PUBLIC

SONY BMG
MUSIC ENTERTAINMENT

550 Madison Avenue . New York . NY . 10022-3211 . 212.833.8000

TESTIMONY OF

ANDREA FINKELSTEIN

Senior Vice President, Business Affairs Operations and Administration

SONY BMG MUSIC ENTERTAINMENT

New York, NY

Before the
COPYRIGHT ROYALTY JUDGES
Washington, D.C.

QUALIFICATIONS

My name is Andrea Finkelstein, and I am the Senior Vice President, Business Affairs Operations and Administration for SONY BMG MUSIC ENTERTAINMENT. In that capacity, I oversee the administration of the mechanical licenses SONY BMG obtains to create recordings and make our music available to the public. In addition, I oversee the Artists & Repertoire ("A&R") Administration function for the Sony Music and SONY BMG Commercial Group labels, and have responsibility for the financial administration of the business and legal affairs area of the company. I have worked in the music business for 25 years, all of that time at CBS Records, Sony Music and now SONY BMG. I joined CBS Records immediately after graduating from Columbia Business School and worked in the Finance area for three years before moving to the A&R Administration and Business Affairs area. I graduated from Dartmouth College in 1977.

SUMMARY

The mechanical compulsory license plays a fundamental role in the music industry. However, both its licensing process, which is largely defined by statute, and its rate structure and terms of payment, which are the subjects of this proceeding, are relics of another time – a time when record companies sold basically one product through one distribution channel.

During the last decade, as the number of different products that record companies create and the methods of distribution have multiplied, the current rate structure has proven too prone to fundamental disputes. In one situation after another, uncertainty concerning the application of the compulsory license (including its rates and terms) to new products and services has led to disputes with publishers. Those disputes have, in turn, impeded major business initiatives, prevented us from making creative works available to the public, and thereby hurt both the public and everyone in the music value chain. We need to be able to rely on the rates and terms

set in this proceeding to obtain and administer licenses for numerous diverse existing product types and for new products and business models that we cannot think of today. We are most likely to be able to do that if the Copyright Royalty Judges (the "Judges") were to adopt a percentage rate structure. A fair percentage royalty rate structure that does not make payments subject to variation because of the behind-the-scenes technology would provide certainty and eliminate the potential after-the-fact "gotcha" claim.

Rates set in this proceeding also need to take into account the enormous license administration costs that are imposed by Section 115 and only partially ameliorated by the alternative licensing structures that have evolved in the marketplace. Unlike in most countries of the world, record companies in the U.S. are responsible for publisher-by-publisher, work-by-work, share-by-share administration of mechanical licenses. As a result, a major record company like SONY BMG obtains a lot of mechanical licenses – on the order of 50,000 per year in the U.S. for physical products only, and many thousands more for digital products. And in a typical accounting period we render about 12,000 statements and payments to music publishers. The administration of these licenses requires a huge effort and represents a significant investment in the products we make available to the public.

In my testimony, I will first describe some of the background circumstances that make mechanical licensing difficult. Second, I will explain administration of mechanical licenses so that the Judges will understand the investment record companies make in mechanical licensing, and why the costs of mechanical license administration borne by the record companies are much higher in the U.S. than under foreign mechanical licensing systems that provide a relevant benchmark in this proceeding. I also will highlight circumstances in which the current rate structure and terms have impeded our ability to make creative works available to the public and

further increased the administrative cost of obtaining licenses. Finally, I will explain why the rates and terms proposed by RIAA are a significant improvement on those that apply today.

DISCUSSION

I. Problems for Administration of Mechanical Licenses

Several phenomena make administration of mechanical licenses particularly difficult.

A. Work-by-Work, Share-by Share, Configuration-by-Configuration Licensing

Mechanical licensing in the U.S. is very burdensome, because Section 115 is not a "blanket" license.[1] That means that a Section 115 license does not cover the entire repertoire of musical works. Instead, a separate Section 115 license needs to be obtained for each individual musical work. And typically each recording and each "format" or "configuration" (e.g., CD, download) are licensed separately. Furthermore, new licenses are sought whenever a song is used on a new product (e.g., a different set of tracks on a disc) – even if licenses have previously been obtained for the same recording of the same song in the same format.

This process makes Section 115 unlike the statutory licenses provided by Sections 112 and 114, and unlike performance licensing of musical works. In this respect, Section 115 is also unlike mechanical licensing in Europe (and almost every other country), where rates have historically been higher than in the U.S. but are now lower because of recent disproportionate growth in U.S. royalties.

B. Split Copyrights

In practice, work-by-work licensing is even harder than it sounds because of a phenomenon referred to as "split copyrights." Musical works are usually the result of collaborative efforts, and each contributor typically ends up owning a share of the song. Today,

[1] *See* 17 U.S.C. § 115 (RIAA Ex. K-101-DP).

songs are often the result of collaboration between the producer and artist. For example, a producer might have an idea for the tune of a song, and after being hired to produce a track on an album, work with the artist to create lyrics to accompany the tune. Songs often come together in the studio during recording sessions, or even later in the production process, and the songs incorporate suggestions from different members of the band and other participants in the production process. Each contributor to a song is entitled to a share of copyright ownership of the final musical work. The negotiation of those relative shares can drag on for months or even years, since the writers initially may claim shares that in total exceed 100% of the copyright.

"Samples" are another reason there are so many split copyrights. A sample is a piece of an earlier recording, or a piece of an existing composition that is re-recorded, then electronically processed and often looped as a component in a new recording. Nearly all of the urban albums we release contain multiple samples. Use of the sampled musical work and recording generally needs to be licensed. As part of that process, the owner of the copyright in the sampled song typically ends up owning a share of the new song incorporating the sample. Once the sample share is known, the writers of the new song will divide the balance of the copyright.

As a result of collaboration and sampling, most songs are co-owned by at least two publishers, and often three or five. I have seen songs divided among as many as seven publishers. To license an album, we often need to work with more than 15 publishers. This is more of a problem in some genres than others. In the case of rap and other urban genres, it is a particularly acute problem. For example, rappers often write a rap to a beat created by their producer. It is not unusual to have writing credit on a urban song split 5 or 6 ways. Historically, this was less of an issue for pop music, but recently there has been a trend toward adding rap and urban effects, including samples, to pop tunes.

C. The Compulsory License Process Is So Burdensome It Is Almost Never Used

The mechanical compulsory license plays an important role in the music industry, but technically it is virtually never invoked. It contemplates too much searching of incomplete and sometimes paper-based Copyright Office records, provision of too much information in too cumbersome a way, too many manual processes, too short an accounting cycle, and too expensive an annual certification process to be used by record companies except in desperation. We prefer to enter into voluntary licenses.

The licensing and accounting process envisioned by the compulsory license might have worked in 1909 when recordings were an expensive luxury item and record companies were not issuing thousands of releases a year, as SONY BMG does on average. But for most of the time that the compulsory license has existed, the recording and music publishing industries have operated on the basis of voluntary mechanical licensing, often through The Harry Fox Agency ("HFA"), but also often through publishers directly. Voluntary licensing processes are less burdensome than the statutory process, and most notably, accounting is on a quarterly basis, 45 days after the end of each quarter, rather than monthly as provided in Section 115.

At SONY BMG,

[redacted]

The compulsory license nonetheless serves an important role in the industry, and that is why we are participating in this proceeding. In addition to ensuring the availability of musical works so that record companies can make creative new sound recordings available to the public, the compulsory license provides a benchmark rate for a number of purposes that don't necessarily depend on the availability of the compulsory license. Writers' agreements with publishers authorize them to license mechanical uses at the statutory rate without further consent,

even if a writer's consent may be required for other uses. Because there is the last resort of a compulsory license (no matter how impractical), publishers and writers almost always license use of any song at a rate no higher than the statutory rate. Even if the compulsory license doesn't technically apply they almost always do the same. Record companies seldom seek to negotiate with music publishers rates less that the statutory rate, because we know it is usually futile. And when licenses are granted at less than the statutory rate, they are almost always granted at a stated percentage of the statutory rate.

II. Administration of Mechanical Licenses

A. The Clearance Process

To obtain the right to use particular songs, and to provide correct credits to songwriters and music publishers on album packaging, record companies engage in what is called the "clearance" process. I oversee the department at SONY BMG that handles the clearance process.

The clearance process begins when recording of a new album is largely completed, so it is known what songs the artist and label want to release and what form the songs will take (so that they can, for example, be reviewed to see if they contain any samples). Because the songs on the album, and the final form of each song (including samples and each potential co-writer's contributions to the song), may not be known until that point, it would not be practicable to begin the clearance process much earlier.

Artist and producer management typically provide the basic publisher information for the songs that have been recorded. The A&R department then provides our Copyright department with that basic identifying information for the tracks – so-called "label copy" – and information about all the samples in each recording that have been identified by the artist or label. Because it is our goal to have proper credits for packaging, we endeavor to reach out to each publisher well

in advance of the release date. At that time we ask publishers to confirm their specific corporate entity that owns the copyright and make their split claims. In a different era, songs recorded by our artists were frequently brought to us by one of the music publishers seeking placement of a song. Today, that is not often the case. These days, far from promoting songs to us, the publishers typically do not know of the existence of a new song when we approach them to confirm the label copy. While a publisher may identify a particular writer as the publisher's, and be able to confirm credit information for that writer, our call may be the first time that the publisher has heard of the song. It is also unlikely that splits will be known at that time. Of course, at that point, the band (which typically includes some of the writers) and the label are always anxious to get the recording to market as soon as possible.

The Copyright department's process of verifying the label copy provided by the A&R department and confirming the identity of the copyright owner and its split so that we can request a license may sound reasonably straightforward. In the case of cover recordings it usually is. However, approximately 85% of the songs we clear on new album releases are new songs, and identifying all the copyright owners and their shares of a new song can be maddeningly difficult. It can take months or even years for the participants in the recording process to sort out who made contributions to the finished version of the song. But if the splits are in dispute, we cannot complete our share-by-share licenses. Record companies are in a "Catch 22" situation, because in most cases the publishers will only license their own share of a work, but yet they often don't know what that share is. Record companies must follow up repeatedly in order to obtain final split information from music publishers. Resources such as HFA's database are of no help with these new songs. Sometimes the record company A&R representatives will assist by going back to the songwriters to encourage them to attend to the resolution of the splits.

As a matter of law, any one co-owner could license a song outright. And Section 115 contemplates that one co-owner will receive 100% of royalties and distribute it to the other co-owners. However, as a matter of practice, this is not usually how it works. Publishers will only license the portion of the song that it owns, thus requiring that we get a separate license and separately account for each share of each song. In the case of physical products, HFA will issue a license for the shares licensable through HFA, but not other shares. In the case of digital phonorecord deliveries ("DPDs"), HFA will issue a license for "the whole song," but requires direct payment to publishers who own other shares. Even when the controlled composition clause included in as artist's recording agreement gives us a license to a whole song, publishers want us to pay each publisher directly, and we typically honor that preference.

Thus, once we have the minimum information required, we will request licenses from each of the relevant publishers and/or HFA if we know a publisher licenses through HFA. However, even if the publisher now knows of the existence of the song, HFA often does not know of the existence of a new song when we request a license from it. As a result, license requests frequently are not granted promptly, and it takes time and explanation for everyone to understand that a new song is available to be licensed.

Licenses are also typically issued for specific configurations. At SONY BMG, we try where possible to request licenses for a broad range of configurations when doing the initial clearance for an album. However, during the last few years, both the number of configurations and the number of product variations in each configuration have multiplied, increasing the likelihood that we will have to re-license tracks later, at additional cost. Each time we want to release a recording under a new record number, publishers require that we re-license the song for that record, even if the exact same recording of the composition has already been licensed for

release in that configuration. In the current environment, different specialized versions of an album with unique content for a specific retail account have become a way to stimulate sales. For example, Wal-Mart might sell a different version of an album than Target. Each version has its own record number, and each new record number means re-licensing content. Even more important, in these times of great technological change, re-licensing vast portions of our catalog for new types of offerings like downloads and subscription services has been a huge undertaking.

New technologies have made the process of obtaining licenses more difficult in another significant way as well. Everyone understands what a CD is. However, with each new product or service introduction, we need to go through a large educational effort – first to educate our Copyright department about the offering and how it should be treated for licensing purposes, and then to do the same for the many publishers we deal with every day. Publishers may be slow to respond to our requests for licenses for these unknown products or wonder how the mechanical royalty rate structure applies to them. In our hit-driven, short attention span culture, it is not in anybody's interest to delay licensing of new products. We believe that publishers and songwriters want record companies to push the envelope and find new and interesting ways to make money from recorded music, yet we who finance the recordings and develop the new products sometimes are left to beg for licenses because there too often is uncertainty concerning application of the current royalty rate structure. There should be a royalty rate structure that will allow record companies to create new products and services without worrying about possible royalty rate disputes with publishers. By avoiding such disputes, a percentage royalty structure would maximize the availability of music to the public and be faithful to the underlying intent of the compulsory license.

The bottom line is that clearance and licensing is a complex, labor-intensive process, which is getting worse. There are often long delays and lots of back and forth before we can get all the necessary paperwork in place and can get the proper royalty rates coded into our royalty accounting system.

The license request process potentially could include negotiation of mechanical royalty rates, but it usually does not. We almost always receive licenses at the statutory rate, unless we have a license, or the right to obtain a license, at a discounted rate under a controlled composition clause (i.e., a provision in an artist's recording contract that grants us a mechanical license to songs written by the artist, and related rights such as for videos). Thus, while Section 115 technically does not apply to the first use of a song, so the publisher could demand a higher rate than the statutory rate, the only situations I can think of where publishers have refused to grant a voluntary license for a single musical work at the statutory rate are the new configurations I describe below. Only very rarely, when we need to license multiple songs for a single track – such as in the case of multiple samples within one new composition or in a medley – does our aggregate mechanical royalty payment for physical products exceed the statutory rate.

Conversely, on frontline products, we seldom ask for a lower rate in our dealings with publishers, because the transaction costs of negotiation are high, and experience has taught us that it is usually futile. If we do ask for a lower rate, it is usually for use with specific products, such as a particular budget release. Even if there is a compelling argument as to why tracks on a certain album might be good candidates for reduced rates, we know that in order to obtain such rates we will have to contact each publisher who has any share of a work. HFA does not have authority to grant reduced rate licenses without the consent of its publisher-principal, so working

through HFA is not an effective substitute for our negotiating with all the affected publishers individually. And even if some publishers are willing to grant reduced rates, they are typically on a "most favored nations" basis, meaning that we only get the benefit of the reduced rates if every publisher with a song on the album agrees. In view of that reality, it usually is not worth requesting discounted rates unless the number of publishers with songs on the album is small.

B. Problems Obtaining Licenses

What I have just described is the clearance process when it works normally. In the past five years, every major new product or service type has given rise to disputes that have prevented the clearance process from working normally. Instead, our inability to obtain licenses because of these disputes has delayed product launches and limited industry growth. If the Judges continue the current cents rate structure, we will probably experience similar problems in the future. With a more flexible rate structure, I believe that similar kinds of problems can be avoided.

In 1999-2000, Sony (we had not then merged with BMG) was ready to license download services, but HFA would not issue DPD licenses due to disagreements over the licensing process, rates, technical requirements and other matters. Given HFA's reluctance to issue DPD licenses, we were concerned that only controlled compositions would be available as downloads.

HFA eventually relented on permanent downloads, but we continued to disagree over how Section 115 applied to subscription services offering limited downloads and on-demand performances. We served approximately [redacted] notices of intention for subscription services, and received back form letters claiming that they were invalid. Subscription services were able to launch only after RIAA, NMPA and HFA reached a private agreement concerning a licensing framework in 2001.

In 2003-2004, we were very excited about the DualDisc format. However, publishers asserted an interpretation of the rate regulations that required us to pay twice for each track. The

statutory rate of 9.1 cents is payable for "every phonorecord made and distributed."[2] Publishers argued that each side of a DualDisc is a separate "phonorecord" for purposes of the relevant regulations. The second instance of the recording existed only as a technical enhancement or for inter-operability purposes, and the economics of DualDisc certainly would not have permitted us to pay twice. However, we just could not get HFA or publishers to issue licenses at the statutory rate, and we believed it was imperative to launch this new format as a way to entice the consumer to purchase a physical album rather than cherry pick a favorite song as a download.

While publishers seemed to understand that Dual Disc might be an opportunity to breath life in to the physical marketplace, they still used ambiguity in the current statutory royalty rate structure as leverage to get record companies to pay them a premium before they would participate. Publishers were even reluctant to accept a single payment for other multisession products where the second session existed purely as an antipiracy effort or an interoperability feature for the consumer's convenience. To get to market with DualDiscs, SONY BMG led the industry in concluding "New Digital Media Agreements." These negotiations were inordinately time consuming and difficult as the issues were complex and each publisher would only agree to license its share of a song. For those shares of important compositions that were not subject to one of the new agreements, the Copyright department was left to explain the nature of the deal to the individual publishers and seek one-off licenses.

At the same time, we were launching mastertones, but publishers insisted that mastertones were not digital phonorecord deliveries and refused to license them as such. Instead, they continued to demand the very high royalty rates that they were able to obtain from monophonic and polyphonic ringtone aggregators when no direct contribution or investment by a

[2] 37 C.F.R. § 255.3(m) (RIAA Ex. K-102-DP).

featured artist and record company was involved in the product made available to the public. And when we considered relying on the compulsory licensing process, we heard informally that publishers would probably sue anyone who tried to do so. Because publishers were able to exploit uncertainty in the application of the compulsory license to DualDiscs and mastertones, we were forced in our New Digital Media Agreements to agree to high rates for mastertones as the price for getting DualDiscs licensed at the statutory rate. And even though the Register of Copyrights has now held that mastertones are licensable as DPDs, publishers are still refusing to license them as such.

These recurring difficult and frustrating experiences teach me that we need rates and terms that are as flexible as possible to accommodate numerous kinds or products, services and business models. A percentage rate would best serve that goal, because a royalty that is a percentage of actual revenues will allow us to obtain and administer licenses no matter what the nature of the offering or business model. These experiences also teach me that in order to avoid future disputes about how future new offerings should be classified, we need rates and terms that do not depend upon fine technical distinctions. The licensing process and the launch of new kinds of product and service offerings should not be allowed to grind to a halt over these kinds of disputes in the future. A royalty system that (1) clarifies that the end-to-end process of distributing music is covered by one license, and (2) specifies a fixed percentage of revenues for all reproduction and distribution rights, independent of the means of distributing the music, would prevent administration of mechanical licensing from interfering with bringing music to the public. This would, in turn, enhance the ability of publishers and record companies alike to realize returns on their music.

C. Accounting and Payment

The process of administering mechanical licenses only begins with obtaining them. Each license must be coded into our royalty accounting system and linked to the correct royalty account. Then, each accounting period, we must calculate and distribute royalties among the various payees and issue and verify royalty statements. With SONY BMG's approximately [redacted] physical product titles in active release, and [redacted] tracks available in electronic formats, accounting for every publisher's share of every track is a monumental task.

Each record company must expend enormous efforts to maintain its own database of compositions and ownership and payment information to keep track of splits and pay co-publishers. We have to validate and process a huge volume of data. We must revise our calculations each time the royalty rate changes. We also must be aware of changes in the ownership of copyrights and update our databases to reflect termination of writer agreements with publishers, frequent changes in ownership of publishing catalogs and other changed circumstances. Keeping up with these changes, and sometimes making retroactive adjustments to reflect them, is itself a huge administrative burden.

Record companies are not the only industry participants that struggle with the burden of administering mechanical licenses. "Digital" service providers have found it difficult or impossible to meet the demands of the mechanical licensing system, and have sought reforms of the system.

It is important to understand who receives mechanical royalty payments. In the case of a large percentage of the recordings we release, the artist or producer is the writer or a co-writer. As a result, the lion's share of our mechanical royalties go to artists and producers who also receive artist or producer royalties from us for the sale of those releases, in addition to related streams of income from performances, touring, and use of the song and/or recording in motion

pictures or television. Even in 2005, where SONY BMG had unusual success with albums of covers, nearly 60% of the mechanical royalties for our top 20 albums were credited to the artists and producers of those albums.

D. Costs of Administration

The business processes I have just described are very expensive. That expense should be taken into account as an investment and cost incurred by record companies with respect to the products made available to the public. It also should be taken into account when drawing comparisons to other benchmarks that do not require the same level of administrative cost – such as European mechanical rates.

We have [redacted] people in our Copyright department who are responsible for clearance up through coding licenses into our royalty accounting system. We have [redacted] employees in our Royalties department who are responsible for preparing mechanical royalty statements. Together, the annual budget for these two departments is over [redacted]. In addition, we have made huge capital investments in infrastructure to support these business processes. For example, over the last five years, we have spent an estimated [redacted] in improvements to our royalty accounting and label copy systems to accommodate new types of products and services, rate structures and other changes. Were we to rely on the true compulsory license our costs would be much higher.

The relative burdens, and the capital investment and technological contribution of record companies in the infrastructure necessary to make new kinds of products available to the public should be taken into account in setting the mechanical royalty rate.

The situation is very different in almost every other country, where record companies assume much less of the administrative burden of mechanical licensing. In most other countries, record companies are licensed on a blanket basis by national collecting societies like MCPS in

the UK and GEMA in Germany. We report label copy for new releases to the society, and sales in each accounting period, and it bills us for our royalties on an aggregate basis. Record companies simply write a single royalty check to the society, which then allocates and distributes the royalties to publishers. The experience is very much like performance licensing of musical works or sound recordings in the U.S. As a result, in considering any comparison of U.S. mechanical rates to international rates, it should be understood that in the U.S., record companies bear a much higher administrative burden, performing tasks that are handled and funded by publishers and their collecting societies at their expense in other countries.

III. RIAA's Proposed Rates and Terms

I have reviewed the statutory rates and terms proposed by RIAA in this proceeding. The centerpiece of that proposal is a percentage rate. I believe that a percentage royalty like this is the right way to structure mechanical royalties for the good of the whole music industry. This method will allow us to have some certainty as to our overall copyright expense and margins before we make the investment to record a product. It is also workable and can be implemented by record companies effectively. I believe that RIAA's proposal will go a long way toward avoiding the kinds of disputes that have plagued the launch of all major new products and services, and help make the actual compulsory license more workable when it needs to be relied upon.

However, the transition from a cents rate royalty to a percentage royalty will take some time. Our royalty accounting system is sufficiently flexible to handle a percentage royalty, but we will have a significant project to recalculate royalty allocations for our back catalog and code them into our accounting system. We want to do that right, but we cannot plan for or execute the project until we know the outcome of this proceeding. Accordingly, we will need an appropriate

transition period to do what needs to be done to make the transition to a percentage royalty a success.

RIAA's proposed terms include confirmation that the Section 115 license extends to all reproductions necessary to engage in activities covered by the license, including masters and cached, network, and buffer reproductions. It is just common sense that the entire chain of reproduction and distribution activities needed to bring music to the consumer is covered by the license, just as in an earlier era, it was understood that a single mechanical license covered the entire process of bringing vinyl records to market, including any intermediate reproductions made in order to press the final records. This language, based on the Section 115 Reform Act that was introduced in Congress this last year, is the only administratively workable approach to these incidental copies. It would not, for example, be practicable to account for incidental copies individually.

RIAA has also proposed a few terms that represent revisions to the compulsory accounting regulations. I hope that record companies will not need to invoke the actual compulsory licensing process in the future any more than we have in the past. However, doing so should be a realistic option if necessary. RIAA's proposals help make that a possibility by (1) making it practicable to account for DPDs not reported to record companies until after month end; (2) conforming the signature requirements for statements of account to those applicable to notices of intention; and (3) conforming the audit requirement to that applicable under Section 114.

CONCLUSION

The recorded music business has changed dramatically during the last decade. It is imperative that the royalty rates and terms applicable under Section115 be rationalized to fit the current industry so that we can make more works available to the public. Rates and terms set in

this proceeding need to work for numerous diverse existing product types and for new products and business models that we cannot think of today. Rates set in this proceeding also need to take into account the enormous license administration costs that are incurred by record companies.

I declare, under penalty of perjury, that the foregoing testimony is true and correct to the best of my knowledge.

Andrea Finkelstein

Date: November 29 2006

Exhibits Sponsored by Andrea Finkelstein (Public)

Exhibit Number	Description
K-101-DP	17 U.S.C. § 115
K-102-DP	37 C.F.R. § 255.3