

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

In re

DETERMINATION OF ROYALTY
RATES AND TERMS FOR
EPHEMERAL RECORDING AND
DIGITAL PERFORMANCE OF SOUND
RECORDINGS (*WEB IV*)

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TESTIMONY OF
JEFFREY S. HARLESTON
General Counsel and Executive Vice President
for Business and Legal Affairs for North America
for Universal Music Group

PUBLIC VERSION

Witness for SoundExchange, Inc.

I. BACKGROUND AND QUALIFICATIONS

1. My name is Jeffrey S. Harleston. I am the General Counsel and Executive Vice President for Business and Legal Affairs for North America for the group of companies that are known as the Universal Music Group (collectively, “UMG”). In that capacity, I oversee all of the legal functions for UMG in North America, and I serve as a member of UMG’s senior management team.

2. I have worked in the music business for more than twenty years. In 1993, I joined the record label MCA Records as an Associate Director of Business and Legal Affairs. MCA Records later became a part of what is now UMG. Between 1993 and 2003, I held several different positions within the MCA Business and Legal Affairs department, with increasing responsibility for increasingly complex deals. My initial responsibilities were primarily focused on negotiating and drafting artists’ recording agreements. By 1999, I had become the head of the Business and Legal Affairs department for MCA.

3. In 2003, I became the General Manager of Geffen Records after Geffen merged with MCA Records. As the General Manager, I was involved in all aspects of the record business – from the creative side to the business side. I worked with a number of chart-topping artists, including Mary J. Blige, Common, Nelly Furtado, Ashley Simpson and Snoop Dogg. In 2008, I moved back to the corporate offices of UMG and rejoined the Business and Legal Affairs department. I have served in my current role since 2010.

4. I received my Bachelor’s degree from Williams College. I graduated from Boalt Hall, the law school of the University of California at Berkeley, in 1988.

5. In this testimony, I will describe the creative process of a record label’s business, the significant investment involved in developing new music, as well as the inherent risks

associated with our business. I will also highlight some of the major cost categories in our business. Of course, the particular path from discovery to the release of an artist's first record will vary – across artists, genres, and labels. My goal in this testimony is to describe a typical path from discovery to release – not every path.

6. The reason for detailing our significant effort, investment and the attendant risks in creating and releasing sound recordings is simple: record labels and artists bear the risk of a record succeeding or failing. If a considerable investment in a new artist is lost, the digital service providers who play our music do not bear that loss. Our digital partners will continue to benefit by having the ability to play our music that is popular—without having to bear any of the risks inherent in creating it, and without having to bear any of the losses we incur in artist investment. Digital services that build their business on our content should pay a fair price for that content that appropriately reflects this disparity in creative contribution, investment, costs and risks.

II. UMG

7. UMG today is the largest record company in the world. It is the home of scores of well-known record labels that produce music from across every genre: Motown Records, Interscope Records, Island Records, Def Jam Records, Geffen Records, A&M Records, Capitol Records, Virgin Records, Mercury Nashville, Universal Music Latino, Verve Records, Republic Records, Universal Music Classics, and many more. Our catalog includes some of the most significant recordings in history, including recordings by greats like The Beatles, Ella Fitzgerald, Louis Armstrong, James Brown, The Who, Stevie Wonder, Patsy Cline and Johnny Cash. Our labels have signed and marketed some of today's most successful acts, including U2, Katy Perry, Rihanna, Lady Gaga, Imagine Dragons, Ariana Grande, and Eminem.

III. THE WORK OF A RECORD LABEL

8. Record labels discover, create, produce, market and sell music. We are the engines that power the entire music industry, by releasing new music and making sure it gets into the hands of consumers every day. Right now, our company is (we hope) in the process of discovering your next favorite artist, or honing the recording of what will be your next favorite song. But that process of discovering new music and positioning artists to reach mainstream success is an art, not a science. Finding artists, working with them to create new music, marketing that music, and getting it into the hands of consumers involves significant investment and is fraught with unique risks.

A. Artists & Repertoire (A&R)

9. Our work creating the next, big hit record begins in the A&R Departments of our labels. The A&R Departments are responsible for discovering, nurturing and delivering new talent to our labels. A&R representatives search the country for new artists. They listen to thousands of demonstration recordings (“demos”), scour the Internet, conduct market research, attend live shows, and meet with artists and their managers. A&R representatives often use their understanding of music and industry trends to identify those artists with substantial talent. But talent is just the beginning. Artists we ultimately sign also typically have something unique about them that we believe would make them compelling to a larger audience. We are always looking for a new sound, and a new fresh persona to go with it. The trick is in finding an artist that is new and fresh and unique – but not so new that the world is not yet ready to embrace them.

10. Out of the hundreds of talented artists identified by our A&R scouts every year, only a small fraction of them are ever signed to a recording agreement. Committing to an artist

requires a huge investment of money – not to mention considerable time and effort. We do not make that commitment lightly. Every artist – even an established artist – poses a financial risk. The only question is one of degree. In deciding whether to sign a new artist, we must assess not only whether the artist’s music is marketable, but whether the artist also is marketable. Very rarely does a new artist present themselves to us with a fully realized image that we believe is likely to gain mass appeal without tremendous work and effort. We must consider what type of investment we will have to make in that artist to get both the artist and their music to a place where we expect the public to accept and love them. Those efforts can include all kinds of financial investment in creating the complete package: dance and vocal lessons, personal stylists, makeup artists, trainers, media training, etc. can all be a part of the process and the investment we make in a new artist in whom we believe.

11. As the department charged with maintaining an ongoing pipeline of talent to create new products, the A&R department at a record label is similar to the “research and development” departments of other consumer product companies. And as with “R&D” efforts in other industries, these efforts are very expensive. Our A&R departments incur significant costs that represent extensive investment in our future. In fiscal year 2013, we spent a total of [REDACTED] on gross A&R expenditures, including both overhead and payments to third parties.

B. Business and Legal Affairs

12. Once the decision has been made to sign an artist, the Business and Legal Affairs department takes over the process of negotiating and entering into an artist recording agreement. This process can be complex. Often numerous record labels are in competition for the same artist. The more competitive a prospective signing, the more complex the deal negotiations are likely to be and the more expensive the deal will be.

13. Our recording agreements differ and are individually negotiated, but the relationship between the artist and his or her label is typically structured in the following way: The record label fronts all of the costs of recording, mixing and mastering a record. Record labels also typically offer an advance to attract the artist to their label. The artist also receives a share in the proceeds from the label's exploitation of the artist's recordings in the form of royalties. If the artist is very successful, then both the record label and the artist reap the benefits. Artists receive royalties only after the advance and recording costs have been recouped by the label. But if the artist does not achieve a high level of success – as is often the case – then the record company must absorb the loss. As an example, our 2013 income statement reflects [REDACTED] in advances for new artist signings and write offs from established artists -- net of recoveries.

C. The Production and Recording Process

14. Once an artist has been signed, the process of making an album begins. The A&R department, most likely the A&R representative who signed the artist, oversees this process. The pre-production phase focuses on selecting the material to be recorded. A&R representatives often work closely with artists to sift through their material and develop the most promising ideas into songs that the A&R representative believes can comprise a successful record.

15. The A&R representative also frequently works to match an artist with the right combination of producer and studio that best suits that artist. For some hip hop and pop artists, A&R representatives may sift through as many as thousands of rhythm tracks to attempt to find that perfect pairing of artist with producer and studio. The right combination of artist and producer can be invaluable in helping to propel an artist to superstardom.

16. A&R representatives will also put artists together to collaborate with other artists. That can be a very effective means of introducing artists to another artist's fan base. As an example of this phenomenon, consider the recent release "Bang Bang," a huge hit that combined the efforts of Ariana Grande, Jessie J, and Nicki Minaj. The track is featured on both Ariana Grande's second album, "My Everything," and as the first single off of Jessie J's second album, "Alive," released in September. When these artists combined their efforts, their respective fan bases were exposed to each artist. Ariana Grande and Jessie J's immense fan base of pop listeners became exposed to the more hip hop leaning rap style of Nicki Minaj and vice versa. Another example that has succeeded on more than one occasion is the combination of Rihanna and Eminem, who recorded together for the first time on the hit "Love the Way You Lie." As a consequence, Rihanna's pop audience gained favorable exposure to Eminem, and Eminem's rap audience was introduced to Rihanna.

17. A&R representatives also assist in making sure that the other musical elements of a recording session are in place: they ensure that the right session musicians are hired, as well as background musicians, vocalists, etc. These are musicians and vocalists who are hired to work during the recording session. The A&R administration department manages the business and administrative aspects of getting the record made: reserving and paying for studio time, covering and arranging travel expenses, renting equipment, etc.

18. Once the material has been chosen, the producer chosen and the studio time booked, the artist is ready to record. The A&R representative typically continues to be involved throughout the recording process, to make sure that the sessions run smoothly, to be someone that the artist can bounce ideas off of, etc.

19. In the process of recording an album, oftentimes more tracks will be recorded than ultimately will be used on the album. Therefore, after recording sessions for an album have concluded, the A&R representative and others at the label may work with the artist to decide which tracks should be included on the album release. The remaining tracks which were not included on the “basic” version of the album can still play a significant part of the marketing plan for an album. For example, major retail partners – like Best Buy, Target, Wal-Mart, etc. – often ask us to include specialized, exclusive content on the albums available for sale via their stores. The exclusive use of tracks not available elsewhere helps distinguish the products sold in one store versus another. In addition, as the recording process concludes, the Art, Marketing and Production departments begin to work with the artist to design artwork and take photos to set the visual themes for the album.

20. The recording process requires significant investment of financial resources. While the costs of putting an album together generally are recoupable from artist royalties, there are no royalties if an album does not generate revenue through sales or streams. The record label bears the risk of losing all of these upfront costs. For a brand new artist, we can easily spend up to [REDACTED] before we put an album out in recording costs and advances. (We also spend considerable amounts of money on marketing the album, but I will address that later.) The record label has made a significant investment of both time and money, and taken a considerable financial risk long before it can know whether an artist is going to be a commercial success. And, unfortunately, most of the time for new artists, that risk does not pay off. Although record labels hope that all of their artists will be highly successful, based upon their experiences, they operate on the principle that out of every ten artists signed, only one is likely to succeed. As a result, the success stories must pay for the costs of those other efforts that do not end as well.

21. Our odds of success improve with an established artist, but the expenses we incur and the investment we make also substantially increase. In the case of an artist with a track record, the recording process tends to be much more prolonged and expensive, and we typically pay larger advances. The pre-release costs for an established artist can run in the [REDACTED]. And as I discuss further below, in our business, prior success is no guarantee of future success.

D. Marketing

22. The process of marketing and promoting an artist is a creative endeavor that calls upon a record label's music industry expertise. Our marketing professionals help an artist develop and define their image and style, and through that find their niche in the marketplace. Through the unique marketing plan designed for each artist, we create opportunities for the artist to communicate their message. And our promotion staff works to identify opportunities to garner exposure for that artist.

23. Our promotion departments use their expertise to develop pathways of discovery and exposure for our artists across all media platforms. Our goal is to create awareness among consumers about the artist's music, and to increase interest and excitement surrounding the artist to incentivize consumers to purchase the music. We use our expertise to help each artist build a buzz that is engineered to "break" that artist to specific demographics. Our methods of marketing and promoting artists vary depending on the style and genre of the artist we are marketing and promoting. For some artists, we may emphasize their social media platforms and their artist websites. For other artists, we may employ marketing methods aimed at building a viral, "street" buzz. For still others, we may focus on putting together exactly the right tour. For

all of our artists, we work to get them out in front of the public in a way that will get them noticed, and will make consumers want to acquire the artists' music.

24. Our marketing and promotion staff includes experts across several different departments. We have video departments that work with the artist and video directors to deliver an audio-visual interpretation of the recording. The challenge is to ensure that an artist's music videos are creative and exciting, and developed consistently with the artist's genre and image. Music video production costs are one of the most significant marketing costs we incur.

25. We have artist development departments that work with artists and their management to identify touring opportunities and coordinate all of the various marketing efforts on behalf of that artist while the artist is out on the road. We have in-house publicity staff that works with media outlets and supervises the work of outside publicists engaged for particular projects. We have sales departments at each of our labels and at our distribution company who work to ensure that our artists' products are available to the consumer and positioned in the best way possible to succeed. And we have new media staff who are responsible for marketing artists on the Internet through social media and other tools. All of our efforts are aimed at creatively making certain that an artist is able to reach the customers who are likely to buy their music.

26. As in decades past, our marketing and sales efforts include working with our brick-and-mortar retail partners to make certain that the record is visible in stores. We employ marketing materials like stand-ups, cardboard cutouts and posters featuring the artist. We feature the artist in Sunday newspaper circulars for retailers like Best Buy, spotlighting new releases for that week. We plan for and ensure that an artist's new release is featured on the "end caps" in the retail stores, the prime real estate at the end of an aisle where research shows customers are more likely to notice products.

27. In the same way we work with brick-and-mortar stores, we also work with our digital partners to ensure that our artists are featured prominently on their services. Whether a digital customer visits the iTunes Store, or Amazon, or Spotify or Beats – we work to ensure that our artists and their music is prominently featured on the home page or included in curated playlists. More than ever before, our marketing and sales departments are focused on developing playlists of our own to feature on these services, and encouraging tastemakers to feature our music on their playlists. We encourage our artists to create playlists. Often, in our deals with interactive services, our partners offer marketing considerations, [REDACTED]

28. These marketing efforts can mean the difference between success and failure for a new artist. But they can also mean the difference between success and failure for an artist that has already developed a significant fan base. Just because an artist's first album was successful, that does not mean the second album will be. Sometimes it is more difficult to achieve success with a second effort when the first album was successful. For example, when an artist comes out with a new sound in their first album, by the time that their sophomore effort is released, that new sound may have been mimicked by others and is no longer as fresh and unique as the first time around. Often, bands have worked for years to craft the music they include on their first album, while the follow up has not had as much time to develop. Every album essentially requires a new marketing plan to ensure that it rises above the din and does not get lost in the millions of tracks available from us and our competitor for purchase or to stream through one of our digital partners.

29. Robin Thicke is a good example of an artist that has been signed with our labels for many years before he found true superstar level success. Thicke signed with Interscope

Records when he was 16 years old. Interscope spent years with Thicke helping him make records, tour and work with other artists. Although he had achieved some success with previous albums, he did not reach the number one slot on the U.S. pop charts until the summer of 2013 when “Blurred Lines,” a track off of Thicke’s sixth studio album of the same name, became a tremendous worldwide hit.

30. All of these efforts cost money, time and effort. In fiscal year 2013, we spent [REDACTED] on gross marketing costs net of recoveries to third parties, as well as [REDACTED] on our marketing overhead for the various departments focused on this important work. It is very difficult to predict which artists will succeed and which will fail. We do our best to sign artists who we believe will find success, and then we do our best to make sure that our marketing departments support their efforts and position them to succeed.

E. Manufacturing and Distribution

31. The last step in the process involves the actual manufacturing of records, and the distribution of music to retailers and digital partners for delivery to consumers. In recent years, our manufacturing and distribution operations have changed. While UMG once owned its own pressing plants, today it conducts its physical manufacturing through various third-party pressing plants. Those manufacturing costs for physical records represent significant third-party costs, totaling [REDACTED] in fiscal year 2013 for only a subset of Universal labels (excluding EMI). This includes costs we advance for pressing and distribution deals.

32. We also have invested and continue to invest in developing methods of efficient digital distribution. Since commercially viable digital services first emerged in the early 2000s, we have invested in excess of [REDACTED] in IT infrastructure and operating costs and in professionals that today distribute the thousands of digital files we provide to hundreds of digital

service providers every year. Our digital supply chain has evolved over time and today is comprised of several interacting electronic database systems, many of which have been developed only within the past few years.

33. We have a division called Universal Mastering Studios, or UMS, that converts artists' master sound recordings (or "masters") into digital audio files. We have systems that maintain our content assets, including the artwork and digital audio files that will eventually comprise our digital releases. A separate database controls the scheduling of our digital releases. While digital releases are often simultaneous with physical releases, that is not always the case. Our digital scheduling system ensures that product is released at the appropriate time. We also have a global repertoire system that tracks all of the key data associated with each recording, a global pricing system that we can use to determine price, and a global rights system that defines how we are permitted to use the recording. We have two more systems that work together to finalize and prepare the product for delivery to our digital partners. One system maintains our partner profiles and determines which content goes to which partner. And another system serves as our encoding engine, which ensures that each partner receives the artwork and digital audio files that meet their individual specifications.

34. Trained professionals are necessary to ensure that all of these systems work and that our digital releases reach the public smoothly. Before a digital release, a group within our Digital Supply Chain department is charged with reviewing the metadata that is supplied with the digital audio file to ensure that it is accurate, contains the correct categories of information, and is generally suitable for public dissemination. We also must ensure that the accompanying metadata that reflects the artwork, artist information, track information, etc., so that the service

can properly identify the recording in its system. People also need to handle the quality control and the administrative support required to make sure that these operations run smoothly.

IV. The Changing Music Business and its Effect on Our Decisions to Sign Artists

35. Over the last decade, the market for music has changed tremendously. Since 1999 and the emergence of Napster, music sales in the United States have declined over 50%. As a result, our revenues also have declined dramatically. This decline only increases the pressure on us to manage our costs and our losses wisely. In a market with declining sales, making the right calls and the right investments in the right artists is more important than ever. Signing an artist today involves even more of a commitment to invest significant money and time, and an even greater risk without any guarantee of a return.

36. The complexity of today's music market further complicates the risk that we face when deciding to sign a new artist. Today, music lovers consume music differently than they have ever before. Services that offer music "access" as opposed to traditional models of "ownership" are more popular today than they have ever been. As a result, our industry has shifted from a model that was focused primarily on selling records, to one in which every revenue stream matters. In order to defray our significant costs and reduce our considerable risk, we must hope that an artist becomes a success across all of the available platforms – and not just through sales of records.

37. As but one example, consider Eminem – by any measure one of our company's true superstars. In May of 2000, Eminem released his second album, the Marshall Mathers LP. That record was a huge success, selling over 10 million copies in the United States. In May of 2013, Eminem released a follow up as his seventh studio album: the Marshall Mathers LP 2. That album was also a huge success when compared to other albums released at that time.

However, it sold only a fraction of what the first Marshall Mathers album sold – i.e., Marshall Mathers LP 2 sold approximately 2 million copies in the United States versus approximately 10 million copies for the first Marshall Mathers LP album. While the Marshall Mathers LP 2 has had several chart-topping singles, music fans simply do not purchase music at the level that they once did. That is not because they are not listening to the Marshall Mathers LP 2. To the contrary, Spotify this year named Eminem the most streamed artist of all time – based significantly on the over one hundred million streams for hits like “The Monster” off of Marshall Mathers LP 2.

38. Turning a new artist into the next breakout star is the product of hard work, significant investment, industry expertise, and considerable risk. We are in business to make money, of course, but we are in *this* business because we love music. We find the artists, help them record their music, and then market and distribute that music to music consumers everywhere. And, when the music is not commercially successful, we are the ones that bear the financial risk. Our digital partners get the benefit of our efforts as the creative input of their business is our artists’ sound recordings. By contrast, our digital partners do not have to live, as we do, with the risk of failure despite our substantial efforts to bring a new artist’s music to the public.

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

Date: October 6, 2014


Jeffrey S. Harleston