offer, and three accepted our offer on a "most favored nation" basis. Five publishers denied our requests for a discount, one of them saying it would not agree to a reduced rate unless we gave it an advance on one million units. Five publishers simply did not respond at all to our repeated contacts. In the end, we had to pay the full statutory rate for all but one song.

The transaction costs associated with obtaining mechanical licenses at the statutory rate are lower because no negotiation is involved. For new works, there is as good deal of work done to identify shareholders and obtain splits but, once the publishers know that they own the song and the splits are negotiated among the publishers and writers, such licenses generally are available through straightforward licensing procedures offered by HFA and individual

publishers. To obtain a mechanical license at the statutory rate, SONY BMG submits a standard mechanical license request to either HFA or the publisher that provides information identifying the relevant song and the various products to be released. For HFA-represented publishers, we generally do this electronically and in bulk, and if the song is in HFA's database, the license is issued electronically, or even automatically. Obtaining a statutory rate license from individual publishers is not much different. Once the publishers know they own the song and the splits are negotiated among the publishers and writers, there generally is little, if any, need to have a discussion about licensing at the statutory rate. Such licenses are often obtained with nothing more than an email request. Because the process is very streamlined, the transaction costs associated with obtaining licenses for known works at the statutory rate are very modest.

SONY BMG's Copyright Administration Department has determined that incurring the transaction costs of seeking reduced-rate licenses can seldom be justified in the case of single-disc products that are anticipated to sell fewer than [redacted] units. We strongly discourage requests by SONY BMG labels to seek reduced mechanical rates for single-disc products anticipated to sell fewer than [redacted] units. Thus, the publishers' claim that this Court could simply set a high mechanical rate and the parties would then negotiate fair reduced rates is simply untrue.

B. SONY BMG Does Not Pay Commissions or Fees to HFA

My understanding is that one of the publishers' expert witnesses, Professor Landes, testified in the direct case that record companies pay commissions or fees to HFA in connection with mechanical licenses.[10] Professor Landes' claim is simply wrong with respect to SONY BMG. SONY BMG does not pay fees or commissions to HFA for the processing of mechanical

[10] 2/7/08 Tr. 2119: 18-20 (Landes).

licenses. Although we do pay *advances* to HFA against mechanical royalty payments that have yet to be processed, those payments are not commissions or fees; they are merely advances of payments due. I am also not aware that HFA seeks to collect, or that other record companies pay, fees or commissions to HFA for the processing of mechanical licenses.

By contrast, I understand that the publishers presented testimony that they do pay commissions to HFA. I understand that HFA's current commission rate is generally 6.75% of royalties distributed, plus a supplementary 1% commission to fund NMPA's participation in this proceeding, for a total of 7.75%. This indicates that the publishers are willing to accept less than the current statutory rate of 9.1 cents – i.e., they are willing to accept a rate of 9.1 cents minus the commissions they pay to HFA (which yields about 8.4 cents after the commission) for a voluntary license at what is ostensibly the full statutory rate.

C. Declining Mechanical Royalty Payments through HFA Probably Reflect Direct Licensing

I understand that the publishers provided testimony that the aggregate payments through HFA have been declining.[11] If true, this phenomenon can probably be explained at least in part by a higher incidence of direct licensing by publishers. SONY BMG does not have ready access to historical data about the share of our mechanical royalty payments made through HFA. However, we will license directly from a publisher or through HFA as the publisher wishes. My sense is that major publishers increasingly are asking us to license from them and pay them directly rather than through HFA, particularly on our most significant releases.

[11] 1/31/08 Tr. 1007: 18 - 22 (Robinson).

D. The Relevance of the Statutory Rate: Controlled Composition Clauses Do Not Control Digital Phonorecord Deliveries Specified in Contracts Entered Into After June 22, 1995.

I understand that several of the publisher and songwriter witnesses complained that controlled composition clauses reduce the actual amount of mechanical royalties they receive, and that the Judges therefore should increase the statutory mechanical royalty rate.[12] As an initial matter, these witnesses are simply arguing against the marketplace. If they voluntarily accept less than the statutory rate because they want their songs recorded and that is all SONY BMG or another record company is prepared to pay, why should the statutory rate go up as a result? But that testimony also overlooks the critical fact that the statutory mechanical royalty rate applies in lieu of contrary rates under controlled composition clauses in the case of DPDs of recordings made under recording contracts entered into after June 22, 1995.[13] For DPDs of recordings made under post-1995 recording contracts, which are becoming an increasingly large part of the market, we cannot negotiate for a discounted rate as part of our artist contracts. Accordingly, it is up to this Court to set an appropriate royalty rate. Certainly the mechanical rate should not be set artificially high with the expectation that the parties can and will negotiate rates below it – as there is no practical opportunity to do so for DPDs made pursuant to post-1995 recording contracts. To the contrary, the rate should go down to internalize in the statutory rate the kinds of marketplace negotiations that have traditionally resulted in significant discounting from the statutory rate.

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[12] *See* CO Trial Ex. 4 (Galdston WDT) at ¶12; CO Trial Ex. 5 (Shaw WDT) at ¶14; and CO Trial Ex. 13 (Peer WDT) at ¶55.

[13] *See* 17 U.S.C. § 115(c)(3)(E). I note that this provision does not make our artist contracts or even controlled composition clauses illegal, or vitiate the license that typically is granted to us in our controlled composition clauses. To the contrary, it contemplates that controlled composition clauses will continue to exist. It simply provides that the statutory rate "shall be given effect . . . in lieu of any contrary royalty rates specified in" a controlled composition clause.

This is particularly important in the case of album downloads. Our controlled composition clauses typically contain a cap on the number of tracks on which we will pay mechanical royalties, which limits the mechanical royalties paid per physical album to a defined amount. This cap has historically allowed us to give the artist freedom to determine how many tracks the artist wants on his or her album, and artists frequently have included on their albums a number of tracks in excess of the cap. In that circumstance, artists and co-writers who have agreed to the cap receive reduced mechanical royalties. This system worked well for physical albums, but paying the full cents rate statutory rate for the download equivalents of physical albums can lead to extremely high mechanical royalty payments and significantly undermine the profitability of digital albums. The publishers' proposed download rate of 15 cents implies a mechanical royalty payment of $1.95 for a 13 track album with a wholesale price of about $7.00. That is a mechanical royalty rate of almost 28% of wholesale. On a 15-track album, the mechanical royalty payment would be $2.25, or 32% of wholesale. At those rates, it is likely that we would have to limit the tracks we record and distribute, resulting in less availability of musical works and sound recordings to the public and fewer opportunities for songs to get their songs recorded.

Another important aspect of our controlled composition clauses is their treatment of promotional uses. They typically allow us to use controlled compositions for promotional purposes without charge. That makes sense because we are not profiting from promotional uses, but record companies, publishers and writers alike all benefit when, as a result of the record company's promotional investment, more recordings are sold. Promotional uses can take many forms, but increasingly, promotion is happening online, and most often in the form of on-demand streams of recordings. RIAA's rate proposal enables online promotional uses because record

companies would pay mechanical royalties only when they recognize revenue from a use. A cents rate royalty (or minimum), particularly for on-demand streams, could devastate the ability of record companies to promote recordings online, to the detriment of everyone who benefits from paid sales.

Recognizing that the statutory mechanical royalty rate applies in lieu of contrary rates under controlled composition clauses in the case of DPDs of recordings made under in recording contracts entered into after June 22, 1995, it is vitally important that the rates determined in this proceeding have the effects of controlled composition clauses in allowing artists to include on their albums the songs they want to make available to the public and enabling promotion of recordings. A percentage rate would do that automatically. If this Court determines that a cents rate structure or cents rate minima are more appropriate, they should be set at levels that enable album download sales and online promotions.

I declare under penalty of perjury that the foregoing testimony is true and correct.

Date: April 3, 2008

Andrea Finkelstein

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RIAA Ex. 134-RP

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ATTN: DANIEL SUSLA, #2321
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NEW YORK, NY 10022

LICENSE NO. 108-033-1274
March 24, 2008
TRX.NO. 14869110

Refer to provisions hereof reproduced in (E) varying terms of compulsory license provision of Copyright Act. The following is supplementary thereto:

A. SONG CODE: A62530
TITLE: ANOTHER BRICK IN THE WALL WRITERS: ROGER WATERS

B. INCOME PARTICIPANT(S):
WARNER TAMERLANE PUB CORPO/B/O MUZIEKUITGEVERIJ ARTEMIS BV 100%

C. RECORD NO.: (CD) 886927297430101

ARTIST: KORN

ROYALTY RATE: STATUTORY
PLAYING TIME: 2 MINUTE(S) 21 SECOND(S)

D. ADDITIONAL PROVISIONS:

THE AUTHORITY HEREUNDER IS LIMITED TO THE MANUFACTURE AND DISTRIBUTION OF PHONORECORDS SOLELY IN THE UNITED STATES, ITS TERRITORIES AND POSSESSIONS AND NOT ELSEWHERE.

CREDIT: IN REGARD TO ALL PHONERECORDS MANUFACTURED, DISTRIBUTED AND/OR SOLD HEREUNDER, YOU SHALL USE YOUR BEST EFFORTS TO INCLUDE IN THE LABEL COPY OF ALL SUCH PHONORECORDS, OR ON THE PERMANENT CONTAINERS OF ALL SUCH PHONORECORDS, PRINTED WRITER/PUBLISHER CREDIT IN THE FORM OF THE NAMES OF THE WRITER(S) AND THE PUBLISHER(S) OF THE COPYRIGHTED WORK.

THE MANUFACTURER FURTHER AGREES THAT ALL SUMS INDICATED AS DUE AND

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OWING ON STATEMENTS RENDERED HEREUNDER SHALL BEAR INTEREST AT THE RATE OF 7% PER ANNUM FROM THE DATE DUE IF NOT PAID WITHIN 30 DAYS AFTER THE DATE DUE AND PAYABLE.

CONFIG : CD PUB: WARNER CHAPPELL MUSIC AUSTRALIA PTY. LTD.

ALBUM: GREATEST HITS, VOL. 1
DATE OF RELEASE: March 2008 RECORD LABEL: SONY BMG CATALO

CONFIGURATION CODE: CD - COMPACT DISC (ALBUM)

E. GENERAL VARIATIONS OF COMPULSORY LICENSE PROVISION:

You have advised us, in our capacity as Agent for the Publisher(s) referred to in (B) supra, that you wish to obtain a compulsory license to make and to distribute phonorecords of the copyrighted work referred to in (A) supra, under the compulsory license provision of Section 115 of the Copyright Act.

Upon your doing so, you shall have all the rights which are granted to, and all the obligations which are imposed upon, users of said copyrighted work under the compulsory license provision of the Copyright Act, after phonorecords of the copyrighted work have been distributed to the public in the United States under the authority of the copyright owner by another person, except that with respect to phonorecords thereof made and distributed hereunder:

1. You shall pay royalties and account to us as Agent for and on behalf of said Publisher(s) quarterly, within forty-five days after the end of each calendar quarter, on the basis of phonorecords made and distributed;

2. For such phonorecords made and distributed, the royalty shall be the statutory rate in effect at the time the phonorecord is made, except as otherwise stated in (C) supra;

3. This compulsory license covers and is limited to one particular recording

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of said copyrighted work as performed by the artist and on the phonorecord number identified in (C) supra; and this compulsory license does not supersede nor in any way affect any prior agreements now in effect respecting phonorecords of said copyrighted work.

4. In the event that you fail to account to HFA and pay royalties as herein provided for, said Publisher(s) or his Agent may give written notice to you that, unless the default is remedied within 30 days from the date of the notice, this compulsory license will be automatically terminated. Such termination shall render either the making or the distribution, or both, of all phonorecords for which royalties have not been paid, actionable as acts of infringement under, and fully subject to the remedies provided by, the Copyright Act.

5. You need not serve or file the notice of intention to obtain a compulsory license required by the Copyright Act.

6. Additional provisions are reproduced under (D) supra.

THE HARRY FOX AGENCY, INC.

BY: Gary L. Churgin

Gary L. Churgin
President and CEO

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SONY BMG MUSIC ENTERTAINMENT

SIGNED BY: tracey fisher

An Authorized Representative

License Electronically Signed via HFA Online