Before the
COPYRIGHT ROYALTY JUDGES
Washington, D.C.

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

PROPOSED CONCLUSIONS OF LAW OF THE RECORDING INDUSTRY ASSOCIATION OF AMERICA, INC.

TABLE OF CONTENTS

<u>CONCLUSIONS OF LAW</u>

I. LEGAL BACKGROUND TO SECTION 115 OF THE COPYRIGHT ACT

A. Background and History of Section 115

1. Congress first enacted a mechanical compulsory license as part of the Copyright Act of 1909. Copyright Act of 1909, Pub. L. No. 60-349, ch. 320, § 1(e), 35 Stat. 1075. Congress retained the mechanical compulsory license and codified it in Section 115 as part of the general revision of the copyright laws in 1976. Copyright Act of 1976, Pub. L. No. 94-553, § 115, 90 Stat. 2541.

2. A principal purpose of the mechanical compulsory license was and remains to prevent the exercise of monopoly power by the owners of musical works. *See* H.R. Rep. No. 60-2222, at 7 (1909) (explaining that the mechanical compulsory license has "the double purpose of securing to the composer an adequate return for all use made of his composition and at the same time prevent the formation of oppressive monopolies, which might be founded upon the very rights granted to the composer for the purpose of protecting his interests."). In fact, when Congress held joint hearings concerning revisions to copyright law, "[i]t became evident that there would be serious danger that if the grant of right was made too broad, the progress of science and useful arts would not be promoted, but rather hindered, and that powerful and dangerous monopolies might be fostered which would be prejudicial to the public interests. This danger lies in the possibility that some one company might secure, by purchase or otherwise, a large number of copyrights of the most popular music, and by controlling these copyrights monopolize the business of manufacturing the selling music-producing machines, otherwise free to the world." *Id.* at 7.

3. As explained by the Copyright Royalty Tribunal ("CRT") after reviewing the legislative history of Section 115, "Congress enacted the compulsory license as part of the

Copyright Act of 1909 because it feared that the Aeolian Piano Roll Company would monopolize the music industry by entering into exclusive contracts with copyright owners. . . . The compulsory license was intended to prevent the formation of a 'music monopoly' by guaranteeing to all mechanical producers full access to copyrighted music." *Adjustment of Royalty Payable Under Compulsory License for Making and Distributing Phonorecords; Rates and Adjustment of Rates*, 46 Fed. Reg. 10466, 10483 (Feb. 3, 1981) ("*1981 Mechanical Royalty Proceeding*").

4. Congress re-confirmed its concerns about monopoly by music publishers and songwriters during the legislative process leading to the enactment of the 1976 Copyright Act. *Recording Industry Association of America v. Copyright Royalty Tribunal*, 662 F.2d 1, 3-4 (D.C. Cir. 1981). In particular, Congress considered whether to retain the compulsory system based on the understanding that "the 1909 statute adopted the compulsory license as a deliberate anti-monopoly condition" on the grant of mechanical rights. H.R. Rep. No. 90-83, at 66 (1967). While the publishers sought to eliminate the compulsory license altogether, the record companies "maintained that the dangers of monopolies and discriminatory practices still exist, and repeal would result in a great upheaval of the record industry with no benefit to the public." *Id.* Agreeing with the record companies, Congress concluded "that a compulsory licensing system is still warranted." *Id.* at 67; *see* H.R. Rep. 94-1476, at 116 (1976) (explaining that the House Committee's conclusions on this point are the same as the 1967 report).

B. Scope and Operation of Section 115

5. Section 115 establishes a compulsory license for musical works for all types of reproduction and distribution of sound recordings with certain specified exceptions. The compulsory license does not apply to dramatico-musical works and does not apply to the reproduction and distribution of musical works that have not previously been distributed in the

form of phonorecords. 17 U.S.C. § 115(a)(1) ("When phonorecords of a nondramatic musical work have been distributed to the public in the United States under the authority of the copyright owner, any other person, including those who make phonorecords or digital phonorecord deliveries, may, by complying with the provisions of this section, obtain a compulsory license to make and distribute phonorecords of the work."). Thus, "first uses" of musical works are licensed not subject to the compulsory license and are only licensed through voluntary agreements.

6. In addition to establishing a compulsory license, Congress in Section 115 specified numerous requirements for the use of the compulsory license, including: (1) the filing of a notice of intention to use the compulsory license (17 U.S.C. § 115(b)); (2) the payment of royalties as specified by statute or a copyright royalty proceeding (17 U.S.C. § 115(c)); and (3) a termination right which permits the owner of the musical work to terminate a compulsory license if monthly payments, monthly statements of account, or annual statements of account are not properly submitted, thereby rendering the making and distribution of phonorecords embodying the musical work into an act of infringement (17 U.S.C. § 115(c)(6)).

7. This provision for a termination right stands in stark contrast with other statutory licenses, such as the Section 112 and 114 statutory licenses considered by this Court in the webcasting and SDARS proceedings, which do not specify a termination right for failure to comply with the statutory licenses. *Compare* 17 U.S.C. § 115(c)(6) with *Determination of Rates and Terms for Preexisting Subscription Services and Satellite Digital Audio Radio Services*, 73 Fed. Reg. 4080, 4099 (Jan. 24, 2008) ("*SDARS Decision*") ("Copyright owners and performers have no recourse under [the Section 114] statutory license. They cannot terminate, short of a finding of infringement by a federal court, access to their works under the license."); *Digital*

Performance Right to Sound Recordings and Ephemeral Recordings, 72 Fed. Reg. 24084, 24107 (May 1, 2007) ("*Webcasting II Decision*") (same).

8. Although Section 115 establishes a compulsory license, it also makes clear that voluntary agreements between parties generally trump the compulsory license. Thus, parties are free to negotiate rates and terms for the reproduction and distribution of phonorecords that are different from the statutory rates and terms. 17 U.S.C. §115(c)(3)(B). As discussed below, however, Congress limited the effect of certain voluntarily negotiated royalty rates with respect to digital phonorecord deliveries in the Digital Performance Right in Sound Recordings of 1995 ("DPRA").

9. Finally, Section 115 specifies in detail the procedures that this Court must undertake to set rates and terms for mechanical licenses and also sets forth the scope of the Court's responsibilities. Among other things, this Court is required to set rates and terms for any activity that falls within the compulsory license, not just for a limited set of products or services, as the Copyright Owners apparently desire, as indicated by the gaps in their rate proposal. 17 U.S.C. § 115(c)(3)(C) ("Proceedings under chapter 8 shall determine reasonable rates and terms of royalty payments for the activities specified by this section").

C. The Digital Performance Right in Sound Recordings Act of 1995

10. In the DPRA, Congress made clear that the compulsory license applies to phonorecords delivered through digital transmissions. 17 U.S.C. § 115(a)(1), (c)(3). Such deliveries are called "digital phonorecord deliveries" or "DPDs." Section 115 defines a DPD as

> each individual delivery of a phonorecord by digital transmission of a sound recording which results in a specifically identifiable reproduction by or for any transmission recipient of a phonorecord of that sound recording, regardless of whether the digital transmission is also a public performance of the sound recording or any nondramatic musical work embodied therein. A digital phonorecord delivery does not result from a real-time, non-

> interactive subscription transmission of a sound recording where no reproduction of the sound recording or the musical work embodied therein is made from the inception of the transmission through to its receipt by the transmission recipient in order to make the sound recording audible.

17 U.S.C. § 115(d).

11. In adding the DPD provisions to Section 115, Congress sought to "confirm and clarify the right of musical work and sound recording copyright owners to be protected against infringement when phonorecords embodying their works are delivered to consumers by means of transmissions rather than by means of phonorecord retail sales. The intention in extending the mechanical compulsory license to digital phonorecord deliveries is to maintain and reaffirm the mechanical rights of songwriters and music publishers as new technologies permit phonorecords to be delivered by wire or over the airwaves rather than by the traditional making and distribution of records, cassettes and CD's." S. Rep. No. 104-128, at 36 (1995), *as reprinted in* 1995 U.S.C.C.A.N. 356, 383.

12. The DPRA established two distinct categories of DPDs and required that rates distinguish between them. Specifically, under 17 U.S.C. § 115(c)(3)(C), the Court must "distinguish between (i) digital phonorecord deliveries where the reproduction or distribution of a phonorecord is incidental to the transmission which constitutes the digital phonorecord delivery, and (ii) digital phonorecord deliveries in general." 17 U.S.C. § 115(c)(3)(C). The former are commonly referred to as "incidental DPDs" and the latter as "general DPDs."

13. In the legislative history of the DPRA, Congress described what it meant by an incidental DPD. Referring to 17 U.S.C. § 115(c)(3)(C), the Senate Report explains:

> The subparagraph states that if any digital phonorecord delivery statutory mechanical royalty rates and terms are determined as a result of a voluntary negotiation proceeding, then such rates and terms shall distinguish between: (1) rates and terms for digital phonorecord deliveries where the reproduction or

> distribution of a phonorecord is "incidental" to the transmission which constitutes the digital phonorecord delivery, and (2) rates and terms for digital phonorecord deliveries in general. The Committee recognizes that there are likely to be different types of digital transmission systems that could result in the making of a digital phonorecord delivery. In the case of some of these transmission systems, delivering a phonorecord to a transmission recipient could be incidental to the purpose of a transmission. For example, if a transmission system was designed to allow transmission recipients to hear sound recordings substantially at the time of transmission, but the sound recording was transmitted in a high-speed burst of data and stored in a computer memory for prompt playback (such storage being technically the making of a phonorecord), and the transmission recipient could not retain the phonorecord for playback on subsequent occasions (or for any other purpose), delivering the phonorecord to the transmission recipient would be incidental to the transmission. If such a system allowed transmission recipients to retain phonorecords for playback on subsequent occasions, but transmission recipients did not do so, delivering the phonorecords to the transmission recipients could be incidental to the transmissions. On and after January 1, 1998, statutory mechanical royalty rates shall distinguish between "incidental" digital phonorecord deliveries that take into account the different purpose and effect of these transmissions and digital phonorecord deliveries in general.

S. Rep. No. 104-128, at 39, *as reprinted in* 1995 U.S.C.C.A.N. at 386. DPDs that are not incidental DPDs are general DPDs. 17 U.S.C. § 115(c)(3)(C).

14. In the DPRA, Congress imposed a significant restriction on users of copyrighted musical works. Congress legislated to trump the operation of voluntarily negotiated royalty rates for DPDs in agreements between artists and record companies entered into after June 22, 1995. Pursuant to 17 U.S.C. § 115(c)(3)(E), discounted royalty rates in the controlled composition clauses of agreements between singer-songwriters and record companies are to have no effect with respect to the distribution of DPDs. Thus, even if record companies and singer-songwriters agree to lower rates, they are compelled to operate under the then governing statutory rate with respect to DPDs. The provision does not apply to the distribution of physical phonorecords, to controlled composition clauses in agreements entered into on or before June 22, 1995, or to

agreements between singer-songwriters and record companies entered into after completion of the relevant recording. 17 U.S.C. § 115(c)(3)(E)(ii)(II).

15. The DPRA established that royalties for DPDs sold on or before December 31, 1997, were to be equal to those for physical phonorecords. For subsequent periods, the rates were to be set by the procedures set forth in the statute. 17 U.S.C. § 115(c)(3)(A). Ever since enactment of the DPRA, the statutory rate for general DPDs has been the same as the statutory rate for physical phonorecords. 37 C.F.R. § 255.5.

D. The Copyright Royalty Distribution and Reform Act of 2004

16. In the Copyright Royalty Distribution and Reform Act of 2004 ("CRDRA"), Congress abolished the prior Copyright Arbitration Royalty Panel ("CARP") system and replaced it with a new system in which determination of royalty rates and terms is committed to the Copyright Royalty Judges. In the CRDRA, Congress specified that the Copyright Royalty Judges must give appropriate deference to prior proceedings conducted by the courts, the Librarian of Congress, and the predecessor CRT:

> The Copyright Royalty Judges shall act in accordance with regulations issued by the Copyright Royalty Judges and the Librarian of Congress, and on the basis of a written record, prior determinations and interpretations of the Copyright Royalty Tribunal, Librarian of Congress, the Register of Copyrights, copyright arbitration royalty panels (to the extent those determinations are not inconsistent with a decision of the Librarian of Congress or Register of Copyrights), and the Copyright Royalty Judges (to the extent those determinations are not inconsistent with a decision of the Register of Copyrights that was timely delivered to the Copyright Royalty Judges pursuant to section 802(f)(1)(A) or (B), or with a decision of the Register of Copyrights pursuant to section 802(f)(1)(D)), under this chapter, and decisions of the court of appeals under this chapter before, on, or after the effective date of the Copyright Royalty and Distribution Reform Act of 2004.

17 U.S.C. § 803(a)(1).

E. Authority to Promulgate Terms and other Regulations

17. In addition to the requirements of the compulsory license specified in the statute, Section 115 also authorizes the Register of Copyrights to promulgate regulations concerning a variety of aspects of the compulsory license. Since 1976 and the creation of the first tribunal to set *rates* for mechanical licenses, Congress has always divided the responsibility for the administration of the mechanical compulsory license between the Register of Copyrights and the rate-setting tribunal (previously the CRT and CARPs and now the Copyright Royalty Judges).

18. From the passage of the 1976 Copyright Act until 1995, Congress granted the CRT (and then the CARPs) the authority only to *set rates*, not terms. Authority to determine requirements for obtaining compulsory licenses, making payments and submitting statements of account was given to the Register pursuant to 17 U.S.C. § 115(b)(1) and (c)(5) (formerly (c)(3)). These subsections remain in force.

19. As the result of an extensive rulemaking that concluded in 1980, *see* 45 Fed. Reg. 79,046 (Nov. 28, 1980), and subsequent proceedings, the Register adopted intricate regulations that are currently embodied in 37 C.F.R. § 201.18-19. These regulations in substantial detail the procedural aspects of the mechanical compulsory license.

20. When the DPRA added to Section 115 its provisions concerning DPDs, Congress specified that a CARP was to set "reasonable terms and rates of royalty payments" for DPDs. 17 U.S.C. § 115(c)(3)(C), (D) (1996). Those terms were subject to modification by the Librarian on the recommendation of the Register. 17 U.S.C. § 802(f) (1996). That same legislation preserved the Register's sole control over terms related to physical products and also extended the Librarian's authority to "establish requirements by which copyright owners may receive reasonable notice of the use of their works . . . , and under which records of such use shall be

kept and made available by persons making digital phonorecord deliveries." 17 U.S.C. § 115(c)(3)(D) (1996).

21. The legislative history of the DPRA also explains the limited role for the Copyright Royalty Judges (previously the CARPs) in establishing terms for use of the statutory license. As explained in the Senate Report, the CARPs' authority extended only to "additional" terms that may fill in areas related to DPDs not already covered by the Copyright Office's regulations:

> The parties are expected to negotiate, or if necessary arbitrate, "terms" as well as rates. By "terms," the Committee means such details as how payments are to be made, when, and other accounting matters. While these details are for the most part already prescribed in section 115, and related details are to be established by the Librarian under section 115(c)(3)(D), the bill allows for additional such terms to be set by the parties or by CARP's in the event that the foregoing provisions or regulations are not readily applicable to the new digital transmission environment.

S. Rep. No. 104-128, at 40, *as reprinted in* 1995 U.S.C.C.A.N. at 387.

22. In the CRDRA, Congress also authorized the Copyright Royalty Judges to set "reasonable rates and terms of royalty payments" for all product configurations, 17 U.S.C. § 115(c)(3)(D), and to establish notice and recordkeeping requirements, but did not replace or limit the Register's longstanding rulemaking authority. As discussed more fully below and in RIAA's *Brief on the Jurisdiction of the United States Copyright Royalty Judges to Set Certain Terms and Motion to Strike Terms Outside that Jurisdiction* (Feb. 22, 2008) (incorporated by reference herein and attached as Ex. 1), the effect of these statutory provisions is that this Court is prohibited from adopting terms inconsistent with those already established by the Register and within the Register's jurisdiction, except where the statute expressly authorizes the Court to supplant the Register's regulations with respect to notice and recordkeeping. 17 U.S.C.

§ 803(c)(3) ("Among other terms adopted in a determination, the Copyright Royalty Judges may specify notice and recordkeeping requirements of users of the copyrights at issue that apply in lieu of those that would otherwise apply under the regulations.").

II. LEGAL STANDARDS TO BE APPLIED IN SETTING RATES

A. The Appropriate Method to Be Used in Setting a Rate under Section 801(b)(1)

1. The Policy Objectives of Section 801(b)(1) and Section 115

23. Fundamentally, the Court's task in this proceeding is to set "reasonable" rates calculated to achieve the four statutory objectives set forth in 17 U.S.C. § 801(b)(1) and the policies underlying Section 115. *1981 Mechanical Royalty Proceeding, 46 Fed. Reg. at 10479; Determination of Reasonable Rates and Terms for the Digital Performance of Sound Recordings and Ephemeral Recordings*, 67 Fed. Reg. 45240, 45244 (July 8, 2002) ("*Webcasting I Librarian's Decision*") (explaining that rates set pursuant to Section 801(b)(1) are "policy-driven"); *SDARS Decision*, 73 Fed. Reg. at 4084 (holding that the Court is required to "adopt reasonable royalty rates that satisfy all of the objectives set forth in Section 801(b)(1)(A)-(D)"). As the CRT explained in the first mechanicals proceeding, "the term reasonable in the statute is of dominating importance." *1981 Mechanical Royalty Proceeding*, 46 Fed. Reg. at 10479.

24. This proceeding is distinguished from the Court's prior proceedings under Section 114 because the Court must apply the statutory factors with the specific purpose and legislative history of Section 115 in mind. As the CRT explained in the first mechanical royalty rate proceeding about its obligations under Section 115 and Section 801(b)(1), "consistent with the anti-monopoly purpose of the compulsory license system, a reasonable adjustment of the statutory rate should work to ensure the full play of market forces, while affording individual copyright owners a reasonable rate of return for their creative works." *1981 Mechanical Royalty*

Proceeding, 46 Fed. Reg. at 10479. While there was no legislative history to suggest that Congress was concerned about attempted monopolization in the Section 112 and 114 statutory licenses, there is no dispute that Section 115 was created in order to address attempts at monopolization by music publishers. *Id.*

25. Rates are to "be calculated to achieve" the four objectives set forth in Section 801(b)(1) of the Copyright Act. 17 U.S.C. § 801(b)(1).

26. Because the statute requires the Court to focus on reasonable rates calculated to achieve the statute's policy objectives, the royalty rates set in this proceeding need not be market rates. "The standard for setting the royalty rate . . . is not fair market value." *Determination of Reasonable Rates and Terms for the Digital Performance of Sound Recordings*, 63 Fed. Reg. 25394, 25399 (May 8, 1998) ("*PES I Librarian's Decision*"). The D.C. Circuit upheld the Librarian's interpretation that the statute's use of "reasonable rates" does not compel the use of market rates. *Recording Industry Association of America v. Librarian of Congress*, 176 F.3d 528, 533 (D.C. Cir. 1999). On the other hand, as discussed *infra*, market benchmarks can be a very useful starting point, even in proceedings governed by the Section 801(b)(1) factors.

27. The Court has authority to set multiple different rates for different products, even if they utilize the same statutory license. Where products inhabit two different markets or sub-markets, the Court may determine – as it did in the webcasting proceeding – that it is appropriate to set different rates for different uses of the statutory license. *Webcasting II Decision*, 72 Fed. Reg. at 24097-98. The key is that "each type of ultimate use must be different." *Id.* at 24097. Thus, the Court has found that non-commercial webcasters and commercial webcasters inhabit different markets, even though they each provide 24-hour per day streaming of music. *Id.* Similarly, digital cable radio services need not have the same rate as satellite digital audio radio

services because the consumer demand and the type of use at issue is simply too different. *SDARS Decision*, 73 Fed. Reg. at 4089.

28. Finally, the Court is to set a reasonable rate – a rate that would be reasonable based on the totality of individual transactions that occur for mechanical licenses and consistent with the statutory criteria. That the Section 115 compulsory license is rarely used does not alter the fundamental role of the Court here – to set a rate that would be reasonable if the license was regularly used by copyright owners and copyright users. *Recording Industry Association of America*, 662 F.2d at 11-12; *id.* at 13 ("the royalty rate must be reasonable as set"). Thus, the statutory rate must be "a royalty of reasonable resort." *1981 Mechanical Royalty Proceeding*, 46 Fed. Reg. at 10480.

2. The Product Subject to the Compulsory License

29. There is another significant difference between this proceeding and the proceedings involving the Section 112 and 114 statutory licenses. As the Court and the Librarian have held, the Section 112 and 114 statutory licenses are blanket licenses, so rate setting must focus on the hypothetical market for blanket licenses in sound recordings negotiated between a record company and a webcaster. *Webcasting I Librarian's Decision*, 67 Fed. Reg. at 45244 (explaining that "the product consists of a blanket license from each record company which allows use of that company's complete repertoire of sound recordings"); *Webcasting II Decision*, 72 Fed. Reg. at 24087, 24091 (adopting same definition of the product); *Report of the Copyright Arbitration Royalty Panel, In re Ratesetting for Digital Performance Rights in Sound Recordings and Ephemeral Recordings*, Docket No. 2000-9 CARP DTRA 1 & 2 at 24 (Feb. 20, 2002) ("the Section 114(f)(2) hypothetical marketplace [is] one where the buyers are DMCA-eligible . . . services, the sellers are record companies, and the product being sold consists of a blanket

license for each record company's repertory of sound recordings") ("*Webcasting I CARP Decision*").

30. Rather than a blanket license, however, the Section 115 statutory license is a license for a single copyrighted work. *1981 Mechanical Royalty Proceeding*, 46 Fed. Reg. at 10479 ("Section 115 of the Act operates on an individual and not an industry-wide basis"); *id.* ("The legislative history of the Act makes clear that Section 115 of the Act contemplates the compulsory use of an individual song, by an individual record manufacturer."). Thus, with respect to consideration of relevant benchmarks, the Court's focus must be on the hypothetical negotiation between a record company and a music publisher/songwriter for a single copyrighted work. *Id.*

31. This difference between a blanket license and the license for a single copyrighted work is significant. As the rate court in the Southern District of New York has held in considering royalties for music publishers in prior cases (involving ASCAP and BMI), a blanket license is altogether different from -- and more valuable than -- a requirement to license works on an individual-by-individual basis. *See United States v. American Society of Composers, Authors, and Publishers*, 2008 WL 1967722, at *65 (S.D.N.Y. April 30, 2008) ("An ASCAP blanket license is a unique transaction. In addition to conveying the right to perform the ASCAP musical works publicly, a blanket license offers the flexibility of immediate and unlimited access to a vast and ever-growing repertory of compositions, without the cost and delay of consummating individual agreements, and without the concern of exposure to liability for copyright infringement. With regard to ASCAP members, the blanket license achieves efficiencies in the monitoring and enforcement of individual copyrights; its absence would significantly raise the cost of licensing and the cost of performing the desired compositions.");

United States v. American Society of Composers, Authors, and Publishers, 1991 WL 224284, at *2 (S.D.N.Y. Oct. 22, 1991) ("the value of a blanketlicense is found in part in the aggregative service that it performs, and this benefit accrues to the licensee irrespective of the amount and nature of the music used.").

32. The Southern District of New York's rate court recently summarized prior case law (including the Supreme Court's decision) holding that blanket licenses are more valuable than a series of licenses for individual works and that blanket licenses include the value of each work in the repertoire plus a premium for the aggregation of the works:

> The Supreme Court has recognized the inherent benefits of the blanket license:
>
> This substantial lowering of costs, which is of course potentially beneficial to both sellers and buyers, differentiates the blanket license from individual use licenses. The blanket license is composed of the individual compositions plus the aggregating service. Here, the whole is truly greater than the sum of its parts; it is, to some extent, a different product. The blanket license has certain unique characteristics: It allows the licensee immediate use of covered compositions, without the delay of prior individual negotiations and great flexibility in the choice of musical material. Many consumers clearly prefer the characteristics and cost advantages of this marketable package....
>
> *Broad. Music, Inc. v. Columbia Broad. Sys., Inc.*, 441 U.S. 1, 21-22, 99 S.Ct. 1551, 60 L.Ed.2d 1 (1979) ("BMI v. CBS"). The efficiency and cost saving features are even more valuable to Internet companies like Applicants that stream millions of works online. Unlike traditional broadcast media, who could seek direct and source licenses for the ASCAP music they perform (see *Capital Cities I*, 831 F.Supp. at 152-53), Applicants could not perform the millions of works they offer without the blanket license mechanism. Because the benefits of a blanketlicense exceed the value of the right to perform the music in the repertory, the blanketlicense fee must reflect these extra benefits. *Buffalo Broadcasting*, 1993 WL 60687, at *36 ("Since we are valuing the license itself, and not merely the particular music used in the stations' syndicated and local programming ... pricing the license for the stations based purely on the amount of music used may understate the appropriate fee for the license") (internal citation

> omitted); *United States v. Am. Soc'y of Composers, Authors and Publishers (Application of Showtime/The Movie Channel, Inc.)*, 1989 WL 222654, *20 (S.D.N.Y. Oct.12, 1989) ("full value" of blanketlicense includes "market value of the aggregative function of the license").

United States v. American Society of Composers, Authors, and Publishers, 2008 WL 1967722, at *65 (S.D.N.Y. April 30, 2008).

B. Step 1: Identifying Appropriate Benchmarks

1. Overview

33. As this Court and prior rate setting tribunals have found, it is reasonable for the Court to begin with benchmarks, which, if comparable, provide a starting point for analyzing a reasonable rate consistent with the four statutory factors and the policies underlying Section 115. Prior tribunals have routinely looked to "marketplace points of reference." *PES I Librarian's Decision*, 63 Fed. Reg. at 25409; *Amusement & Music Operators Ass'n v. Copyright Royalty Tribunal*, 676 F.2d 1144, 1157 (7th Cir. 1982) (explaining that marketplace analogies are "appropriate points of reference"). In the SDARS case, the Court (with agreement of the parties) began its analysis by looking at marketplace benchmarks for comparable services that might be indicative of the prices that would prevail for sound recordings to be used by the satellite radio services. *SDARS Decision*, 73 Fed. Reg. at 4088.

34. In this case, the Court must consider the marketplace transactions offered by the parties to "determine[] whether the proposed models mirrored the potential market transactions which would take place to set the rates" for a negotiation between an individual songwriter or music publisher and an individual record company for the mechanicals rights to a single music work to be used in various products subject to the statutory license. *PES I Librarian's Decision*, 63 Fed. Reg. at 25399.

35. The Court is not compelled to rely on a single benchmark, although it has discretion to do so in appropriate circumstances. In prior determinations, tribunals have found that benchmarks offered by the parties and other evidence provide "points of reference" from which the Court can engage in an analysis of the four policy considerations. *Amusement & Music Operators Ass'n*, 676 F.2d at 1157.

36. Here, the RIAA has proposed that the Court rely on benchmarks directly reflective of the rights at issue – *i.e.*, the rates established for mechanical rights for sound recordings (1) historically, (2) in current voluntary agreements, and (3) in two countries, the U.K. and Japan, which have rates highly relevant to setting a reasonable rate for the United States.

37. The Copyrights Owners rely on three benchmarks that are claimed to establish a range of reasonable rates: (1) the synch rights/master use license market, (2) the payments mandated in the Audio Home Recording Act, and (3) the rates negotiated for the right to use musical compositions in mastertones. The Copyright Owners have also submitted their own evidence about overseas rates.

38. For the reasons set forth here, the most informative benchmarks are those offered by the RIAA.

2. The Critical Issue with Respect to a Benchmark is Comparability.

39. A benchmark "need not be perfect in order to be considered in a rate setting proceeding." *PES I Librarian's Decision*, 63 Fed. Reg. at 25404. But this Court and prior tribunals have emphasized the importance of "comparability," which "is a key issue in gauging the relevance of any proffered benchmarks." *SDARS Decision*, 73 Fed. Reg. at 4088.

40. The Court noted in the SDARS proceeding that the Section 801(b)(1) standard gives the Court broader scope in reviewing potential benchmarks than the willing buyer/willing seller standard used in the webcasting proceedings. Although a broader range of benchmarks

may be permissible sources on which to base the rate, "nevertheless potential benchmarks are confined to a zone of reasonableness that excludes clearly noncomparable market situations." *SDARS Decision*, 73 Fed. Reg. at 4088. Thus, the Court should select benchmarks that "reflect accurately the characteristics and dynamics of the industries subject to the proposed rate." *PES I Librarian's Decision*, 63 Fed. Reg. at 25404.

41. In assessing the comparability of a benchmark proposed by one of the parties, the Court has identified several critical factors.

a. There Must Be Good Reason to Believe Demand Is Similar Between the Benchmark Market and the Target Market.

42. As the Court explained in its Webcasting II decision, the demand for a license for copyrighted works (sound recordings in the Section 112 and 114 statutory licenses and musical works here) is a derived demand – derived from the consumer's value for finished products and services of different types. *Webcasting II Decision*, 72 Fed. Reg. at 24092 ("Both markets are input markets and demand for these inputs is driven by or derived from the ultimate consumer markets in which these inputs are put to use"); *SDARS Decision*, 73 Fed. Reg. at 4089 ("demand for the music input is a demand derived from its use in the consumer service offered"). As a basic economic matter, the more consumers are willing to pay for music in the relevant consumer offering, the more the copyright owners will receive. Similarly, the less consumers are willing to pay, the less copyright owners will receive.

43. That is not to say, however, that all products requiring a mechanical license need to or should pay the same royalty. Demand for even the same product or the same rights to copyrighted works may be different in different markets. Even where the same commodity is at issue, there may be multiple demand curves and multiple prices, just as there are separate commercial and consumer electricity and telephone rates. *Webcasting II Decision*, 72 Fed. Reg.

at 24097. "The multiple demand curves represent distinct classes of buyers and each demand curve exhibits a different price elasticity of demand. By definition, if the commodity in question derives its demand from its ultimate use, then the marketplace can remain segmented only if buyers are unable to transfer the commodity easily among ultimate uses." *Id.*

44. Similarly, where demand for one service is radically different than for another, such as where demand for one service is weak and another is strong, this demonstrates that there is a "substantial difference so as to make them poor comparators." *SDARS Decision*, 73 Fed. Reg. at 4089.

45. As part of its focus on derived demand, the Court has expressed its interest in the comparability of the elasticities of demand between a benchmark market and a target market. In the Webcasting II proceeding, the Court noted that it would have preferred if there was more information in the record concerning the relative elasticities of demand between the interactive and non-interactive markets, but found that sufficient evidence had been introduced in the record to suggest that the elasticities of demand were close. *Webcasting II Decision*, 72 Fed. Reg. at 24093. In the SDARS case, the Court rejected one of SoundExchange's proposed benchmarks based on non-music programming, finding that there was "[no] substantial evidence regarding the relevant cross-price elasticities of demand." *SDARS Decision*, 73 Fed. Reg. at 4091.

b. The Purpose for Which Consumers Choose the Product Is Critical to the Question of Demand and Comparability.

46. As the economists in this proceeding have testified, the reason why a consumer chooses a product is a critical component of the analysis of the comparability of benchmarks. If consumers choose one product for one purpose and another product for another purpose, the former is unlikely to be a good benchmark for the latter. Thus, this Court and prior tribunals

have held that products or services that are not fundamentally about listening to music are not good benchmarks for products or services that are.

47. In the PES I proceeding, the Librarian upheld the CARP's determination that where the consumer chooses two different products or services for different reasons, one product is not a good benchmark for the other. In that case, the CARP rejected RIAA's preferred benchmark for digital audio services – cable movie networks – because the consumer experience is so different and consumers pay for cable movie networks for completely different reasons than they pay for digital audio services: "the subscriber chooses each service for different reasons, and therefore, they do not represent choices in the same market." *PES I Librarian's Decision*, 63 Fed. Reg. at 25397.

48. Similarly, where a benchmark relates to a product or service that is incidental to some non-music product offering, the Court has found that it provides little guidance concerning the appropriate royalties for a product for which music to be listened to by consumers is a primary element. Thus, in the SDARS proceeding, the Court rejected digital cable radio services as a benchmark because that service was "incidental to [consumers'] primary activity of television channel usage." *SDARS Decision*, 73 Fed. Reg. at 4089. This contrasted with the SDARS service for which music listening "is an integral part of the consumer activity." *Id.* These differences meant that the consumer demand for music was different for the two services, which rendered the proposed benchmark comparison uninformative. *Id.*

c. Products Must Be in the Same Market or a Similar Market in Order for Them to Provide Comparable Benchmarks.

49. This Court and prior tribunals have regularly rejected benchmarks from very different markets, where the product is sufficiently different or the consumer use is sufficiently different that there is little reason to believe that rates from one market are likely to provide

useful information about another. Where "[t]here is no established nexus between the industries, the marketplaces in which they operate, or the rights for which the rates are set," a benchmark has no value. *Webcasting I Librarian's Decision*, 67 Fed. Reg. at 45265.

50. For these reasons, royalty rates for a product that is a substitute for the product for which royalty rates are being set provide a far better benchmark than those for products that do not compete in the same market. As the Court noted in the SDARS proceeding, the best benchmarks would be those that are actually substitutes for each other, rather than complements. *SDARS Decision*, 73 Fed. Reg. at 4091-92 & n.28. Similarly, in the Webcasting I proceeding, the CARP and the Librarian rejected the proffered musical works benchmark in part because musical works and sound recordings do not compete in the same market, i.e., they are not substitutes for each other. *Webcasting I CARP* Decision at 41.

51. In Webcasting I, the CARP and the Librarian rejected all other benchmarks proposed by RIAA and the webcasters, finding that the best approach was to use a single agreement for the precise rights at issue. As the CARP and the Librarian recognized, licenses for the exact rights at issue and the exact product at issue require fewer adjustments and provide more confidence that the benchmark will accurately mirror transactions that would take place in the marketplace in the absence of a statutory license.

d. The Cost Structures of Potential Benchmarks May Come Into Play.

52. An ideal benchmark market would reflect similar demand and cost characteristics. *Determination of Statutory License Terms and Rates for Certain Digital Subscription Transmissions of Sound Recording*, Docket No. 96-5 CARP DSTRA, at 39 (Nov. 12, 1997) ("*PES I CARP Decision*"). This Court has twice previously rejected, as the Webcaster I CARP and the Librarian had, the argument that copyright owners of musical works and sound

recordings should receive the same compensation. *SDARS Decision*, 73 Fed. Reg. at 4089-90. As the Court has noted, compensation for sound recordings is generally a multiple of what it is for musical works in the marketplace, and record companies invest far more than music publishers in the creation of sound recordings from which they each benefit. *Id.*

53. As the Court recognized in rejecting the musical works benchmark, the repeated costs incurred by market participants in producing products for sale or license – such as the "repeated, substantial outlays year after year" faced by record companies, *SDARS Decision*, 73 Fed. Reg. at 4090 – are relevant to comparing the comparability of benchmarks. Where one product requires large and repeated investments for its creation and another does not, the latter is not a good benchmark for setting rates for the former. *Id.* In the SDARS case, as in the webcasting case, the Court found that record companies make "substantially greater investment . . . in sound recordings as compared to musical works." *Id.*

e. Agreements Covering Multiple Products and Services Are Less Useful As Benchmarks For a Single Isolated Product, Especially Where It Is Clear That Trade-offs Were Made.

54. As the Librarian explained in the PES I proceeding, a royalty rate in an agreement that reflects a series of trade-offs cannot provide a good benchmark. *PES I Librarian's Decision*, 63 Fed. Reg. at 25402. In that proceeding, the Librarian reversed the decision of the CARP to rely on royalty rates negotiated as part of a bundled agreement with several interrelated parts. "[S]trong ties between provisions in a negotiated document raise the question of how much give-and-take occurred in negotiating the final terms. Courts recognize that complex transactions encourage tradeoffs among the various provisions and lead to results that most likely differ from those that would result from a separately negotiated transaction." *Id.*; *see also ASCAP v. Showtime/The Movie Channel, Inc.*, 912 F.2d 572, 590 (S.D.N.Y. 1989).

55. Similarly, the Webcaster I CARP found that the RIAA-Yahoo! agreement contained higher royalty rates for one type of product in exchange for lower rates on other products.

f. Agreements With Services That Never Launched or Paid No Royalties Are Poor Benchmarks.

56. Agreements for which no royalties were ever actually paid, no royalties beyond the minimum were paid, or for a service that never went into operation are "of virtually no use as a rate benchmark." *Webcasting I CARP Decision* at 45; *id.* at 53-54. As the CARP explained, "[i]f those Services had reached agreement with RIAA, and then paid no royalties beyond the recited minimum or quickly went out of business, the Panel would accord those agreements very little weight either. For the reasons previously cited, it is difficult to imagine how one could rely on such agreements with any confidence." *Id.* at 60.

57. Similarly, agreements for new products that have had a short lifespan are less useful as benchmarks than comparable agreements for products that have withstood the "test of time." *Webcasting I CARP Decision* at 47.

58. The Webcasting I CARP also found that where special circumstances, such as a need to get into the market quickly, compelled a copyright user to enter into a license agreement, such agreement would not provide a good benchmark. *Webcasting I CARP Decision* at 54-56 (discussing the MMM and Websound licenses with RIAA).

g. Benchmarks for Products or Services That Are Different From the Target Market Frequently Need to Be Adjusted in Order to Provide Useful Information.

59. In its prior proceedings, this Court has focused on benchmarks that are similar to the target market with respect to the manner in which the product is delivered to the public and the purpose for which the consumer acquires the product. *SDARS Decision*, 73 Fed. Reg. at

4091. Even after applying these criteria and determining that a benchmark is sufficiently comparable, the Court has made adjustments to account for differences in consumer functionality and the value of the product to the subscriber. *Id.* In rejecting other benchmarks, the Court has found that to "[f]ail to account for key differences that consumers value" is fatal to the comparability of a benchmark. *Id.*

3. Application to the Benchmarks Proposed Here

60. These aspects of comparability all point in favor of reliance on the RIAA's proposed benchmarks and rejection of those offered by the Copyright Owners. The RIAA relies on rates paid for mechanical rights in precisely the same type of market at issue here. It relies on historical rates, current voluntary rates and international rates applicable to those buying the right to use a musical work in a new sound recording to be created and sold to the public. Thus, comparability is not an issue.

61. But the same cannot be said for the Copyright Owners' benchmarks. The synch rights market involves different buyers buying different rights for different purposes, under circumstances where the relative leverage of the publishers and record companies is skewed and at a time when the costs that would be taken into account are entirely different. The AHRA does not set a market rate at all, let alone a comparable one. As for the rates set for mastertones, a mastertone and a full track recording are purchased by consumers for very different purposes and the two markets (mastertones and sales of full track recordings used for listening) reflect very different supply and demand characteristics. And the circumstances under which the rates currently being paid for mechanical rights for mastertones also were such that they do not provide a reliable measure of what the rate would be in a free-standing free-market negotiation.

C. Interpretation and Application of the Section 801(b)(1) Objectives

62. Following the identification of different points of reference from the benchmark analysis, the Court must then weigh the Section 801(b)(1) policy considerations and make appropriate adjustments. *SDARS Decision*, 73 Fed. Reg. at 4094. As the Librarian has explained, ratemaking "requires evaluating the marketplace points of reference and tempering the choice of any proposed rate with the policy considerations underpinning the objectives of Congress in creating the license." *PES I Librarian's Decision*, 63 Fed. Reg. at 25049. That includes the policies that underpin both the Section 801(b)(1) factors and Section 115.

63. This weighing, however, is not "a beauty pageant where each factor is a stage of competition to be evaluated individually to determine the stage winner and the results aggregated to determine an overall winner." *SDARS Decision*, 73 Fed. Reg. at 4094. Rather, the Court found, the proper approach is to analyze the statutory factors to determine whether they counsel in favor of adjusting the rates identified by the analysis of benchmarks. *Id.* at 4091.

64. As prior courts have noted, the four statutory factors can pull in opposite directions and require some measure of balancing. *Recording Industry Association of America*, 662 F.2d at 8. For example, the second and third statutory factors invite the Court to attempt to "achieve an equitable division of music industry profits between copyright owners and users." *Id.*

65. The factors also compel the Court to look broadly at the future of the music industry itself – and not simply at the narrow question before the Court of payments for a particular musical work. *Recording Industry Association of America*, 662 F.2d at 8 ("some of the statutory factors require the Tribunal to estimate the effect of the royalty rate on the future of the music industry"). This is especially true about the first and fourth statutory factors, which require the Court to look beyond mechanical royalties in this proceeding and to evaluate the

impact that rates set in this proceeding will have on the public's access to creative works and the potential impact that the rates set in this proceeding might have on all of the players in the music industry.

1. Section 801(b)(1)(A): Maximize the Availability of Creative Works

66. The first statutory objective directs the Court to "maximize the availability of creative works to the public." 17 U.S.C. § 801(b)(1)(A).

67. As the Court noted in the SDARS case, the "ultimate question is whether it is necessary to adjust the result indicated by marketplace evidence in order to achieve this policy objective." *SDARS Decision*, 73 Fed. Reg. at 4094. Under the first statutory factor, the issue is whether the rates identified as part of the benchmark analysis will result in the "maximum amount of product availability consistent with the efficient use of resources." *Id.* at 4095.

68. This proceeding is different from the SDARS proceeding in the application of this factor in two significant ways. First, in the SDARS proceeding, the issue was the rate to be paid by two companies engaged in just one form of distribution of copyrighted sound recordings, where the same recordings were available through many other avenues of distribution. Those distributors also offered little, if anything, in terms of creative contribution. In that context, there was only one creative work that would be affected – the sound recording. As the Librarian and the CRT have held in the past, one narrow class of distributors out of many has little effect on the availability of creative works to the public. *See PES I Librarian's Decision*, 63 Fed. Reg. at 25406 ("[t]here is no record evidence to support a conclusion that the existence of the digital transmission services stimulates the creative process."); *1980 Adjustment of the Royalty Rate for Coin-Operated Phonorecord Players*, 46 Fed. Reg. 884, 889 (Jan. 5, 1981) ("*Jukebox*") ("We do not maintain that the jukebox rate is crucial to assuring the public of the availability of creative works.").

69. In stark contrast, in this proceeding, the Court is setting a royalty rate for one type of creative work – musical works – but musical works only become available to the public when they are incorporated into another type of creative work – sound recordings. Teece WDT at 82, RIAA Trial Ex. 64. It is the sound recording that is distributed to the public. In order to advance this statutory factor, the Court needs to ensure that there are sufficient incentives to maximize the creation and dissemination of *sound recordings* to the public; only by doing so will it ensure the maximum availability of musical works to the public. Numerous witnesses for the music publishers have conceded that the only way their works reach a mass audience – or an audience of any size – is through the creation and dissemination of sound recordings. *See, e.g.*, Carnes WDT at 4, CO Trial Ex. 1; Galdston WDT at 4-5, CO Trial Ex. 4. Thus, there is voluminous evidence in this proceeding to demonstrate that the work of record companies and recording artists in creating, marketing and disseminating sound recordings in myriad forms provides the incentives to create musical works. Through sound recordings, people access musical works and songwriters and music publishers earn virtually all of their revenues.

70. Second, while in the SDARS proceeding a higher royalty rate was nearly certain to result in increased creation of copyrighted sound recordings which then would be disseminated through multiple channels, in this proceeding, a higher rate may increase the production of musical works (perhaps beyond the efficient level), but at the same time increasing the rate will likely decrease the number of sound recordings created – thereby resulting in fewer musical works actually being made available to the public (and less aggregate compensation to the Copyright Owners).

71. The higher the rate that the Court sets in this proceeding, the lower the incentives to create sound recordings – especially in the declining market that exists today. As Bruce

Benson testified, after allocation of overhead, per-track profits for recorded music products are generally small (or nonexistent). Benson WRT at 4, RIAA Trial Ex. 82. The increases proposed by the Copyright Owners would more than consume all profits of the CD and download businesses; even a slight increase would materially affect profitability.

72. Raising consumer prices is not a realistic option at a time when aggregate consumer demand is declining, and the record demonstrates a precipitous and ongoing decline in retail and wholesale prices, both in real and nominal dollars. *See* RIAA PFF Section II.E.1.f. As the Court held in both the SDARS and Webcasting proceedings, if record companies are unable to cover their costs, the incentive to produce sound recordings is diminished. *Webcasting II Decision*, 72 Fed. Reg. at 24094; *SDARS Decision*, 73 Fed. Reg. at 4090. Moreover, the process of determining future investment in sound recordings is a "dynamic one," requiring record companies to evaluate all their costs and revenues in determining whether to make additional investments in the creation of new music and the further dissemination of existing music (including the creation of new sound recordings from existing musical works). *Id.*

73. In applying this factor, the record provides specific evidence about the amounts of compensation needed to cause songwriters to create musical works to be made into sound recordings and disseminated by record companies. As the testimony of Dr. Wildman as well as that of multiple songwriters demonstrates, songwriters regularly write new musical works for far less than the current statutory rate. RIAA PFF Section III.C; 1/30/08 Tr. 829:20-830:13 (Shaw); 1/28/08 Tr. 208:7-208:11, 211:12-212:4 (Carnes); Shaw WDT at 5, CO Trial Ex. 5; 1/30/08 Tr. 796:14-797:4 (Galdston). This is strong evidence that rate needed to provide incentives for the creation of new musical works is far below the current statutory rate.

74. Dr. Landes suggested that songwriters may be willing to accept low rates to write songs for first uses in order to reap large rewards based on higher royalty rates for second uses. But there is absolutely no evidence in the record to support this speculative supposition. Indeed, all of the evidence is to the contrary – the vast majority of the most popular sound recordings are first uses, Wildman WRT at 42, RIAA Trial Ex. 87, and songwriters believe that subsequent uses of a musical work are less likely to be successful because the first use (even of a popular song) can so associate the musical work with the artist that it will be difficult to persuade anyone to re-record it. 1/28/08 Tr. 220:12-220:21 (Carnes).

75. Thus, the Court has before it a precise measure of the incentives necessary to cause songwriters to write new works – the rates for first uses – and they are far below the current statutory rate. Because all of the other activities necessary to make musical works available to the public – discovering the recording artists, making the musical work into a sound recording, marketing the sound recording, and distributing the sound recording – are undertaken by the record companies and recording artists, this statutory factor counsels a rate no higher than that which is necessary to give songwriters sufficient incentives to write new musical works.

76. Finally, even if the Court was to focus solely on creation of musical works under this statutory factor, in evaluating a royalty rate that will provide incentives to ensure the efficient number of musical works, it necessarily must consider all of the incentives that songwriters and music publishers have for the creation of musical works. That includes the non-mechanical income of songwriters. Dr. Landes, the music publishers' own expert, testified that "mechanical royalties are not the only determinant of the 'availability of creative works to the public' because creators also receive compensation from other sources." Landes Amended WDT ¶ 30, CO Trial Ex. 406. In so doing, Dr. Landes was merely conceding what is an unassailable

economic reality that the Court itself specifically recognized in the SDARS case – copyright owners' "incentives to produce new music are based on revenues from all available sources." *SDARS Decision*, 73 Fed. Reg. at 4090 (quoting Dr. Ordover).[1]

77. In this regard, it is critical to recognize, as shown by the testimony of Terri Santisi, the radical difference in the situation of music publishers and record companies as they come to this proceeding. Music publishers have multiple revenue streams, most of which do not depend on the mechanical rate set in this proceeding (except to the extent that a lower mechanical rate would stimulate production of more recordings and generate additional non-mechanical revenues for the Copyright Owners). The publishers' other revenues also are not significantly affected by the trends that have affected the industry as a whole (piracy being one of the most significant). RIAA PFF Section II.E.2.a-b. Their synchronization and performance royalties have been increasing rapidly and more than offsetting any decline in overall mechanical royalties. Thus, the effect of a lower rate in this proceeding on the overall incentives to music publishers and songwriters is cushioned by these other, unaffected revenue streams.

78. In stark contrast, mechanical royalties are paid on roughly 90% of the total revenues of record companies (including CDs and digital downloads, which provide the overwhelming majority of the record companies' revenues). CO Trial Ex. 41, at RIAA_0008423. Setting a higher royalty rate in this proceeding will therefore result in an increase in costs for virtually every product the record companies sell. As the record shows, in a time of flat or declining prices, that cost increase will mean fewer artists signed, more firings of employees, fewer marketing dollars spent, and fewer new sound recordings created. That will

---

1 For further discussion of the relevance of the Copyright Owners' non-mechanical income, see RIAA's prior briefing on the issues (attached as Exhibit 2) as well as RIAA COL Section II.D.

result in fewer creative works being made available to the public in direct contravention to the policies underlying the first statutory factor, and may even result in lower aggregate compensation to the Copyright Owners.

2. Section 801(b)(1)(B): Afford the Copyright Owner a Fair Return and the Copyright User a Fair Income under Existing Economic Conditions

79. The second statutory factor requires the Court to "afford the copyright owner a fair return for his creative work and the copyright user a fair income under existing economic conditions." 17 U.S.C. § 801(b)(1)(B). As the D.C. Circuit explained, this is one of the factors that the Court must balance to "achieve an equitable division of music industry profits between copyright owners and users." *Recording Industry Association of America*, 662 F.2d at 8.

80. As a threshold matter, this factor expressly directs the Court to consider "existing economic conditions" – which, as the record shows, means a period in which record companies have faced and continue to face enormous challenges, in which consumers are willing to pay less and less for CDs, the prices of digital downloads are stagnant or softening and the prices of ringtones are falling, and in which music publishers are making healthy profits far beyond a reasonable risk-adjusted return on capital.

81. In this regard, the "existing economic conditions" of the 1981 mechanical royalty proceeding and this proceeding could not be more different. As the CRT found in the 1981 mechanical proceeding, the state of the record industry as a whole is relevant to determining whether an increase or a decrease in the statutory rate is required. In that proceeding, the CRT found that the record companies' rapid revenue growth and sustained high level of profitability justified a rate increase because record companies could earn a fair return even after a rate increase. *1981 Mechanical Royalty Proceeding*, 46 Fed. Reg. at 10480. Indeed, the CRT in 1981 expressly found that an increase in the mechanical royalty would have only minimal impact

on the record companies and that, indeed, record companies would still have a profit margin 144% higher than a decade earlier. *Id.* at 10481.

82. In contrast to the record companies' good fortune in the 1970s and early 1980s, the CRT found that it was the copyright owners who were facing difficult times. The CRT found that in the decade prior to the 1981 mechanical proceeding, the fortunes of the record companies had been enhanced while the fortunes of songwriters and music publishers had dwindled. *1981 Mechanical Royalty Proceeding*, 46 Fed. Reg. at 10483. In justifying a rate increase, the CRT looked to "the market position of copyright owners" which had "drastically deteriorated in absolute as well as relative terms." *Id.* at 10485.

83. The "existing economic conditions" in this proceeding present exactly the opposite situation. Today, as the record in this proceeding establishes, it is the record companies whose "market position" has "deteriorated in absolute as well as relative terms." *1981 Mechanical Royalty Proceeding*, 46 Fed. Reg. at 10485. Sales are down drastically and prices continue to decline, resulting in massive cost cutting, firing of employees, and the creation of less music. RIAA PFF Section II.E.1. In contrast, music publishers today are enjoying record high revenues, high profit margins, and Wall Street assessments that they are businesses with little risk that essentially print money. RIAA PFF Section II.E.2.

84. In analyzing the equitable distribution of profits in the music industry, as required under this factor, the CRT focused on the profit margins of music publishers and record companies and on the relationship of mechanical royalties to wholesale and retail prices and revenues.

85. In 1981, the CRT found that the mechanical rate was too low because, despite astounding growth in the market for music, the mechanical royalty had decreased as a percentage

of record sales over time. *1981 Mechanical Royalty Proceeding*, 46 Fed. Reg. at 10481; *id.* at 10483 ("[m]echanical royalties paid in the period 1974-79 did not keep pace with record company gross revenue.").

86. Similarly, while record companies had seen their profit margins grow rapidly in the 1970s and early 1980s, traditional music publishers received a relatively low return on their investment of between 5.17% of revenue and 8.46% of revenue from 1977 to 1979. *1981 Mechanical Royalty Proceeding*, 46 Fed. Reg. at 10469.

87. In this proceeding, the evidence shows precisely the opposite. Mechanical royalties are now a higher percentage of record companies' gross revenues than they have ever been and that trend is only accelerating with the move toward digital distribution. In contrast to the booming record company revenue in the 1970s, sales and revenues are declining rapidly. Consumer prices for sound recordings are falling as well. For the same reasons that the CRT in 1981 found that a significant increase in the mechanical royalty was required, a significant decrease is required in this proceeding.

88. The Copyright Owners appear to argue that a "fair return" under this statutory factor requires the Court to give music publishers at least as much in mechanical revenue as they received in past years and to ensure that the value of future mechanical payment is the same on an inflation-adjusted basis. As the publishers repeatedly make clear in their testimony, a primary basis for the exorbitant increase they have demanded is their view that they are entitled to receive as much in mechanical royalties as they have in prior years, and their demand for increases based on the Consumer Price Index ("CPI") – unsupported in any of the agreements they have proffered – is based on a claim that such monies are necessary for a fair return. That is not so.

89. First, this Court and prior tribunals have rejected the argument that copyright owners are entitled to a guarantee of a certain threshold level of royalties, maintained at a constant dollar level. Indeed, in a similar context, the D.C. Circuit rejected the argument that the CRT was required to provide copyright owners with inflation-adjusted increases each year of a royalty term "to maintain the value of royalty receipts." As the D.C. Circuit explained, the legislative history of this and other statutory licenses makes clear that the periodic rate-settings every five years were intended to ensure that royalty rates are adjusted to keep up with changes in inflation and other market factors. The D.C. Circuit thus rejected exactly such a demand from copyright owners in proceedings against cable systems. *National Cable Television Association v. Copyright Royalty Tribunal*, 689 F.2d 1077, 1083 & n.51 (D.C. Cir. 1982).

90. Notably, this Court has twice rejected arguments for CPI increases, finding them unsupported by any marketplace agreements in either the webcasting proceeding or the SDARS case and finding it inappropriate to grant copyright owners increases of indeterminate size. *E.g., SDARS Decision*, 73 Fed. Reg. at 4098 n.42. The facts are identical in this proceeding. The music publishers can point to no marketplace agreements admitted into evidence in which there are CPI increases because there are no such agreements.

91. Indeed, the 1981 CRT considered a variety of factors, including inflation, and determined that the only fair method of adjusting the mechanical royalty rate was to track record prices – not inflation – because record prices would incorporate both the effects of inflation and the changing consumer value of music. The CRT found expressly that, in order for the rate to remain reasonable, "it is necessary to set the rate in a manner that will respond to record prices." *Mechanical Royalty Proceeding*, 46 Fed. Reg. at 10485. The CRT thus "determined that any adjustment to the rate should and must be directly related to the retail list price of records, now

and in the future." *Id.*[2] That was consistent with the argument that music publishers made to the CRT – that a rate adjusted based on inflation was less equitable than a rate adjusted consistent with purchase price (such as a percentage rate). *Id.* at 10471.

92. Second, historical data about returns that music publishers receive are highly relevant to determining what is fair in this proceeding – as the music publishers themselves argued in 1981. In the 1981 proceeding, the music publishers argued for a rate of 6.5% of the suggested retail price or 8.5% of the price actually paid by consumers, arguing and submitting evidence that such rates reflected the historical effective rate during periods when the record industry was relatively stable. *1981 Mechanical Royalty Proceeding*, 46 Fed. Reg. at 10467. They suggested that the statutory mechanical royalty rate had historically been at approximately 11% of wholesale revenues. *Id.* The CRT did not agree that publishers had historically received such a high share of the retail or wholesale price and adopted a smaller increase corresponding to 5% of the suggested retail price. *Id.* at 10481.

93. Further, the music publishers argued that mechanical rates should adjust based on changes in record prices and all other costs that record companies bear. *1981 Mechanical Royalty Proceeding*, 46 Fed. Reg. at 10467. They also argued that royalty rates should be set without regard to the volume of sales and the total volume of royalties, focusing instead only on the per-unit royalty, which should adjust based on the consumer price of sound recordings. *Id.* at 10467-68.

94. As should be obvious from this proceeding, music publishers – having benefited from rulings in their favor in 1981 when economic times were difficult for them – now argue

---

2 This portion of the CRT's ruling was reversed on appeal not because it was error but because the interim proceeding scheduling by the CRT to adjust the rate were beyond its jurisdiction. *Recording Industry Association of America*, 662 F.2d at 17-18.

precisely the opposite. But the CRT's decision and the record in this proceeding compel the conclusion that, in order to "achieve an equitable division of music industry profits between the copyright owners and users," *Recording Industry Association of America*, 662 F.2d at 8, as this factor requires, the statutory rate must come down.

95. Indeed, in contrast with the 5% of suggested retail price implied by the CRT's decision, or even the somewhat higher percentage rates that the music publishers claimed were based on historical norms in 1980, the statutory rate is now higher than it has ever been as a percentage of retail or wholesale price, and the publishers are now demanding almost double the supposed historical norms (even as they calculate it) for digital downloads, likely increasing to more than double those percentages over the course of this license period. For CDs, the rates are likely to be even greater as record prices continue to slide.

96. Finally, it is worth noting one other salient fact that is relevant to the fair return calculus. Copyright owners have sought to present evidence about songwriter income, attempting to persuade the Court that songwriters cannot make ends meet under the current mechanical rate and that it is the rate that is the problem rather than any other industry conditions. But the record clearly reflects that it is the music publishers themselves who are the primary culprits in terms of taking money out of songwriters' pockets. As the record shows, the music publishers do very little for the revenues that they receive – they employ few people, make few investments (other than advances on royalties that they recoup most of the time), and face little risk. At the same time, they frequently take 50% of the revenues paid to songwriters for use of their musical works, and the music publishers decry that their share has, in many agreements with songwriters, been reduced to 25%. The result of the current system is that music publishers generate bloated profit margins and record companies and songwriters each bear the brunt.

97. The second statutory factor also requires the Court to ensure a fair income for record companies. The CRT and the Librarian made clear that this requirement must be understood in light of the anti-monopoly focus of Section 115 and is intended to facilitate entry into the market by potential copyright users.[3] The "fair income" under the compulsory license refers to "Congress' decision to permit entry into the music market by a potential copyright user." *1981 Mechanical Royalty Proceeding*, 46 Fed. Reg. at 10480. Thus, the statutory rate must be set at a level "to permit any record companies to enter the market at will." *Id.* As the Librarian noted specifically with respect to the Section 115 statutory license at issue in this proceeding, "the mechanical license regulates the price of music to lower the entry barriers for the potential users of music." *PES I Librarian's Decision,* 63 Fed. Reg. at 25049. The statutory rate therefore must be "a royalty of reasonable resort." *1981 Mechanical Royalty Proceeding*, 46 Fed. Reg. at 10480.

3. Section 801(b)(1)(C): Reflect the Relative Roles of the Copyright Owner and the Copyright User with Respect to Contribution, Investment, Cost and Risk

98. The third statutory factor requires the Court to "reflect the relative roles of the copyright owner and the copyright user in the product made available to the public with respect to relative creative contribution, technological contribution, capital investment, cost, risk, and contribution to the opening of new markets for creative expression and media for their communication." 17 U.S.C. § 801(b)(1)(C).

---

3 This aspect of the second statutory factor - based on the policies behind Section 115 - is much different than the application the second statutory factor to the PES and SDARS statutory licenses under Section 114, which does not have an anti-monopoly rationale, and cannot be understood as seeking to facilitate entry into the marketplace because Congress expressly limited the availability of the PES and SDARS statutory licenses to 5 (now 4) specific entities.

99. As the D.C. Circuit has recognized, this factor is part of Congress's direction to the Copyright Royalty Judges to establish royalty rates that reflect an equitable distribution of the profits of the music industry, reflecting the relative contributions, including costs and risks, that copyright owners and record companies put into the "product made available to the public." The "product made available to the public" is the *sound recording*, and the Court must consider each party's contribution to bringing that product to the public. *See PES I Librarian's Decision*, 63 Fed. Reg. at 25407-08 (holding that the "product made available to the public" is the sound recording and the digital music service and that such definition of the product "is consistent with the 1980 rate adjustment for the mechanical license").

100. In examining the contribution, costs, and risks of each party, this Court and prior tribunals have made a number of things clear. First, the Court must consider all the costs and revenues that may derive from the copyrighted work. That copyright owners have multiple outlets for their works means that they have face less risk as a result of any change in the statutory license at issue and less risk generally in their business. For example, in the PES I proceeding, the CARP analyzed the total revenues of the record industry and total sales of individual albums in finding that record companies faced fewer risks than the PES. *PES I CARP Decision* at 28-30 ("The recording industry as a whole is a large, well-established entity. Its unit shipments and dollar values of compact discs, cassettes and music videos have consistently increased from 1982 to 1996."). Similarly, the Librarian and the CRT have consistently found that, in considering the investment, cost, and risks faced by the parties, it is necessary to consider all of the parties' investment, cost, and risk – not simply some subset that is attributable to mechanical royalties. *See PES I Librarian's Decision*, 63 Fed. Reg. at 25407 (focusing on how record companies had reduced risk because they had consistently earned significant revenues

from other sources for their sound recordings); *1981 Mechanical Royalty Proceeding*, 46 Fed. Reg. at 10466. As the Court held in the SDARS case, record companies "undertake significant and irreversible investments to develop talent and produce new works." *SDARS Decision*, 73 Fed. Reg. at 4096.

101. Second, the trends that each industry is facing in the marketplace are relevant to analyzing this factor. In the PES I Proceeding, the CARP and the Librarian found it highly relevant that the business model of the PES was undergoing change as they were no longer able to sell their service as they had previously (as subscriptions), while the record companies had seen sales and revenues regularly increasing over a decade. *PES I Librarian's Decision*, 63 Fed. Reg. at 25407. Here, the opposite is true. The record companies' business model is changing radically and they are facing declining sales and revenues, while at the same time the music publishers are facing much less difficult economic times.

102. Third, where copyright owners benefit from substantial and ongoing investments made by users, without which the creative works cannot be made available to the public, that factor may weigh in favor of a discount off rates determined with reference to specific benchmarks. *SDARS Decision*, 73 Fed Reg. at 4096.

103. Fourth, the impact of investment by record companies on other revenue streams of the music publishers is highly relevant to the risks that each party faces. Where, as here, expenditures of the record companies on the creation, marketing, and distribution of sound recordings actually facilitate and promote other revenue streams of the music publishers (such as synchronization and performance revenues), that promotion reduces the risk faced by songwriters and music publishers. The CRT in 1981 found that the investments and expenditures of record companies benefit the music publishers and songwriters and thus must be taken into

account. *1981 Mechanical Royalty Proceeding*, 46 Fed. Reg. at 10482. Similarly, the Librarian found that evidence of promotion and substitution is relevant to third factor because, to the extent that one product generates revenue in other area or substitutes for that revenue, it affects the costs and risks of creating the product in the first place. *PES I Librarian's Decision*, 63 Fed. Reg. at 25047-48; *PES I CARP Decision* at 31-32 (finding that, where the efforts of the copyright user promote other sales of the copyright owner, the costs and risks attributable to the copyright user decline, justifying a lower rate).

104. Finally, with respect to the opening of new markets, the Court has suggested that it is critical to evaluate whether record companies are the sole or primary outlet for musical works or whether they are merely one of many distributors. In the SDARS case, there was little to distinguish the SDARS from other digital music distributors because all contribute to opening new markets, so the Court found no reason to make an adjustment in benchmark rates. *SDARS Decision*, 73 Fed. Reg. at 4096. The present case is fundamentally different. The record companies make all of the investments to create sound recordings, market and distribute them, and are essentially the sole (and certainly the primary) outlet for musical works. Without record companies, songwriters would have no markets in which to sell their works. It has been record companies, in conjunction with digital music services, that have opened all of the vast array of new services from which musical works copyright owners earn revenues.

4. Section 801(b)(1)(D): Minimize Disruptive Impact on the Structure of the Industries

105. The fourth statutory factor requires the Court "[t]o minimize any disruptive impact on the structure of the industries involved and on generally prevailing industry practices." 17 U.S.C. § 801(b)(1)(D). This Court and the Seventh Circuit have each made clear that

"marketplace evidence, standing alone, does not address" this statutory objective. *Amusement & Music Operators*, 676 F.2d at 1157; *SDARS Decision*, 73 Fed. Reg. at 4097-98.

106. The disruption factor requires the Court to examine not just current economic circumstances, but also the impact of a rate on the future of the industry. *Recording Industry Association of America*, 662 F.2d at 8. As a result, the financial health of the two industries is directly relevant to the fourth statutory factor. *PES I Librarian's Decision*, 63 Fed. Reg. at 25010.

107. In examining the fourth factor, the Librarian has made clear that the Court must look at all revenues of music publishers and of record companies. *PES I Librarian's Decision*, 63 Fed. Reg. at 25048 (focusing on the impact that an increase in the royalty rate would have on all record company revenue). Similarly, the CRT found that "it was valuable for us to be aware of the financial status of both the recording industry and the copyright owners." *1981 Mechanical Royalty Proceeding*, 46 Fed. Reg. at 10482.

108. In the SDARS case, the Court interpreted the disruption prong to seek to avoid "directly produc[ing] an adverse impact that is substantial, immediate and irreversible in the short-run because there is insufficient time for either the SDARS or the copyright owners to adequately adapt to the changed circumstances produced by the rate change." *SDARS Decision*, 73 Fed. Reg. at 4097.[4] The Court made predictions about a relatively new industry and its economics, and it rendered a decision concerning the effects of the royalty rate on the future attainment of EBITDA profitability by the SDARS.

109. In this proceeding, by contrast, the disruption that the recorded music industry would experience as a result of an increase in the mechanical royalty rate is different and far

4 The Court's decision concerning the disruption factor is currently on appeal by SoundExchange.

more acute. This case does not involve a new industry making investments today with significant losses in the full expectation that it will reap the financial benefits from those investments in the future. Rather, the Court here is faced with an established recorded music industry with known costs that must be repeatedly incurred year-after-year, album-after-album in order to continue the flow of new music into the marketplace, but with sharply declining revenues and prices. Rather than an SDARS industry with rapidly growing revenues for which losses will lessen over time, the Court is presented with a recorded music industry that continues to face a rapid contraction of the markets from which record companies earn revenue.

110. An increase in the royalty rate as proposed by the Copyright Owners will make it difficult, if not impossible, for the record companies to earn a profit at all under almost any set of circumstances – whether current economics or the expected future declines. Thus, the issue of disruption does not arise from future predictions of profitability – it arises because, today, increasing the mechanical royalty at all, much less to the exorbitant levels proposed by the Copyright Owners, may well result in record companies being unable to earn a reasonable or any profit in the future in this declining market. *SDARS Decision*, 73 Fed. Reg. at 4097 (explaining that, if the royalties charged will place an undue constraint on critical future investment, there is a potential for disruption). While the potential disruption to the SDARS was declining over time as their revenues grew, in this case the potential that a rate will cause disruption will increase as the market continues to contract. *Id.*

111. To be sure, the Court found that proof that the new rate would increase costs or decrease revenues is not sufficient, by itself, for a finding of disruption. *SDARS Decision*, 73 Fed. Reg. at 4097; *see also 1981 Mechanical Royalty Proceeding*, 46 Fed. Reg. at 10481, 10486. But when an increase in royalty rates would make a well-established industry like the recording

industry unable to continue to earn profits with respect to the majority of activity covered by the compulsory license, the fourth factor precludes the increase. That is precisely the situation here. As shown by the analysis of Bruce Benson, an increase in royalty rates (especially at the level that the music publishers demand) is likely to result in record companies being unable to make a reasonable profit – or any profit – without any reasonable prospect of earning a return on their investments. Record companies have already slashed their other costs. It is only mechanical royalties that have continued to increase over time, and sound recording markets are not growing. Requiring record companies to pay more for a product that is worth less without any reason to think it would ultimately be economically rationale to do so is disruptive.

112. Once again, the situation faced by this Court is exactly the reverse of that faced by the CRT in 1981. In considering potential disruption, the CRT found that the state of the record industry as a whole is relevant to determining whether an increase or a decrease in the statutory rate is required. In that proceeding, the CRT found that the record companies' rapid revenue growth and sustained high level of profitability justified a rate increase because record companies could still earn a fair return. *1981 Mechanical Royalty Proceeding*, 46 Fed. Reg. at 10480. In sharp contrast, the record industry comes to this proceeding in the midst of a precipitous decline, facing the most challenging time in their history with sharply declining sales and revenues. RIAA PFF Section II.E.1.

113. Relatedly, in 1981 the CRT found that there was no evidence that it would be difficult for record companies to pay a higher rate. To support that conclusion, the CRT found that the record companies had been able to absorb other cost increases without any disruption, principally by raising retail rates. *1981 Mechanical Royalty Proceeding*, 46 Fed. Reg. at 10481. The CRT focused expressly on increases in total cost per album (which had increased 146%) and

the much lower increase in mechanical royalties per album (an increase of only 14.5%). Based on this evidence, the CRT concluded that a cost increase in the mechanical royalty could be absorbed by the record companies. *Id.* As the record in this case reflects, however, record companies have been slashing other costs because (far from being able to raise retail rates) record prices and revenues continue to decline. RIAA PFF Section II.E.1.d.

D. The Section 801(b)(1) Objectives Require Consideration of Evidence of the Copyright Owners' Non-Mechanical Income.

114. The Copyright Owners have spoken out of both sides of their mouth about the relevance of non-mechanical income. They have put evidence into the record about all of their costs and about the percentage of their *overall* revenues derived from mechanical royalties, and they have put into evidence data about all of the record companies' revenues (including from products that do not bear mechanical royalties). At the same time, they have argued that RIAA should not be permitted to introduce evidence concerning the music publishers' vast other revenue streams.

115. RIAA has briefed this issue during the course of this proceeding, and RIAA incorporates by reference in these conclusions of law its prior briefing on the issue. *See RIAA's Brief Concerning the Relevance of Evidence of the Copyright Owners' Non-Mechanical Streams of Revenue* (May 8, 2008) (attached hereto as Ex. 2).

116. This Court has already ruled that the Copyright Owners have waived arguments concerning this issue. *See* 5/19/08 Tr. 7201:11-7202:12 (Landes) (ruling with regard to the Copyright Owners' motion *in limine* to exclude evidence of non-mechanical revenues that "issues of relevance are no longer pending, as the movant has waived that argument by virtue of the entire trial being presented without that issue being established").

117. Nonetheless, because of the importance of these issues to the Court's analysis, RIAA will repeat its arguments in summary.

118. Evidence depicting the complete financial situation of the participants has routinely been admitted in royalty rate proceedings. Indeed, in the first mechanical royalty rate setting proceeding, the Copyright Royalty Tribunal ("CRT") expressly ordered music publishers to compile and submit "representative aggregate data concerning the financial condition of the music publishers." *1981 Mechanical Royalty Proceeding*, 46 Fed. Reg. at 10467. This data was to include, among other things, "[d]omestic and foreign revenues from mechanical royalties, performance fees, [and] print license revenues." *Id.* at 10475;[5] *see also PES I Librarian's Decision*, 63 Fed. Reg. at 25408 (approving of Copyright Arbitration Royalty Panel's consideration of "[Copyright Owners'] revenues generated from the exercise of other rights granted to them under the Copyright Act" in order to "demonstrate the financial health of the industries").

119. The reason such evidence has been admitted is because it is relevant and important to proper consideration of each of the four Section 801(b)(1) objectives.

1. Maximizing Availability of Creative Works to the Public

120. The non-mechanical licensing revenues of Copyright Owners are relevant to determining the royalty rate that will "maximize the availability of creative works to the public." See Section 801(b)(1)(A). Prior tribunals have held that this policy objective relates directly to the production of creative works that are released to the public, *1981 Mechanical Royalty*

---

5 Because the particular information eventually received from music publishers proved to be "not a reliable indicator of the financial condition or profitability of the music publishing industry" due to methodological shortcomings in the NMPA's compiling of the data, *1981 Mechanicals Decision* at 10483, the CRT eventually determined that the information did not provide clear guidance under the facts of that case. *Id.* Nonetheless, the CRT did not hesitate to emphasize that "it was valuable for the Tribunal to be aware of the financial status of copyright owners and users." *Id.*

Proceeding, 43 Fed. Reg. at 10479, and this Court's analysis in the SDARS case is consistent with this focus on incentives.

121. In the *SDARS Decision*, the Court focused on issues related to potential promotion of, or substitution for, other revenue streams in its discussion of the incentives to create and make available new works. In so doing, the Court looked at the evidence concerning the impact of the SDARS service on other revenue streams not subject to the statutory license at issue in that proceeding. *SDARS Decision*, 73 Fed. Reg. at 4095. This Court also relied upon and quoted Dr. Ordover's analysis that "[copyright owners'] incentives to produce new music are based on revenues from *all* available sources." *Id.* at 4090 (emphasis added).

122. The Court's observation in the SDARS proceeding was correct. First, it is not possible to determine a rate that will maximize the availability of works to the public without understanding the broader economic context in which songwriters and music publishers operate. Songwriters do not make decisions about whether to create musical works based solely on the possibility of earning mechanical royalties; they take into account the full spectrum of royalties that may be available to them as a result of their creative endeavors. That is a concept that is widely understood among economists, including even the Copyright Owners' main expert witness, Dr. Landes, who testified in the direct case that "mechanical royalties are not the only determinant of the 'availability of creative works to the public' because creators also receive compensation from other sources." Landes Amended WDT ¶ 30, CO Trial Ex. 22. Indeed, as discussed below, other royalty streams are particularly relevant here because those royalty streams result directly from the creation of sound recordings.

123. Similarly, it is not possible to set a rate that will maximize availability of creative works to the public without taking into account the effects of that rate on recorded music

companies – companies that are essential to making creative works available by their creation and distribution of sound recordings. If the mechanical royalty rate were set so high that it led recorded music companies to cut back on the number of musical works they recorded, it would lead to a *reduction*, rather than an increase, in the availability of creative works to the public – an outcome that would of course frustrate the objective of Section 801(b)(1)(A).

124. Recorded music companies earn roughly 90% of their revenues from sales of musical works resulting in payment of mechanical royalties, while songwriters and music publishers get less than half their revenues from mechanical royalties. CO Trial Ex. 41, at RIAA_0008423 (record companies); Santisi WRT at Table A, RIAA Trial Ex. 78 (publishers). It follows that an increase in the mechanical royalty rate will have a greater effect on the incentives motivating record companies than a reduction would have on the incentives of songwriters or publishers. Unless the Court takes this differential into account, it could set a rate that, perversely, causes a net reduction in the availability of musical works to the public – precisely the opposite of what Congress intended in the first Section 801(b)(1) factor.

2. Fair Return and Fair Income Under Existing Economic Conditions

125. The Copyright Owners' non-mechanical revenue is also relevant to the "fair return" to copyright owners under Section 801(b)(1)(B). This objective is stated broadly, and requires consideration of "existing economic conditions" – all applicable economic conditions, not just a small subset of them. The CRT has, in fact, expressly so held. *See 1981 Mechanical Royalty Proceeding*, 43 Fed. Reg. at 10483 (noting that, notwithstanding methodological limitations of the data in that case, it was "valuable" to have data on the financial status of copyright owners in considering "how to balance fair return as against fair income").

126. The reason why it is necessary to take into account other streams of revenues when balancing fair return for Copyright Owners and a fair income for recorded music

companies is that songwriters, publishers and record companies alike devote resources to the creation of creative works that produce no revenue for any of them until the finished sound recording is produced, distributed and marketed. But when that happens, they all enjoy multiple streams of revenue (writers and publishers to a much greater degree than record companies). These revenues would not exist were it not for the recorded music company's efforts to market and popularize the sound recording. Santisi WRT at 19, RIAA Trial Ex. 78.

127. A proper reading of the second statutory factor compels the conclusion that this overall picture should be considered in this proceeding. Where recorded music companies, through their investments, create, market and popularize a sound recording and enable songwriters and publishers to reap the benefits of multiple revenue streams, a fair return and fair income cannot be determined if the economics of the whole enterprise of writing and acquiring musical works, producing and marketing recordings of them, and then exploiting both the musical works and sound recordings in multiple ways is not taken into account. Any other approach could, for example, lead to absurd results in circumstances where mechanical revenues have been going down but performance revenue is increasing due to a shift in the preferred forms of consumption of music.

128. Moreover, as the Court recognized in the SDARS case, products or services subject to the statutory license may have a promotional or substitutional impact on other revenue streams, which might impact both the first and second statutory factors. *SDARS Decision*, 73 Fed. Reg. at 4094-96. There is no legitimate dispute in this case that the creation of sound recordings for sale through products such as CDs and digital downloads promotes the other revenue streams (such as synch and performance) that the Copyright Owners enjoy; absent a

mechanical license and creation of the sound recording from a musical work, those other revenue streams would not exist for the musical work's Copyright Owners.

3. Relative Roles, Contributions and Risks

129. Evidence concerning the parties' revenue from non-mechanical licensing is also critical to a determination of the relative risks and contributions of the parties in the mechanical licensing context. First, the Court cannot accurately evaluate the relative risk taken by the record companies, music publishers, and songwriters in the creation of a mechanical copy of a sound recording without evaluating the relative importance of mechanical royalties to their total income. As the Copyright Owners' expert, William Landes, has testified, "A music publisher's revenue reflects the return to a diversified portfolio of songs and songwriters, and *it is a well known theorem of finance theory that a diversified portfolio of independent risks will be less risky than any individual component of that portfolio*." Landes WRT ¶ 23, CO Trial Ex. 406 (emphasis added). Similarly, Dr. Landes testifies that "economics also supports shifting a greater burden of the risk to a party if that party is better able to diversify that risk than are others." *Id.* ¶ 37. These principles dictate that in evaluating how much risk the Copyright Owners are taking with respect to their investments in the creation of songs, the Court should not look at mechanical royalty income in isolation, but as part of a risk portfolio. That portfolio, for the Copyright Owners, includes substantial revenues from performance, synchronization and other uses that reduce the risk that their investments in songs will be negatively affected by market conditions affecting mechanical uses.

130. Prior tribunals and this Court's decision in the SDARS case have made clear that evidence concerning the parties' revenue from non-mechanical licensing is relevant to this factor in several ways. In the PES I proceeding, the Librarian focused *not* solely on the risks incurred by the record companies in activities related to the statutorily licensed service, but on a broader

evaluation of risk and a broad range of evidence about the record companies' business. Thus, in assessing the risks that the record companies faced, the Librarian concluded that the copyright owners in that case had "adapted to the vagaries of the music business, and as an industry, have shown consistent growth in units shipped and dollar value of records, CDs, and music videos from 1982-1996." *PES I Librarian's Decision*, 63 Fed. Reg. at 25407. The Court's decision in the SDARS proceeding appears consistent with this approach, as the Court did not separate out risks related to the SDARS' music business from its non-music programming, but focused on the risks to the entire business, including statutory and non-statutory components. *SDARS Decision*, 73 Fed. Reg. at 4096-97.

131. Second, evidence concerning the Copyright Owners' revenues from non-mechanical licensing is relevant to the Court's comparison of the Copyright Owners' costs and investments relative to those of the record companies. The minimal investments that the Copyright Owners make on average result in more non-mechanical revenue than mechanical revenue. RIAA PFF Section II.E.2. Thus, those investments can only be assessed when compared against their diversified revenue streams. In contrast, the relatively substantial investments of the record companies take on an even greater weight when measured against their revenue base, which depends overwhelmingly on revenue from the sale of sound recordings that bear mechanical royalties. The Court cannot gain an accurate understanding of the relative significance of the parties' costs and investments unless they are viewed relative to the parties' very different revenue portfolios.

132. Third, as to the relative contribution of record companies, the publishers' non-mechanical income is relevant because it arises out of the record companies' efforts to develop, create, invest in, and market sound recordings. Were it not for the sound recording that is created

by the record companies and distributed by them to the public at large, there would be far less of a market for synchronization and performance licenses in the first place.

133. Fourth, as to the opening of new markets for creative expression, the Copyright Owners' non-mechanical revenue streams are directly relevant as evidence of the record companies' efforts to open new markets from which the Copyright Owners benefit. Thus, in the PES I proceeding, the CARP looked at whether the PES would open markets for record companies by assisting them in growing other revenue streams, not just revenues from the PES. Similarly, the Librarian focused in detail on how the activities of the PES affected the other revenue streams, such as sales of CDs. *PES I Librarian's Decision*, 63 Fed. Reg. at 25407. Here, the record companies' activities are directly or indirectly the source of the vast majority of the Copyright Owners' revenues – including old and new markets for music.

4. Disruption of the Structure of the Industries

134. The financial condition of the Copyright Owners is also relevant to the "disruption" factor under Section 801(b)(1)(D). Notably, this objective calls upon this Court to consider "the structure of the industries involved," not just one line of business. If Congress had intended this Court to limit its inquiry to disruption in the particular revenue stream at issue in the proceeding, it would have said so, and not directed this Court to consider the much broader structure of the industries.

135. Thus, in the SDARS case, for example, this Court focused on what it perceived the SDARS could afford to pay – based on the entirety of their current business model, including statutory and non-statutory services. *SDARS Decision*, 73 Fed. Reg. at 4097-98. And in the PES I proceeding, the Librarian upheld the CARP's analysis of the disruption factor, which explicitly focused on the revenue sources of the record companies other than those from the statutory license at issue. The CARP had found no likelihood of disruption to the record companies

because the record companies had other revenue streams of sufficient size that a low rate would not harm them. *PES I Librarian's Decision*, 63 Fed. Reg. at 25408 (discussing analysis of non-statutorily licensed revenue streams).

136. Similarly here, determining disruption requires an evaluation of non-mechanical income to accurately assess the total health of the music publishing and songwriting industries. Otherwise, it is impossible to establish what disruptive impact, if any, will occur from a particular rate change. Failing to consider non-mechanical income would skew this Court's vision of the Copyright Owners by implausibly suggesting that publishers and songwriters only or primarily rely on mechanical royalty income. Evidence that songwriters and music publishers enjoy high revenues and profits from several sources, the very evidence that the RIAA presents, provides a more accurate picture of how the industries operate – as robustly profitable enterprises cushioned by the collection of multiple streams of income. RIAA PFF Section II.E.2.

E. In Applying the Section 801(b)(1) Objectives, This Court Should Consider Evidence of Mechanical Royalty Rates Abroad.

137. As the Court knows, both RIAA and the Copyright Owners have introduced evidence concerning foreign royalty rates. *See, e.g.*, Boulton WDT, RIAA Trial Ex. 54; Taylor WDT, RIAA Trial Ex. 53; Fabinyi WRT, CO Trial Ex. 380.

138. The Copyright Owners initially argued that evidence concerning foreign royalty rates was irrelevant. *See National Music Publishers' Association, Inc.'s, the Songwriters Guild of America's, and the Nashville Songwriters Association International's Motion In Limine to Exclude Evidence Relating to U.K. and Japanese Rates Including the Recent Settlement in the U.K. Copyright Tribunal* (Jan. 7, 2008). RIAA opposed that motion. *See RIAA's Opposition to NMPA, SGA and NSAI's Motion In Limine to Exclude Evidence Relating to U.K. and Japanese*

Rates Including the Recent Settlement in the U.K. Copyright Tribunal (Jan. 18, 2008) (incorporated by reference herein and attached as Ex. 3).

139. The Court denied the motion and accepted testimony concerning foreign rates into evidence. 2/7/08 Tr. 2250:18-21 (Landes). The Copyright Owners then submitted the Fabinyi Written Rebuttal testimony making foreign comparisons of his own.

140. This is the second mechanical rate proceeding in which the Copyright Owners have sought to use testimony about rates abroad to their advantage. In the *1981 Mechanical Royalty Proceeding*, music publishers argued that "mechanical royalties abroad are an important point for comparison and stressed that they are much higher than they are in the United States." *1981 Mechanical Royalty Proceeding*, 46 Fed. Reg. at 10468. They also argued that a percentage rate was appropriate because that is how mechanical royalties are paid in other countries. *Id.*

141. Foreign rates are clearly relevant to this proceeding and can serve either as a benchmark for setting rates or as relevant evidence for several of the statutory factors. The CRT in the 1981 mechanicals proceeding found foreign rates to be highly relevant for multiple reasons. The CRT found that "the foreign experience is relevant – because it provides one measure of whether copyright owners in the United States are being afforded a fair return." *1981 Mechanical Royalty Proceeding*, 46 Fed. Reg. at 10483. The CRT noted that the rights are similar (nonexclusive licenses for individual musical compositions in making phonorecords), the record industries in those markets are similar in that large record companies predominate, music publishers play a similar role abroad as they do in the United States, and musical works are an essential input to the recorded music industry. *Id.* at 10483-84.

142. Reviewing the record, the CRT found that mechanical royalty rates in the U.S. were "far less than comparable rates in England, Australia, Japan, and Western Europe." *1981 Mechanical Royalty Proceeding*, 46 Fed. Reg. at 10483. In addition, "mechanical royalties per album in most European countries and Japan are approximately double the royalties paid in the United States." *Id.*

143. The CRT went beyond finding mere relevance, and expressly found that foreign rates were "a benchmark" against which it could assess whether copyright owners would receive a fair return. *1981 Mechanical Royalty Proceeding*, 46 Fed. Reg. at 10484. Ultimately, the CRT concluded that the size and importance of the U.S. market for recorded music actually compelled a lower rate than that which was found in foreign countries. The Court explained that the volume of sales in the United States redounded to the benefit of the music publishers and songwriters and was a reason to set the rate lower than it was set in Europe. *Id.* at 10483.

144. The D.C. Circuit specifically upheld the CRT's determination on foreign rates, noting that it "[saw] nothing in the statute or its legislative history that requires the Tribunal to close its eyes to conditions in other countries while deciding what a fair return to a composer should be." *Recording Industry Association of America*, 662 F.2d at 10 n.23.

III. THE COPYRIGHT OWNERS' PROPOSED RATES ARE LEGALLY FLAWED.

A. The Copyright Owners' Synchronization Licensing Benchmark Has Previously Been Rejected by This Court and Must Be Rejected Again.

145. The Copyright Owners have suggested that the range of reasonable rates in this proceeding stretches all the way from 20% of wholesale revenues to 50% of wholesale revenues – a vast range between the low point and the high point that translates into a difference of well over a billion dollars a year. The range, by itself, is well more than the total amount of mechanical royalties that have ever been paid in any year in the history of the United States. As

Dr. Wildman explained, the vastness of this range can be explained by the fact that Dr. Landes essentially applied no criteria at all in selecting his benchmarks. Wildman WRT at 9, RIAA Trial Ex. 87. Indeed, Dr. Landes used as one of his benchmarks the synchronization market – which this Court and prior tribunals have rejected as a useful benchmark for setting rates and terms.

146. As the Court knows, webcasters attempted to argue in the Webcasting I proceeding that record companies should be paid the same amount as music publishers for the use of their copyrighted works – a claim that even music publishers did not make outside the synchronization licensing context until this proceeding. The primary "benchmark" on which the webcasters' claim was made was the market for synchronization rights, where motion pictures and television programs license musical works and sound recordings for use as background music. The CARP and the Librarian rejected the use of musical works as a benchmark and the claim that the licensing of background music for movies and television shows provides a basis for the argument that musical work and sound recording copyright owners should be paid the same amount in markets where consumers spend money to listen to music. *Webcasting I Librarian's Decision*, 67 Fed. Reg. at 45246-47.

147. In both the Webcasting II proceeding and the SDARS proceeding, services made the exact same arguments to this panel about the supposed equivalence of musical works and sound recordings and the market for synchronization rights. This Court rejected these theories each time, explaining that these arguments were "fatally flawed." *Webcasting II Decision*, 72 Fed. Reg. at 24094; *SDARS Decision*, 73 Fed. Reg. at 4090.

148. Although here offered by the owners of the copyrights in musical works rather than services using sound recording copyrights, the arguments made by Dr. Landes about the supposed synchronization benchmark are identical to those made by the webcasters and the

SDARS and thus must be rejected for the same reasons, as well as the reasons detailed in RIAA PFF Section IV.B.

B. The Copyright Owners' Audio Home Recording Act Benchmark Is Inconsistent with Congress' Intentions.

149. The Copyright Owners have made the novel argument that the statutory division of royalties under the Audio Home Recording Act ("AHRA") should be taken as a benchmark in this proceeding.

150. The AHRA was enacted over 15 years ago – in 1992 – to resolve an impasse between the music industry and the consumer electronics that had delayed the introduction of digital audio tape recorders and led to copyright infringement litigation against device manufacturers. *See* H.R. Rep. No. 102-873, at 2 (1992).

151. Among other things the AHRA requires that certain digital audio recording devices incorporate a copy protection technology called the Serial Copy Management System. 17 U.S.C. § 1002. Manufacturers and importers of such devices, as well as certain blank media, are also required to pay a small royalty into the Copyright Office. 17 U.S.C. §§ 1003, 1004. In exchange, device manufacturers and their customers receive immunity from suit. 17 U.S.C. § 1008.

152. By law, two thirds of the royalty pool is allocated among non-featured musicians and vocalists (through union funds), featured artists and record companies, and one third of the fund is allocated equally between music publishers and songwriters. 17 U.S.C. § 1006(b). This allocation is the result of a legislative compromise resulting from very different policy perspectives of the affected industries as digital audio tape legislation moved through Congress. The recording industry wanted introduction of the new digital audio tape format if it had appropriate copy protection technology, and was prepared to support a bill requiring such

technology even if the bill did not require a small royalty payment. The music publishing industry opposed any bill that gave device manufacturers immunity without requiring them to pay a royalty. The compromise adopted by Congress was to require both the copy protection technology and the royalty in exchange for the device manufacturers' immunity from suit, and to give musical work interests an outsize share of the royalty pool. H.R. Rep. No. 102-870, at 18-22 (1992).

153. Nothing in the AHRA or its legislative history indicates that it was intended to forever set a precedent for any other payments. Presumably the songwriters who receive only 50% of the musical works fund would not agree that they and their publishers should forever split mechanical royalty payments equally because that is the royalty split prescribed in the AHRA. To the contrary, the Copyright Owners' witnesses testified that the marketplace for writer/publisher splits is at least now significantly different from the AHRA split. *See* Firth WDT ¶ 27, CO Trial Ex. 24; 1/29/08 Tr. 505:15-507:5 (Faxon).

154. Certainly nothing in the AHRA or its legislative history indicates that Congress thought it was determining the mechanical royalty rate any more than it was determining the split of mechanical royalties between writers and publishers. When Congress enacted the AHRA, it was well aware of the mechanical royalty rate, which was then 6.25 cents. 37 C.F.R. § 255.3(f). That represented a much smaller fraction of record companies' wholesale revenues than today's mechanical royalty rate. Teece WDT at Ex. 11 at 112, RIAA Trial Ex. 64. If Congress had intended by the AHRA to multiply the mechanical royalty rate so that it amounted to one third of record company wholesale revenues it surely would have done so.

155. To the contrary, Congress left mechanical royalty rates subject to the rate standard set forth in Section 801(b)(1). And despite subsequent changes to Section 115 and Chapter 8 in

the DPRA and the CRDRA, Congress never changed the Section 115 rate setting standard to the allocation set forth in the AHRA. The Section 801(b)(1) objectives bear no relationship to the statutory division of AHRA royalties, and it would be inappropriate to read the AHRA royalty split into Section 115 or 801(b)(1) absent a clear expression of congressional intent.

156. To the extent that the Copyright Owners rely on the statutory division of AHRA royalties as a marketplace benchmark, the reasons to reject it are too numerous to catalog comprehensively. Among other things, (1) it is over 15 years old; (2) it is a payment by device manufacturers for what would have to be viewed as inputs to digital audio tape recorders and blank media that are very different and have a very different purpose from the recorded music products at issue in this proceeding; (3) the consumer demand characteristics and cost structures are very different for recorded music products on the one hand and tape recorders and blank media on the other; (4) the Copyright Owners have provided no evidence concerning the characteristics of the marketplace for digital audio tape recorders and blank media or the use of sound recordings and musical works therein; (5) the royalty split was accepted as part of a larger legislative compromise where it is clear that trade-offs were made; and (6) small payments for inputs to a short-lived and long-failed audio format would have to be given little or no weight rather than being accepted without adjustment. *See* RIAA COL Section II.B.2.

C. The Copyright Owners' "Bargaining Room Theory" Is Inconsistent with Proper Application of the Section 801(b)(1) Objectives.

157. The Copyright Owners have argued that this Court should set a rate at the "high" end of the bounds of reasonableness in order to encourage or permit bargaining below that rate. This is a centerpiece of the testimony of their primary expert Dr. Landes. Landes Amended WDT at 12-15 & 27 n.15, CO Trial Ex. 22.

158. This is simply an effort to dress up in new clothing their "bargaining room" theory that was wholly discredited in 1981. This argument must be rejected for the same reasons that the D.C. Circuit rejected it in 1981 – it is in utter violation of the statute. *1981 Mechanical Royalty Proceeding*, 46 Fed. Reg. at 10478; *Recording Industry Association of America*, 662 F.2d at 11-12.

159. Specifically, the D.C. Circuit found that it was not the intent of Congress or an aspect of the statutory factors to encourage or facilitate bargaining. *Recording Industry Association of America*, 662 F.2d at 11-12. Indeed, although the House of Representatives had once passed a bill that expressed an intent to require the "setting [of] a statutory rate at the high end of a range within which parties can negotiate" – i.e. the bargaining room theory – Congress did not enact that statute. *Id.* at 12-13 & n.29. To the contrary, as the D.C. Circuit found, Congress expressly rejected this approach to setting rates. *Id.* This Court must do so too.

D. The Copyright Owners' Proposed CPI Adjustments Are Inconsistent with Proper Application of the Section 801(b)(1) Objectives.

160. The Court has repeatedly rejected arguments concerning CPI adjustments in these proceedings. In prior proceedings, no party has presented any benchmark agreement that included an express CPI adjustment and that remains true in this proceeding – the music publishers submitted hundreds of agreements containing various rates and terms, but not one has a CPI adjustment such as that which they seek here. *SDARS Decision*, 73 Fed. Reg. at 4098 n.42. Moreover, it makes little sense to tie the rate to the CPI rather than changes in the price of the recorded music products from which demand for mechanical rights derives. As the CRT found in 1981, mechanical royalty rate adjustments should be made based on changes in the consumer value of recorded music products, not an index like the CPI that measures changes in

the prices of a basket of different products and has not always moved in relation to the price of recorded music products. *1981 Mechanicals Royalty Proceeding*, 46 Fed. Reg. at 10474, 10485.

161. This Court has twice rejected arguments for CPI increases, finding them unsupported by any marketplace agreements in both the webcasting proceeding and the SDARS case. For example, in the Webcasting proceeding, this Court rejected a proposed CPI increase to a per performance rate, explaining that there was no basis in the record to permit a CPI increase – essentially an indeterminate future increase in the rates based on factors as yet unknown. *Webcasting II Decision*, 72 Fed. Reg. at 24096 n.34. The facts are identical in this proceeding. The music publishers can point to no marketplace agreement in which there are CPI increases because there are none.

E. The Copyright Owners' Failure to Present Sufficient Evidence on Long Songs Represents Waiver of Their Request for a Separate Rate for Long Songs.

162. Although the Copyright Owners have requested a "greater of" payment that would result in higher payments for works with a playing time of more than five minutes, they have failed to present sufficient evidence to support this request. There is no evidence in the record that long songs are valued more by consumers or other marketplace participants than shorter songs.

163. It was precisely for a similar lack of sufficient evidence that the Webcaster I CARP and the Librarian rejected a "long song" surcharge in the Webcaster I proceeding. *Webcasting I Librarian's Decision*, 67 Fed. Reg. at 45259 ("there was no probative evidence that the marketplace valued a classical recording, or similar sound recordings of longer than average duration, at a different rate").

IV. OTHER LEGAL ISSUES CONCERNING RATES

A. This Court Is Required to Set Rates for All Reproduction and Distribution Activities Covered by Section 115.

164. The Copyright Owners have proposed royalty rates for only specified activities common in the marketplace today – leaving gaps in coverage of general DPDs. The Copyright Owners propose rates for permanent downloads and ringtones, and the parties have entered into a settlement agreement covering interactive streams (including all known forms of incidental DPD) and limited downloads. However, they would have this Court adopt a rate schedule under which there would be no rate for general DPDs other than permanent downloads, ringtones and limited downloads.

165. For example, the Copyright Owners' proposal does not appear to cover locked content or to address hybrid services, leaving uncertainty as to how royalties will be paid. 5/13/08 Tr. 6074:17-6077:3 (Eisenberg); *see also* Wilcox WDT at 10-11, RIAA Trial Ex. 70. It is also not clear how a potential download rent to own business model would fit into the Copyright Owners' rate proposal. Eisenberg WRT at 17-19, RIAA Trial Ex. 89.

166. Section 115 provides that "[p]roceedings under chapter 8 shall determine reasonable rates and terms of royalty payments for the activities specified by this section . . . ." 17 U.S.C. § 115(c)(3)(C). Thus, there can be no doubt about the scope of this proceeding and the determination to be made by this Court: they are to cover "the activities specified by this section." Setting rates for some categories of general DPD and not others would violate this provision.

167. Language equivalent to that quoted above concerning the scope of this proceeding is also found in Section 112 of the Copyright Act. It provides that "[p]roceedings under chapter 8 shall determine reasonable rates and terms of royalty payments for the activities specified by

paragraph (1)." 17 U.S.C. § 112(e)(3). Citing this provision, the Register of Copyrights recently found that this Court's determination to include Section 112 rates within the Section 114 rates in the *SDARS Decision*, without specifying what percentage, if any, is attributable to Section 112, "does not fulfill the Copyright Royalty Judges' responsibility to determine the value of the section 112 license for ephemeral copies." *Review of Copyright Royalty Judges Determination*, 73 Fed. Reg. 9143, 9146 (Feb. 19, 2008). Adopting a royalty proposal that does not comprehensively cover general DPDs would raise the same concern.

168. Importantly, Section 115 is different from Section 114 in its treatment of new types of services. Section 114 contemplates two different, regularly-scheduled types of proceedings for specific types of services, 17 U.S.C. §§ 114(f)(1)(A), (2)(A), 804(b)(3)(A), (B), and additional proceedings that can take place at different times for new types of services, 17 U.S.C. §§ 114(f)(1)(C), (2)(C), 804(b)(3)(C). Section 115 contains no such provisions for addressing new types of services. Accordingly, this Court's imminent determination is the last opportunity to set Section 115 rates for new types of services for this rate period.

169. The Copyright Owners have freely admitted that their rate proposal may fail to cover certain products or services, and suggested that gaps might be filled by private negotiation: "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." A. Finkelstein WRT at 5, RIAA Trial Ex. 84 (quoting 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)).

170. Abdicating this Court's responsibility to set rates for all general DPDs could have devastating consequences. If no rate is set for general DPDs, Congress' intent is eviscerated because there will be, effectively, no compulsory license for a host of activities. The record is replete with cases in which the introduction of new types of products and services has been stymied by the need for record companies to try to re-clear large parts of their catalogues in negotiations with the highly diffuse music publishing industry. The market ground to a halt for years as record companies and their distribution partners struggled to address musical work clearance issues for subscription services, mastertones and other new formats." A. Finkelstein WRT at 6, RIAA Trial Ex. 84; *see also* A. Finkelstein WDT at 11-13, RIAA Trial Ex. 61; Eisenberg WRT at 8-9, RIAA Trial Ex. 89; Wilcox WDT at 23-25, RIAA Trial Ex. 70; Barros WDT at 17-18, RIAA Trial Ex. 74. This Court should not allow similar circumstances to arise again, and should instead adopt royalty rates and a royalty rate structure sufficiently flexible to encompass what Section 115 requires – "the activities specified by this section." 17 U.S.C. § 115(c)(3)(C).

B. This Court Has Authority to Adopt a Percentage Royalty Rate Structure and Should Adopt a Percentage of Wholesale Revenues Rate.

171. This Court has authority under the statute to set a percentage rate. Indeed, the CRT in 1981 rejected an argument that it was beyond their authority to set a percentage rate. *1981 Mechanical Royalty Proceeding*, 46 Fed. Reg. at 10477.

172. Section 801(b)(1) authorizes this Court not only to adjust but to determine royalty rates under Section 115. That provision imposes no limitation on the rate structure that may be adopted by this Court in its determination of rates. What matters is that the rates adopted achieve the objectives set forth in Section 801(b)(1)(A) through (D). Section 801(b)(1) stands in stark contrast to Section 801(b)(2), where Congress clearly limited this Court's authority to mere adjustment of existing rate levels within an existing rate structure. The contrast could not be more clear; absent limitations of the kind provided in Section 801(b)(2), this Court is free to determine a percentage rate structure under Section 801(b)(1).

173. The Copyright Owners evidently agree with this interpretation because they have proposed percentage royalty rate structures different from the cents rate structure presently applicable under Section 115.

174. As discussed in more detail in RIAA PFF Section VI, a percentage of revenue is vastly superior to a cents rate for a wide variety of reasons. Among other things, because a percentage of revenue adjusts automatically as consumer prices adjust and offers flexibility to allow prices to be set at different levels, it encourages innovation and best meets the policy considerations in the four statutory objectives.

175. It is thus no surprise that this Court and prior tribunals have implemented percentage-of-revenue structures in a number of prior proceedings.

176. In the PES I proceeding, the parties essentially agreed on the definition of revenue and each advocated for such a rate structure, which was in fact adopted. *PES I Librarian's Decision*, 63 Fed. Reg. at 25395-96.

177. In the Webcasting I proceeding, the CARP and Librarian accepted a definition of wholesale revenues because it had an established meaning in the industry and the record

evidence showed that the definition "is merely the amount the . . . Services receive from their customers for the use of the music." *Webcasting I Librarian's Decision*, 67 Fed. Reg. at 45268.

178. In the SDARS proceeding, this Court found that a percentage of revenue rate structure was superior to a per performance structure for a host of reasons. *SDARS Decision*, 73 Fed. Reg. at 4085-87.

179. This proceeding is reminiscent of these prior proceedings. Although the music publishers have proposed rates involving various different rate structures, they essentially concede that a percentage of revenue approach is appropriate. Indeed, they proposed percentage-of-revenue rates for several types of products or services, including ringtones, and use percentages of revenue to justify their requested cents rates.

180. Similar to the PES I proceeding, in this proceeding, the record companies and the music publishers have utilized revenue bases (wholesale revenue or "Total Content Costs" in the publishers' vernacular) that, in the case of DPDs, are very similar. The revenue base RIAA proposes is whatever the record company gets paid (with a few other elements to deal with special situations). Moreover, this definition of wholesale revenue is already widely established in the music industry because it is the basis on which recording artists and producers are paid. It thus would be relatively easy to implement and would not create significant additional administrative costs.

181. The Copyright Owners' support of a percentage rate structure (at least in certain circumstances) is longstanding. In 1981, the Copyright Owners argued that "a rate based upon a percentage is preferable . . . because a percentage rate does not lag behind the actual change in inflation, and, second, because the rate applies to records individually. In terms of lower prices records it would be the record companies who would benefit." *1981 Mechanical Royalty*

Proceeding, 46 Fed. Reg. at 10469 (footnote omitted). They also argued that "[t]he industry could convert easily to a percentage system, and such a system already exists with respect to artist royalties." *Id.* (footnote omitted).

182. However, while a percentage rate structure based on wholesale revenues would be highly desirable, a percentage based on retail revenues would raise a host of questions about what falls within the definition of revenue – exactly the issues that led the Court to reject a percentage of revenue approach in the webcasting proceeding. Moreover, because record companies generally acquire the mechanical licenses and pay mechanical royalties (at least for CDs and digital downloads) and they do not regularly have access to retail prices, an approach based on retail revenues would not be readily administrable.

183. The possibility of a percentage of retail list price rate structure was entertained in 1981, because such a system had already been implemented in the industry to calculate artist royalties, so it would not be difficult to do the same for mechanical royalties. *1981 Mechanical Royalty Proceeding*, 46 Fed. Reg. at 10469-70, 10486. However, that has changed. Artists are now compensated on a percentage of wholesale revenue basis, A. Finkelstein WRT at 16, RIAA Trial Ex. 84, and an increasingly large gap between retail list prices and actual retail prices has made retail list price an unreliable basis for setting an economically-appropriate royalty. Teece WDT at 75, RIAA Trial Ex. 64.

C. This Court Has Authority to Provide a Transition Period for Implementation of a Percentage Royalty Rate Structure.

184. RIAA believes that adoption of a percentage royalty rate structure is critically important to the future of the music industry. However, it would take record companies time to implement the new rate structure in their computer systems used for royalty distribution. A. Finkelstein WRT at 21, RIAA Trial Ex. 84; A. Finkelstein WDT at 16-17, RIAA Trial Ex. 61.

For that reason, RIAA has proposed that its requested rates become effective on the first day of the first calendar quarter beginning more than six months after the publication of the determination of the Copyright Royalty Judges in the Federal Register, and that licensees have the option to pay royalties at the current rate for distribution during a further 12 month period of phonorecords released before that effective date. RIAA Second Amended Rate Request at Section III.

185. Thus, assuming publication of this Court's decision during the last quarter of 2008, the 9.1 cent rate would remain in effect until June 30, 2009, and in the case of products released on or before June 30, 2009 and distributed between July 1, 2009 and June 30, 2010, licensees would have the option of paying either the old 9.1 cent rate or the new rate (which RIAA has proposed to be lower). New releases after June 30, 2009 would be subject to the new rate. Assuming that the new rate is lower, licensees would be well motivated to start making payments for earlier releases at the new rate on July 1, 2009 or as soon thereafter as possible. However, this structure would allow record companies to prioritize their transition if necessary, so that royalties for old, low-selling releases could for a time continue to be paid on the same basis as applied to those releases before the effective date, while emphasis was given to converting and validating royalty split data for higher-selling products. A. Finkelstein WRT at 22, RIAA Trial Ex. 84.

186. This Court has discretion to adopt the transition period proposed by RIAA. As a general matter, Section 115 rates adopted by this Court are to be effective "on the first day of the second month that begins after the publication of the determination of the Copyright Royalty Judges in the Federal Register." 17 U.S.C. § 803(d)(2)(B). However, a different effective date may apply "as otherwise provided . . . by the Copyright Royalty Judges." *Id.* The statute thus

authorizes expressly just the kind of delayed implementation of Section 115 rates that RIAA has proposed.

187. RIAA's proposed transition period also would mitigate any disruptive effects of a change in rate level or rate structure, and so is consistent with Section 801(b)(1)(D).

188. This Court and its predecessors have often adopted transition periods to allow all parties to adjust their businesses to new rates and terms. For example, in the Jukebox Proceeding, the CRT concluded that a different interim rate was required in the first year of the license to allow the industries to adjust to new rate and terms. *Jukebox*, 46 Fed. Reg. at 888.

189. In the Webcasting II proceeding, this Court adopted a two-year phase-in period for calculation of royalties on a per performance basis, allowing webcasters to report on the basis of aggregate tuning hours until they had implemented technology to permit the counting of performances. *Webcasting II Decision*, 72 Fed. Reg. at 24096 & n.33.

190. In the SDARS proceeding, this court adopted royalty rates that increased from 6% to 8% of revenues in 0.5% increments throughout the rate period, because it found "that over the passage of time the potential for disruption from the imposition of the 6% rate gradually diminishes." *SDARS Decision*, 73 Fed. Reg. at 4098.

D. Section 115(c)(3)(E) Affirms the Validity of Controlled Composition Clauses and Provides That the Statutory Rate Supersedes Controlled Rates for Digital Phonorecord Deliveries That Are the Subject of Post-1995 Recording Contracts.

191. The controlled composition clauses that are almost always included in artists' and producers' contracts with record companies are important evidence of the royalties paid under voluntary, marketplace agreements for the reproduction and distribution of phonorecords. These contracts are valid, even though the royalty rates specified in some of them are superseded by statute as to DPDs.

192. Section 115(c)(3)(E) trumps the royalty rates in the controlled composition clauses of certain artist contracts with respect to DPDs, but by its terms that provision makes neither the recording contracts nor even the controlled composition clauses invalid. *It speaks only to rates for DPDs.*

193. Specifically, Section 115(c)(3)(E) provides that voluntary license agreements generally "shall be given effect in lieu of any determination by the Librarian of Congress and Copyright Royalty Judges." 17 U.S.C. § 115(c)(3)(E)(i). However, that provision has an exception for certain controlled composition clauses:

> Subject to clause (ii), the royalty rates determined pursuant to subparagraph (C) and (D) shall be given effect as to digital phonorecord deliveries in lieu of any contrary royalty rates specified in a contract pursuant to which a recording artist who is the author of a nondramatic musical work grants a license under that person's exclusive rights in the musical work under paragraphs (1) and (3) of section 106 or commits another person to grant a license in that musical work under paragraphs (1) and (3) of section 106, to a person desiring to fix in a tangible medium of expression a sound recording embodying the musical work.

17 U.S.C. § 115(c)(3)(E)(i). That exception itself has two further exceptions — for contracts entered into on or before June 22, 1995 and for contracts entered into after the relevant sound recording has been completed. 17 U.S.C. § 115(c)(3)(E)(ii).

194. From this statutory language, it is clear that Congress intended recording contracts to continue to include controlled composition clauses. Congress could have written language prohibiting controlled composition clauses or discounted rates if it had wanted to. It did not do that. This is evident from the legislative history of the provision, in which Congress specifically assumed the continued inclusion of controlled composition clauses and emphasized that they would continue to apply in circumstances where the controlled rates are not superseded by statute:

> It should be emphasized that subparagraph (E) applies only to the making of digital phonorecord deliveries and not to the making and distribution of physical phonorecords. Nothing in the bill is intended to interfere with the application of controlled composition clauses to the making and distribution of physical products or to digital phonorecord deliveries where the agreements are not covered by the terms of subsection (c)(3)(E).

S. Rep. 104-128, at 42 (1995) *as reprinted in* 1995 U.S.C.C.A.N. 356, 389 (emphasis in original).

195. This interpretation of Section 115 is completely consistent with general principles of contract law. There is no basis for concluding that record companies' contracts with their artists and producers are invalid. General principles of contract law impose few requisites to the formation of a valid contract: generally mutual assent to terms that are reasonably certain by two or more parties having the legal capacity to contract, and the exchange of consideration. *See Restatement (Second) of Contracts*, §§ 2-3, 9, 12, 18, 33, 71 (1981). Nothing in the record suggests that these requisites are not routinely satisfied by recording contracts.

196. General principles of contract law also recognize that contracts, or terms of contracts, can be unenforceable on grounds of public policy in certain circumstances. *See Restatement (Second) of Contracts*, § 178. However, one term that is unenforceable to some degree does not make a contract unenforceable generally. *See Restatement (Second) of Contracts*, §§ 183-184; II E. Allan Farnsworth, *Farnsworth on Contracts* § 5.1, at 4 (3d ed. 2004). Contract law has evolved various mechanisms respecting the divisibility of unenforceable terms, which courts will often invoke unless the entire agreement is "an integrated scheme to contravene public policy" or "the party seeking enforcement . . . [has] engaged in serious misconduct." II *Farnsworth on Contracts* § 5.8, at 89. Thus, for example, courts are commonly confronted with restrictive covenants that are unenforceable on grounds of public

policy, but they will generally enforce the rest of the contract. II *Farnsworth on Contracts* § 5.8, at 90.

197. Accordingly, Section 115(c)(3)(E) may bear upon enforceability of the agreed-upon rate as to certain DPDs but does not call into question other aspects of the contract or the controlled composition clause.

198. In connection with the testimony of Michael Kushner, there was a suggestion that artist contracts might be *ultra vires* and thus of dubious validity. 2/14/08 Tr. 3504:21-3506:5. That suggestion is incorrect. A private contract is *ultra vires* if it is outside the powers vested in a corporation by its charter and applicable provisions of corporation law. It is only a defense, and one that can only be asserted in limited circumstances not applicable here. *See, e.g.*, 18B Am. Jur. 2d *Corporations* § 1732 (2008); N.Y. Jur. 2d Business Relationships § 492 (2008); Del. Code Ann. tit. 8, § 124.

E. Distribution of Ringtones Consisting Simply of a Musical Work or a Portion Thereof Are Licensable as Digital Phonorecord Deliveries.

199. On August 1, 2006, RIAA requested that the Court refer a question to the Register of Copyrights regarding the eligibility of ringtones for statutory licensing under 17 U.S.C. § 115.

200. On September 14, 2006, the Court, acting on RIAA's request and pursuant to 17 U.S.C. § 802(f)(1)(B), referred two novel questions of law to the Register of Copyrights:

1) Does a ringtone, made available for use on a cellular telephone or similar device, constitute delivery of a digital phonorecord that is subject to statutory licensing under 17 U.S.C. § 115, irrespective of whether the ringtone is monophonic (having only a single melodic line), polyphonic (having both melody and harmony), or a mastertone (a digital sound recording or excerpt thereof)?

2) If so, what are the legal conditions and/or limitations on such statutory licensing?

201. On October 16, 2006, the Register of Copyrights issued a Memorandum Opinion (later published on November 1, 2006 in the Federal Register), concluding that ringtones (including monophonic and polyphonic ringtones, as well as mastertones) generally qualify as DPDs and are licensable under 17 U.S.C. § 115. While there is a range of different types of ringtones available in the marketplace, "[r]ingtones that are merely excerpts of a preexisting sound recording fall squarely within the scope of the statutory license. . . ." *Mechanical and Digital Phonorecord Delivery Rate Adjustment Proceeding*, 71 Fed. Reg. 64303, 54304 n.7 (Nov. 1, 2006) ("*Ringtones*").

202. This Court is required to apply the Register's decision in reaching its determination of rates and terms. 17 U.S.C. § 802(f)(1)(B) ("If such a decision [concerning a novel question of law] is timely delivered to the Copyright Royalty Judges, the Copyright Royalty Judges shall apply the legal determinations embodied in the decision of the Register of Copyrights in resolving material questions of substantive law."). RIAA summarizes below the key conclusions of the Register.

203. Ringtones are DPDs as that term is defined in 17 U.S.C. § 115(d). *Ringtones*, 71 Fed. Reg. at 64307. Both mastertones and monophonic and polyphonic ringtones are sound recordings as that term is defined in 17 U.S.C. § 101. Accordingly, material objects in which ringtones are fixed are phonorecords as that term is defined in 17 U.S.C. § 101. Accordingly, in applying the definition of DPD, the Register found as follows:

> The phonorecord here is the actual sound recording file stored as a "download" on either the cell phone's hard drive or on a cell phone's removable memory storage disk. When downloaded through the Internet or by wireless transmission, a ringtone is part of a "digital phonorecord delivery" and a digital transmission of a sound recording which results in a "specifically identifiable reproduction" by or for any transmission recipient of a phonorecord of that sound recording.

Ringtones, 71 Fed. Reg. at 64307 (footnotes omitted).

204. Because "Section 115 makes no distinction between downloads of song excerpts and full songs delivered by online music services such as Apple's iTunes Music Store and Verizon Wireless' V Cast Music Store," *Ringtones*, 71 Fed. Reg. at 64308 n.59, ringtones are licensable under Section 115.

205. In the briefing before the Register of the questions referred by this Court, the Copyright Owners raised a long series of arguments as to why ringtones might not be licensable under Section 115 despite their clear status as DPDs. The Register properly rejected each of them.

206. The centerpiece of the Copyright Owners' arguments was that selection of an excerpt of a commercially released sound recording to use as a ringtone is the creation of a derivative work not licensable under Section 115. However, "[t]o be considered a derivative work, a ringtone must exhibit a degree of originality sufficient enough to be copyrightable." *Ringtones*, 71 Fed. Reg. at 64310. Because excerpting a sound recording for use as a ringtone does not involve adding embellishments or anything else of substance to the musical work, it is not considered a derivative work. *Id.* at 64311. For that reason, "the Copyright Office would refuse registration of a mastertone that is merely an excerpt of a full musical work because the new work lacks the requisite originality." *Id.* at 64312; *see also Compendium II of Copyright Office Practices*, § 408.07 (1984); Copyright Office Circular No. 14, *Copyright Registration for Derivative Works* (2006); Copyright Office Circular No. 56, *Copyright Registration for Sound Recordings* (2006). (A small minority of ringtones do not consist simply of an excerpt of an existing work but instead involve creation of new lyrics or addition of other new material such as

voice greetings. Detailed consideration of such specialized ringtones was outside the scope of the Register's decision.)

207. The Register had little difficulty rejecting the Copyright Owners' other arguments, including that Section 115 is limited to the reproduction and distribution of phonorecords of entire musical works, *Ringtones*, 71 Fed. Reg. at 64308; that the creation of a ringtone changes the fundamental character of the musical work, *id.* at 64313; and that ringtones are not distributed primarily for private use because cellular phones sometimes ring in public, *id.* at 64315.

208. In the briefing before the Register, RIAA raised two alternative arguments in case the Register did not adopt the position set forth above. First, RIAA argued that the creation of ringtones is covered by the arrangement privilege provided by Section 115(a)(2). The Register found the arrangement privilege irrelevant to typical mastertones, because "a mastertone that merely shortens the full length work to conform it to the physical limitations of the cellphone does not affect the musical work's arrangement." *Ringtones*, 71 Fed. Reg. at 64314. RIAA nonetheless continues to believe that even if identifying an excerpt of a recording to use as a ringtone was the creation of a derivative work, the arrangement privilege would authorize that act. Second, the Register agreed with RIAA that a ringtone would be subject to licensing under Section 115 after first use of the relevant excerpt even if ringtones were not otherwise covered by Section 115. *Id.* at 64315.

V. LEGAL ISSUES CONCERNING TERMS

209. Pursuant to a request by the Court, the parties previously submitted briefs concerning this Court's jurisdiction to set terms. As part of its brief, RIAA moved to strike all but one of the terms proposed by the Copyright Owners, because RIAA believes they are outside the Court's jurisdiction. *See RIAA's Brief on the Jurisdiction of the United States Copyright*

Royalty Judges to Set Certain Terms and Motion to Strike Terms Outside That Jurisdiction (Feb. 22, 2008) (incorporated by reference herein and attached as Ex. 1).

210. This Court denied the portion of RIAA's brief that sought to strike the Copyright Owners' proposed terms, ruling that "the relief requested in the Motion is a matter to be addressed in the Final Determination." *See Order Denying RIAA Motion to Strike Terms* (June 4, 2008). Accordingly, RIAA addresses below the Court's jurisdiction to set terms.

211. Briefly stated, Congress intentionally split the administration of Section 115 between the Copyright Royalty Judges and the Register of Copyrights. The Copyright Office has long had broad authority to establish certain terms that govern operation of the compulsory license. The Copyright Office retained this authority even after passage of the CRDRA in 2004. *See* 17 U.S.C. §§ 115(b)(1), (c)(4), (c)(5). The Copyright Royalty Judges, in turn, were required to "act in accordance with regulations issued by the Copyright Royalty Judges and the Librarian of Congress." *Id.* § 803(a)(1). But they were given broader authority than predecessor tribunals to set terms of the compulsory license, particularly with regard to rules governing notice to copyright owners of uses of works and recordkeeping by users about such uses. *Id.* § 115(c)(3)(D). The resulting tension is resolved in Section 803(c)(3), which provides that a determination by the Copyright Royalty Judges may specify "notice and recordkeeping requirements of users of the copyrights at issue that apply in lieu of those that would otherwise apply under regulations." *Id.* § 803(c)(3). In the areas of notice and recordkeeping, a final determination of rates and terms may supplant applicable regulations of the Copyright Office. As to other matters, however, the Register's regulations are binding on the Copyright Royalty Judges.

A. This Court Is Authorized to Set Terms of Royalty Payments, But It Must Follow Applicable Regulations Promulgated by the Register, Except with Regard to Notice and Recordkeeping Requirements.

212. The statutory provisions splitting the administration of Section 115 between the Copyright Royalty Judges and the Register of Copyrights may initially appear complicated, but they ultimately are clear that the Copyright Royalty Judges' authority over terms has two aspects: (1) authority to set the terms of notice of use and of recordkeeping that is not limited by the grant of authority to the Copyright Office, and (2) additional authority to set other terms that are not inconsistent with regulations promulgated by the Register.

213. This division of authority becomes clear when one reviews the history of the relevant statutory provisions. From the passage of the 1976 Copyright Act until 1995, the Copyright Royalty Tribunal (created by the 1976 Act) and the CARPs (created by legislation enacted in 1993) were authorized only to set mechanical royalty rates under Section 115. That limitation was made clear in former Section 801(b)(1) (granting authority to "make determinations concerning the adjustment of reasonable copyright royalty rates as provided in sections 115 and 116"). Authority over terms was given to the Register. Since 1976, Section 115 has provided that:

> Each monthly payment shall be made under oath and shall comply with requirements that the Register of Copyrights shall prescribe by regulation. The Register shall also prescribe regulations under which detailed cumulative annual statements of account, certified by a certified public accountant, shall be filed for every compulsory license under this section. The regulations covering both the monthly and the annual statements of account shall prescribe the form, content, and manner of certification with respect to the number of records made and the number of records distributed.

17 U.S.C. § 115(c)(5).[6] *See also id.* § 115(b)(1) (also enacted in 1976 and still in force) (notice of intention to obtain compulsory license "shall comply, in form, content, and manner of service, with requirements that the Register of Copyrights shall prescribe by regulation").

214. As a result of an extensive rulemaking proceeding concluded in 1980, *See Compulsory License for Making and Distributing Phonorecords*, 45 Fed. Reg. 79046 (Nov. 28, 1980), and various further proceedings, the Copyright Office has established intricate regulations concerning obtaining licenses and requirements for payments under Section 115. These regulations, set forth at 37 C.F.R. §§ 201.18 and 201.19, comprehensively address nearly every imaginable procedural aspect of the mechanical compulsory license system.

215. Matters changed to some extent in 1995 when Congress added to Section 115 provisions specifically related to mechanical royalties payable for DPDs. *See* 17 U.S.C. § 115(c)(3) (1996). Those provisions authorized a CARP to set "reasonable terms and rates of royalty payments" for DPDs. *Id.* § 115(c)(3)(C), (D) (1996). But such terms and rates, like all CARP determinations, were subject to modification by the Librarian on recommendation of the Register. *Id.* § 802(f) (1996). And the same legislation authorized the Librarian to "establish requirements by which copyright owners may receive reasonable notice of the use of their works . . . , and under which records of such use shall be kept and made available by persons making digital phonorecord deliveries." *Id.* § 115(c)(3)(D) (1996). The Register and Librarian also retained sole authority to set the terms of royalty payments for physical products. The legislative history explained that the goal was to provide CARPs with limited authority to fill in any

6 This language was originally contained in Section 115(c)(3). The section has been renumbered twice as amendments have been made to other parts of Section 115, but the statutory language has remained the same.

unforeseen gaps in the regulations that might arise as a result of the extension of the mechanical royalty system to DPDs:

> By "terms," the Committee means such details as how payments are to be made, when, and other accounting matters. While these details are for the most part already prescribed in section 115, and related details are to be established by the Librarian under section 115(c)(3)(D), the bill allows for additional such terms to be set by the parties or by CARP's in the event that the foregoing provisions or regulations are not readily applicable to the new digital transmission environment.

S. Rep. No. 104-128, at 40, *as reprinted in* 1995 U.S.C.C.A.N. at 387.

216. Then, in the 2004 CRDRA, the new Copyright Royalty Judges were given broader authority in Section 801(b)(1) to set the "terms and rates of royalty payments" under, *inter alia*, Section 115. Section 115, in turn, was amended to provide that the Copyright Royalty Judges had authority to set "reasonable rates and terms of royalty payments." 17 U.S.C. §§ 115(c)(3)(C), (D) (as amended by the replacement of the first sentences in each subsection). *See also id.* § 115(c)(3)(D) (the final sentence as amended in 2004) (replacing the Librarian with the Copyright Royalty Judges as the persons directed to establish rules for notice of use and for recordkeeping). However, the statutory provisions authorizing the Register to regulate the terms of the mechanical license system in general remained in place as well.

217. Thus, it is clear that Congress did not take away any of the Register's authority to regulate in this area, including the Register's specific authority to specify the form and content of notices of intention to obtain a license, 17 U.S.C. § 115(b)(1), authority to set the "requirements" for monthly payments, *id.* § 115(c)(5), and authority to promulgate "regulations covering both the monthly and the annual statements of account," *id.* And it directed the Copyright Royalty Judges to follow the regulations issued by the Copyright Office (through the Librarian of Congress) in most instances. *Id.* § 803(a)(1).

218. However, Congress carved out one area relating to terms in which the Copyright Royalty Judges are able to make final determinations that may not be consistent with existing Copyright Office regulations. As noted above, it made a point in 2004 of amending Section 115(c)(3)(D) to shift from the Librarian to the Copyright Royalty Judges the power to "establish requirements by which copyright owners may receive reasonable notice of the use of their works under this section, and under which records of such use shall be kept and made available by persons making digital phonorecord deliveries." *Id.* § 115(c)(3)(D). And it added a new Section 803(c)(3), which provides as follows:

> Contents of Determination. A determination of the Copyright Royalty Judges shall be supported by the written record and shall set forth the findings of fact relied on by the Copyright Royalty Judges. *Among other terms adopted in a determination, the Copyright Royalty Judges may specify notice and recordkeeping requirements of users of the copyrights at issue that apply in lieu of those that would otherwise apply under the regulations.*

17 U.S.C. § 803(c)(3) (emphasis added). Thus, Congress specifically provided that although the Register retained authority to regulate in the areas of notice of use and recordkeeping, *See id.* §§ 115(b)(1), (c)(5), those specific regulations of the Register could be supplanted in a final determination by the Copyright Royalty Judges of the terms of royalty payments under Section 115.

219. It follows, however, that all other regulations of the Register, such as regulations governing payment of royalties under Section 115, remain binding on the Copyright Royalty Judges. To begin with, Section 803(a)(1) generally requires compliance with any such applicable regulations. Moreover, under basic principles of statutory construction, Congress's decision to carve out a special exception for regulations governing notice and recordkeeping must mean that, outside those specific areas, the Copyright Royalty Judges may not order terms that "apply in lieu of those that would otherwise apply under the regulations." 17 U.S.C. § 803(c)(3); *see, e.g.*,

TRW Inc. v. Andrews, 534 U.S. 19, 28 (2001) ("Where Congress explicitly enumerates certain exceptions to a general prohibition, additional exceptions are not to be implied, in the absence of evidence of a contrary legislative intent.") (quotation marks omitted). In other words, the Copyright Royalty Judges' authority over terms has two aspects: (1) authority to set the terms of notice of use and of recordkeeping that is not limited by the grant of authority to the Copyright Office, and (2) additional authority to set other terms that are not inconsistent with regulations promulgated by the Register.

220. The Copyright Owners have pointed to Section 803(c)(7) as authorization for one of their proposed terms – a late fee. That section, which potentially applies to all of this Court's rate setting proceedings, does indicate that a determination "may include terms with respect to late payment." 17 U.S.C. § 803(c)(7). However, while such general authorization is sufficient to enable adoption of a late fee in some contexts (such as Section 114), it does not authorize the Court to negate Copyright Office regulations within the context of Section 115. As described above, when Congress in the CRDRA sought to authorize particular terms notwithstanding the Copyright Office's regulations, it did so expressly. Thus, Section 803(c)(3) authorizes the Court to adopt notice and recordkeeping requirements notwithstanding the Copyright Office regulations. Section 803(c)(7) contains no similar authority to override Copyright Office regulations. Thus, even though late fees are authorized by Section 803(c)(7) when they do not conflict with Copyright Office regulations, where they do, Section 803(a)(1) requires the Court to follow the regulations.

B. The Appropriateness of the Terms Proposed by RIAA

221. One of the four terms RIAA initially proposed in this proceeding, and continues to set forth in its rate request, is outside the jurisdiction of this Court if the Court agrees with the

foregoing analysis. The other three terms that RIAA has proposed, and continues to propose, are properly within the jurisdiction of this Court.

1. Accounting for Digital Phonorecord Deliveries

222. RIAA has set forth in its rate request a term providing that when a DPD is not distributed directly by the compulsory licensee, it should be treated as distributed in the accounting period in which it is reported to the compulsory licensee. *See* RIAA Second Amended Rate Proposal at Section V.B. This term would apply notwithstanding 37 C.F.R. § 201.19(a)(6).

223. Because this term involves payment issues, rather than notice or recordkeeping, and is inconsistent with the Copyright Office's regulations, it appears to RIAA that the Court is barred from adopting this term.

224. RIAA has set forth this term only in case the Court disagrees with RIAA's view that the Court lacks jurisdiction to adopt this term. If this Court agrees with RIAA on the legal issue, RIAA does not propose that the Court adopt this term. If this Court concludes that it does have jurisdiction to adopt the term, however, then it is abundantly clear that this term is justified by the evidence presented during this proceeding.

2. Signing Statements of Account

225. RIAA has proposed that notwithstanding 37 C.F.R. § 201.19(e)(6) and (f)(6)(i), monthly and annual statements of account are valid if signed by any duly authorized agent of the compulsory licensee. *See* RIAA Second Amended Rate Proposal at Section V.C.

226. The Court has authority to adopt this proposed term. The authority to regulate notice and recordkeeping must include authority to regulate the form in which detailed notice of use is provided and records are disclosed – *i.e.*, statements of account. *Cf.* 17 U.S.C. § 115(c)(3)(D) (granting the Copyright Royalty Judges authority to set rules "by which copyright

owners may receive reasonable *notice of the use* of their works under this section, and under which records of . . . use shall be kept *and made available* by persons making digital phonorecord deliveries.") (emphasis added).

3. Audits

227. RIAA has proposed that notwithstanding 37 C.F.R. § 201.19(f)(6), an audit performed in the ordinary course of business according to generally accepted auditing standards by an independent and qualified auditor should serve as an acceptable verification procedure with respect to the information that is within the scope of the audit. *See* RIAA Second Amended Rate Proposal at Section V.D.

228. The current certification required by 37 C.F.R. § 201.19(f)(6) is redundant. The regulations at 37 C.F.R. § 201.19(g) require licensees to keep and retain records supporting their statements, and these records are regularly audited by publishers and by the record companies themselves. To the extent that 37 C.F.R. § 201.19(f)(6) requires a work-by-work certification separate from verification obtained as the result of a more general audit of the licensee, it merely serves to make actual use of the compulsory license impracticable.

229. The Court has authority to adopt this proposed term. It concerns verification of records, which is an essential element of the keeping of records. Accordingly, it is within the areas in which Congress granted the Copyright Royalty Judges authority to supplant the Copyright Office regulations.

4. Clarification of Covered Reproductions

230. In addition to the three aforementioned terms intended to mitigate the burdensome nature of the compulsory license, RIAA has proposed that this Court clarify that compulsory licenses, and the rates this Court sets, include all reproductions necessary to engage in activities

covered by the compulsory license, particularly the server and buffer copies necessary to deliver a DPD. *See* RIAA Second Amended Rate Proposal at Section V.A.

231. The Court has authority to adopt this proposed term because it does not conflict with any Copyright Office regulation or otherwise exceed the Copyright Royalty Judges' authority.

C. With One Exception, the Terms Proposed by the Copyright Owners Are Contrary to Law.

232. All but one of the Copyright Owners' proposed terms are outside the jurisdiction of this Court to adopt terms, and in some cases contrary to law for other reasons as well.

233. These terms are also completely unwarranted as a factual matter, for the reasons set forth at RIAA PFF Section IX.C. Briefly stated, the Copyright Owners are seeking for this Court to adopt terms that the Copyright Owners have not been able to obtain in voluntary marketplace transactions. The Copyright Owners have demonstrated no basis for their terms in the factual record nor the Section 801(b)(1) objectives. Thus, the Court should reject these proposed terms even if this Court reaches a different legal conclusion than that set forth herein.

234. RIAA does not object to the Copyright Owners' proposal to apply the statutory rate in effect as of the date of distribution of a phonorecord, subject to RIAA's proposed transition period. *See* RIAA Second Amended Rate Proposal at Section III.

1. The Copyright Owners' Payment Terms Are Contrary to Law.

235. In one dense paragraph labeled "payment," the Copyright Owners propose a variety of conceptually separable terms relating to payment. First, the Copyright Owners propose a fee of 1.5% per month for late payments. *See* Written Direct Statement of NMPA, SGA and NSAI at 12; Pedecine WRT at 1, CO Trial Ex. 394. Second, the Copyright Owners have proposed an "automatic 3% assessment" on top of their extraordinarily high proposed rates

in cases where a record company is responsible for mechanical licensing for DPDs sold by the record company through a digital music service. This practice is sometimes referred to as selling an "all-in" license, or referred to by the Copyright Owners as "pass-through" licensing. *See* Written Direct Statement of NMPA, SGA and NSAI at 12; Pedecine WRT at 1-2, CO Trial Ex. 394. Finally, while the Copyright Owners do not seem to have otherwise mentioned this proposal throughout the conduct of this proceeding, they propose that they be allowed to recover attorneys' fees expended to collect past due royalties and late fees. *See* Written Direct Statement of NMPA, SGA and NSAI at 12. All of these proposals are contrary to law.

a. The Copyright Owners' Proposed Payment Terms Conflict with Copyright Office Regulations and Are Not Notice and Recordkeeping Requirements.

236. The Court does not have authority to adopt any of the sweeping provisions it has proposed as payment terms, because they conflict with the Copyright Office regulations and do not relate to notice and recordkeeping requirements.

237. Terms for payment of royalties are set forth in detail in 37 C.F.R. § 201.19. In particular, 37 C.F.R. § 201.19(e)(4) sets forth a detailed five-step "formula" for calculating the "amount of the royalty payment" as well as specific situations in which adjustments are required. Neither a late fee, a surcharge for DPD sales on an all-in basis nor reimbursement of attorneys' fees is comprehended within this formula. Accordingly, these payment adjustments would conflict with Copyright Office regulations. Because these proposals do not relate to notice and recordkeeping requirements, they are outside this Court's authority to adopt in this proceeding.

238. The Copyright Owners have pointed to Section 803(c)(7) as authorization for the adoption of a late fee. However, as described above, that generally applicable provision does not allow this Court to negate Copyright Office regulations within the context of Section 115.

b. The Copyright Owners' Proposed Late Fee Is Improper in a Section 115 Context Because, Unlike Section 114, Congress Has Provided That License Termination Is the Remedy for Late Payment Under Section 115.

239. The Copyright Owners have made clear that the reason they are requesting a late fee in this proceeding is because they are unable to obtain such a provision in voluntarily negotiated agreements absent the additional leverage that would come from such a term being adopted here, 5/19/08 Tr. 7055:6-7056:9, 7090:19-22 (Pedecine); 2/5/08 Tr. 1466:5-14 (Israelite), and they have often elected not to exercise the remedy for late payment that has been provided by statute and therefore is incorporated by reference in most mechanical license agreements, 5/19/08 Tr. 7048:17-7049:11 (Pedecine).

240. In this Court's webcasting decision, it adopted a late fee of 1.5% per month where the record established that such a fee was a marketplace norm. *Webcasting II Decision*, 72 Fed. Reg. at 24107. Here, unlike the webcasting case, the record establishes that the marketplace norm is to have no late fee provision in a mechanical license. Thus, the justification for adopting a late fee in the webcasting case is inapplicable here.

241. In the SDARS case, this court likewise adopted a 1.5% late fee where the record reflected some agreements with late fees at that level and other agreements with a lower (or no) late fee. *SDARS Decision*, 73 Fed. Reg. at 4099. In doing so, the Court focused on maintaining a proper balance of incentives to compliance. To maintain such a balance, the Court found it important that the agreements in the record contained default termination provisions, while Section 114 does not permit license termination. *Id.* In essence, the Court found that the statutory license terms should include a late fee of 1.5% per month to compensate for the fact that agreements with lower (or no) late fees had termination provisions.

242. Section 115 is like the agreements considered by this Court in its SDARS decision, and unlike Section 114, in that Section 115 contains termination provisions for late payment:

> If the copyright owner does not receive the monthly payment and the monthly and annual statements of account when due, the owner may give written notice to the licensee that, unless the default is remedied within thirty days from the date of the notice, the compulsory license will be automatically terminated. Such termination renders either the making or the distribution, or both, of all phonorecords for which the royalty has not been paid, actionable as acts of infringement under section 501 and fully subject to the remedies provided by sections 502 through 506 and 509.

17 U.S.C. § 115(c)(6).

243. This statutory provision makes adoption of a late fee in this case unnecessary and inappropriate. Because the Copyright Owners have the power to terminate compulsory mechanical licenses in sufficiently egregious cases, that power provides a strong incentive to compliance. There thus is no justification for statutory terms that depart from the clear marketplace practice of requiring no late fees.

c. The Copyright Owners' Proposed Surcharge on Mechanical Royalties for DPDs Sold by Record Companies on an All-In Basis Is Inconsistent with Section 115.

244. The Copyright Owners have proposed an "automatic 3% assessment" on top of their extraordinarily high proposed rates in cases where a record company is responsible for mechanical licensing for DPDs sold by the record company through a digital music service. This practice is sometimes referred to as selling DPDs on an "all-in" basis, or, referred to by the Copyright Owners as "pass-through" licensing. *See* Written Direct Statement of NMPA, SGA and NSAI at 12; Pedecine WRT at 1-2, CO Trial Ex. 394. This proposal is a frontal assault on an important element of Section 115.

245. Section 115(c)(3)(A) provides that "[a] compulsory license under this section includes the right of the compulsory licensee to distribute or authorize the distribution of a phonorecord of a nondramatic musical work by means of a digital transmission which constitutes a digital phonorecord delivery . . . ." 17 U.S.C. § 115(c)(3)(A) (emphasis added).

246. In enacting Section 115, Congress made clear that selling DPDs on an all-in basis not only is authorized and expected, but serves important purposes:

> The Committee intends that a compulsory license for digital phonorecord deliveries may be obtained, and the required mechanical royalties may be paid, either directly by a digital transmission service making a digital phonorecord delivery or by a record company authorizing a digital phonorecord delivery. Thus, the changes to section 115 are designed to minimize the burden on transmission services by placing record companies in a position to license not only their own rights, but also, if they choose to do so, the rights of writers and music publishers to authorize digital phonorecord deliveries; and by recognizing that transmission services themselves may obtain a compulsory license to make digital phonorecord deliveries.
>
> As between a digital transmission service and a record company, allocation of the responsibility for paying mechanical royalties could be a subject of negotiation, but copyright owners of musical works would only be entitled to receive one mechanical royalty payment for each digital phonorecord delivery, not multiple payments.

S. Rep. 104-128, at 37, *as reprinted in* 1995 U.S.C.C.A.N. at 384.

247. Record companies regularly acquire the mechanical licenses for the DPDs they sell as a way of reducing the barriers to entry for new services and thereby ensuring that recordings are distributed as widely as possible. A. Finkelstein WRT, at 10-11, RIAA Trial Ex. 84. The proposed surcharge would disrupt this practice and negate an important goal of Congress in enacting the DPD provisions of Section 115 – to minimize the clearance burden on services by enabling sales on an all-in basis.

248. It was clear from the trial testimony of Alfred Pedecine that the Copyright Owners' proposed surcharge is simply an effort to thwart the statutory provision allowing DPD sales on an all-in basis. 5/19/08 Tr. 7106:9-7108:3 (Pedecine). It either would force record companies and services to (1) give up the rights that Congress wanted them to have, or (2) make payment at a level higher than the rate that this Court determines to satisfy the requirements of Section 801(b)(1), thereby violating Congress' express understanding that "copyright owners of musical works would only be entitled to receive one mechanical royalty payment for each digital phonorecord delivery." S. Rep. 104-128, at 37, *as reprinted in* 1995 U.S.C.C.A.N. at 384.

249. Forcing such a choice is not compatible with the structure of Section 115, and is certainly well beyond the scope of what Congress anticipated as terms – "such details as how payments are to be made, when, and other accounting matters." S. Rep. No. 104-128, at 40, as reprinted in 1995 U.S.C.C.A.N. at 387. Accordingly, the surcharge must be rejected.

d. The Copyright Owners' Proposed Payment of Attorneys' Fees in Collection Actions Is Inconsistent with the Attorneys' Fees Provisions of the Copyright Act.

250. The Copyright Owners propose that they be "entitled" to recover attorneys' fees expended to collect past due royalties and late fees. *See* Written Direct Statement of NMPA, SGA and NSAI at 12. The payment of attorneys' fees is already addressed in the Copyright Act and is not a payment term that this Court can or should address in this proceeding.

251. Section 505 of the Copyright Act provides that:

> In any civil action under this title, the court in its discretion may allow the recovery of full costs by or against any party other than the United States or an officer thereof. Except as otherwise provided by this title, the court may also award a reasonable attorney's fee to the prevailing party as part of the costs.

17 U.S.C. § 505.

252. However, as enacted by Congress, the attorneys' fees provisions of the Copyright Act are carefully balanced and have important limits. For example, attorneys' fees generally are not available for infringement of copyright in unpublished works where an infringement commences before the effective date of registration, or where infringement commences after first publication and before registration unless registration is made within three months after first publication. 17 U.S.C. § 412.

253. Attorneys' fees also can only be awarded to a "prevailing party." 17 U.S.C. § 505. There is a body of case law addressing what it means to be a prevailing party, and how to address circumstances where a plaintiff prevails on some claims and not others. *See* 4 Melville B. Nimmer & David Nimmer, *Nimmer on Copyright* § 14.10[B] (2008).

254. An award of attorneys' fees is discretionary. H.R. Rep. 94-1476, at 163, *as reprinted in* 1976 U.S.C.C.A.N. 5779 ("Under section 505 the awarding of costs and attorney's fees are left to the court's discretion . . . ."). A substantial body of case law also addresses the circumstances in which awards should be made. *See* 4 *Nimmer on Copyright* § 14.10[D].

255. Finally, an award may not be made against the United States or an officer thereof. 17 U.S.C. § 505.

256. The Copyright Owners' proposed attorneys' fee term is a blatant effort to position themselves in a uniquely advantageous position relative to everyone else subject to the Copyright Act. It serves no purpose other than to allow the Copyright Owners to obtain attorneys' fees in cases where Congress and the courts have determined they should not be able to recover them. Registration would not matter; even prevailing would not seem to matter; the federal courts would be stripped of the discretion entrusted to them by Congress; and in the probably rare event the United States obtained a compulsory license, it would be subject to this provision.

257. Such a wholesale rewriting of the attorneys' fee provisions crafted by Congress is well beyond the discretion Congress vested in this Court when it authorized this Court to address as terms "such details as how payments are to be made, when, and other accounting matters." S. Rep. No. 104-128, at 40, *as reprinted in* 1995 U.S.C.C.A.N. at 387.

2. Any Change in Reserve Accounting Rules Proposed by the Copyright Owners' Would Be Contrary to Law.

258. In their rate proposal, the Copyright Owners speculated that there was a "general failure" to comply with existing reserve rules "to be further confirmed in the discovery process." When they submitted their written direct case, the Copyright Owners stated that "[s]ubject to our findings in discovery, the Copyright Owners may propose the elimination of reserves for physical product or, at a minimum, new rules designed to correct the abuses." *See* Written Direct Statement of NMPA, SGA and NSAI at 12. However, at no point before the filing of findings of fact have the Copyright Owners ever made any proposal related to eliminating or modifying the rules on reserves. If they do propose such revisions, they would be contrary to law.

259. The reserve accounting rules are at the heart of the Copyright Office's payment regulations. Licensees generally are permitted to maintain a reserve. 37 C.F.R. § 201.19(a)(9). Intricate provisions address adjustment of reserve balances and the relationship between reserves and payment. 37 C.F.R. § 201.19(b), (c).

260. These regulations do not involve either notice of use or recordkeeping rules. Therefore, this Court lacks the authority to supplant them in setting terms.

3. The Copyright Owners' Terms for Configuration-Specific Licensing Are Contrary to Law and the Terms for Reporting Are Moot.

261. The Copyright Owners seek a term requiring that licenses are to be taken by specific configuration and that reporting be broken down by specific configuration. *See* Written Direct Statement of NMPA, SGA and NSAI at 12.

262. As to 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).

263. Neither the authority of this Court to determine terms of payment nor its authority to supplant the Copyright Office's regulations concerning notices of use and recordkeeping gives this Court a role in determining licensing requirements under Section 115. The Copyright Owners' suggestion to the contrary seems based on confusion between the two different kinds of notice that can be given under Section 115. A license is obtained by serving or filing a "notice of intention." 17 U.S.C. § 115(b). By contrast, this Court has the power to depart from Copyright Office regulations with respect to "notice of the use of . . . works." 17 U.S.C. § 115(c)(3)(D). This Court may adopt terms that depart from the Copyright Office's regulations in 37 C.F.R. § 201.19 insofar as they concern notices of use, but it has no authority to address the requirements of notices of intention, which are the subject matter of the Copyright Office's regulations at 37 C.F.R. § 201.18.

264. As to 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). Thus, it is not clear how the proposed reporting differs from what is already required.

Respectfully Submitted,

Paul M. Smith (DC Bar 459605)
David A. Handzo (DC Bar 384023)
Thomas J. Perrelli (DC Bar 438929)
Steven R. Englund (DC Bar 425613)
Jared O. Freedman (DC Bar 469679)
Molly J. Moran (IL Bar 6256421)
JENNER & BLOCK LLP
1099 New York Avenue, N.W.
Suite 900
Washington, D.C. 20001
tel. (202) 639-6000
fax (202) 639-6066
psmith@jenner.com
dhandzo@jenner.com
tperrelli@jenner.com
senglund@jenner.com
jfreedman@jenner.com
mmoran@jenner.com

Counsel for RIAA

July 2, 2008