

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

In re)
)
)
 DETERMINATION OF ROYALTY) DOCKET NO. 14-CRB-0001-WR
 RATES AND TERMS FOR) (2016-2020)
 EPHEMERAL RECORDING AND)
 DIGITAL PERFORMANCE OF SOUND)
 RECORDINGS (*WEB IV*))
)

TESTIMONY OF

DARIUS VAN ARMAN

Co-Founder and Co-Owner of Secretly Group

PUBLIC VERSION

Witness for SoundExchange, Inc.

Background and Qualifications

I am Darius Van Arman, co-founder and co-owner of Secretly Group, which consists of the four independent record labels Jagjaguwar, Dead Oceans, Secretly Canadian, and the Numero Group. Secretly Group is headquartered in Bloomington, Indiana and shares ownership with affiliated companies SC Distribution, Fort William Artist Management, and Secretly Canadian Publishing. Altogether, these companies employ about seventy U.S. employees.

In addition to my position with Secretly Group, I am also actively involved in the independent record label community. I am currently a non-voting observer on the Board of the Music and Entertainment Rights Licensing Independent Network or “MERLIN,” a global rights agency for the independent label sector. I am also a founding and current member of the Worldwide Independent Network (or “WIN”) Council, an international group of independent label owners brought together in 2013 to help advise WIN. WIN is the global representative organization founded in July 2006 to represent independent music companies and their national trade organizations. Previously, I served on the Board of Directors of the American Association of Independent Music (“A2IM”), a not-for-profit trade organization representing over 330 independently owned music labels in the United States. I am also a member of the Board of Directors of SoundExchange, Inc.

I have testified before the Copyright Royalty Judges to present the views of an independent record label in a proceeding concerning royalties payable by SIRIUS XM for its satellite radio service and certain services that stream sound recordings over satellite and cable television. I have also recently testified before the Subcommittee on Courts, Intellectual Property, and the Internet of the House Judiciary Committee to reflect my own views and the perspective of the independent community. I understand that the purpose of this proceeding is to

set the rates and terms of the compulsory license for digital sound recordings in the United States available to non-interactive services (which I will refer to generally as “webcasters”) for the years 2016-2020. While I am testifying based on my own experience and that of Secretly Group, I am also testifying to offer the Judges the perspective of the independent record company community in the United States.

Independent Record Companies and the Digital Music Landscape

The independent record company community is a vibrant and vital part of the American music landscape. When I founded the record label Jagjaguwar out of my bedroom in Charlottesville, Virginia, in 1996, I hardly imagined that the labels I would become a part of would one day be the home of such prominent artists as Bon Iver, a recording artist who won the Grammy Awards for both Best New Artist and Best Alternative Album, or Tig Notaro, a 2014 Grammy nominee for Best Comedy Album. Our labels have rich and diverse rosters totaling over sixty active artists, including emerging, contemporary acts such as singer-songwriter Sharon Van Etten, electronic music project Major Lazer, and the critically acclaimed rock group The War on Drugs, as well as iconic acts like Dinosaur Jr., a band that has been releasing important records to the American public since 1984. In addition to supporting these important artists, Secretly Group helps new generations of music consumers discover classic musical gems through the efforts of the Numero Group, an archival label that creates compilations of previously released music from a variety of genres. Secretly Group releases have become gold singles and albums and have received critical recognition, including multiple Grammy nominations. More importantly, our efforts and the efforts of the artists we work with have made vital contributions to the overall music landscape in the United States.

In this way, our experience is emblematic of independent music companies in general. Independent labels release some of the most prominent and commercially successful records, including those by artists like Paul McCartney, Adele, Macklemore, Taylor Swift, and the Lumineers. In fact, according to Nielsen Soundscan figures for calendar 2013, independently-owned repertoire constituted 34.6% of the market for music sales. Independent record labels not only have a significant commercial share of the market, we also often support the release of sound recordings that would otherwise never be heard, either because the artists are undiscovered or the sound recordings appeal to devoted but niche audiences. We are proud of the quality of our artists and the music they create. And others recognize the value of these sound recordings as well. In fact, this year, independent labels and artists led the industry once again at the Grammy Awards, winning half of this year's awards and claiming half of this year's non-producer nominations. To put it mildly, the contributions of independent record companies and artists are at the center of music in the United States.

Independent Record Companies and Revenue From Digital Music

To ensure that the public is able to receive the benefit of the wonderful sound recordings of our artists, independent record companies must act as would any responsible small business. Our margin of error is much slimmer than other much larger record companies or digital music services who are often backed by significant investors and capital. We have no external source of funding so, generally speaking, we cannot afford to release albums that lose money for us.

At Secretly Group, and at independent record companies generally, we invest a lot of time and effort into each of our artists and their releases. We spend a great deal of time and effort seeking out recording artists that we believe in to sign to our rosters. We listen to a large number of the demos submitted to us by artists looking to work with one of our companies. We attend

PUBLIC VERSION

showcases, shows, and music festivals around the country, we read music websites and magazines, and we receive referrals from other artists, labels, managers and booking agents. We spend considerable time identifying artists we want to work with (based on music merits) but we also talk with them and their representatives to make sure we are compatible both philosophically and with regards to business-related expectations. We freely offer business advice to prospective artists and connect them to others that can help them in ways that we cannot. And, for those artists who ultimately sign to our labels, we spend significant resources promoting their music and career.

Our business model at Secretly Group is straightforward: break even or generate a profit on the majority of our releases. Because we have hit that goal, we remain profitable. While much of the independent record community shares that goal, not everyone is as fortunate as we are, and I often see independent labels shutter.

The reality is that this is a very difficult environment for independent record labels. Sales of physical CDs have been in steady decline for several years, and, more recently, we have seen a decline in the sales of digital downloads. Yet the costs of our efforts and resources in supporting our artists remain as high as ever. So we face declining sales revenues and if we rush to release more records, we will simply dilute our efforts, alienate our artists, and fail to operate within the general model on which the independent record label business is built on – consistent success across the majority of releases.

This challenge is compounded by the reliance of independent record companies on digital revenues. While there are exceptions, more established artists usually release records that have a higher percentage of sales through physical products. Younger, less established artists will, by contrast, tend to release records that earn more through digital products. And, broadly speaking,

independent record companies tend to attract more of the younger, less established artists. Consequently, independent labels experience the overall shift to digital revenues more quickly than the remainder of the industry. For example, in just the past five years, the digital revenues of the Secretly Group labels Jagjaguwar, Dead Oceans, and Secretly Canadian, when combined, have more than tripled, and they have grown from approximately fifty (50) percent of our total distribution revenues to approximately sixty five (65) percent of our total distribution revenues.

Because of these and other challenges, every digital stream of revenue – including webcasting royalties – is crucial to our revenue outlook. No one digital stream of revenue could sustain our business by itself at this moment and the pressure on statutory streaming royalties is heightened by the noticeable decline in digital sales. I estimate that digital audio streaming revenues (noninteractive and interactive, combined) will exceed digital sales revenues for our labels within the next five years. If there is not a strong royalty rate for statutory webcasting or if that royalty rate drags down rates in other streaming models, I am afraid that we will not be able to break even on most of our releases. In that case, we may sign fewer artists, support fewer album releases or take even more drastic business measures. Needless to say, I regard a strong compulsory license rate as crucial to our business future and the future of independent record companies overall.

Independent Record Companies and Licensing of Digital Sound Recordings

Just as independent record companies come in a variety of shapes and sizes, they also license their sound recordings to digital music services in a number of different ways.

Digital Licensing via Major Record Companies. Most prominently, many independent record companies distribute their recordings through the distribution services of the three major record companies – Sony, Universal, and Warner. For instance, according to the Nielsen

PUBLIC VERSION

numbers I referenced above and solely on the basis of copyright *ownership*, 34.6% of the market share of sales of sound recordings is *owned* by independent record companies. However, many independent record companies will distribute their sound recordings through major record companies. While I cannot say for certain how large that percentage is, I do know that a substantial portion of independently-owned sound recordings are digitally distributed by one of the three majors.

When an independent record company uses the digital distribution services of a major record company, it is my understanding that generally it is the terms of the major's license with a digital music service that govern the rates and terms for distribution of those sound recordings. I am aware of exceptional circumstances – including my own past experience – where an independent record company uses a major record company primarily for physical distribution and retains digital distribution rights, but again, that is the exception. For example, whereas Secretly Group is one of the larger and more prominent independent label groups in the marketplace, it was only just recently that the digital distribution of our releases became independent of any major record company. Previously, Secretly Group releases were digitally distributed in the United States by Warner, in connection to Warner's physical and digital distribution agreement with SC Distribution. This changed at the beginning of 2014, however, when SC Distribution, as part of Independent Distribution Cooperative (or "IDC", and which also includes as members such independent record companies as Beggars Group, Domino Records, Merge Records and Saddle Creek), entered into a new physical-only distribution agreement with Alternative Distribution Alliance (or "ADA"), the Warner distribution arm that focuses on independent repertoire. So only now is Secretly Group repertoire independently distributed to digital services.

There are probably a number of reasons that an independent record company may choose to handle its own digital distribution rights. Of course, one of those reasons is that doing so can save the independent record company from paying a distribution fee to the majors. This is no small concern because independent labels often aim to and depend on breaking at least even on the majority of their releases. A hefty distribution fee can make this difficult, especially as the market becomes more focused on digital sales and streams and less concerned with physical product.

Direct Digital Licensing. While less common, some independent record companies handle digital licensing negotiations on their own. This can be challenging from a resource perspective because almost all independent record companies are small or medium-sized businesses. They often lack the staffing resources to engage in direct license negotiations, particularly with the very large and sophisticated companies whose core business turns largely on the license terms they can extract for sound recordings. For instance, Secretly Group and its affiliated companies are one of the larger collections of independent record companies, and we employ about 70 people in the United States, but as I understand it, Pandora alone has over 1,400 employees. This is not just a challenge of quantity of resources, it is one of expertise. In fact, of our 70 employees, our full business affairs team is composed of only 4 people, including me. Only three of our employees have experience with digital licensing negotiations. It would not surprise me if at many independent record companies, the number of employees with licensing expertise is only one or none. This is especially challenging because the negotiators for these digital music services are repeat players who understand what other record companies have required to license sound recordings on the same service whereas we have to learn anew each digital music service and how it intends to make our music available to consumers.

All of these challenges, of course, assume we can even get to the negotiating table with the digital music service. Despite the important value of independent music, sometimes individual independent record companies lack the scale to get the attention of digital music services. If the first challenge of the negotiation is simply to have one, it makes it difficult for an individual independent record label to secure the same terms for their sound recordings as other labels. That is probably one of the reasons that many independent labels choose to distribute their sound recordings through major record companies, despite the distribution fees in the typical range of 10 to 20% that independent labels generally end up paying to majors for digital distribution.

Digital Licensing Through Independent Distributors or Collectives. Sometimes independent record companies attempt to overcome the inherent barriers of going it alone by banding together for digital licensing.

One way to do so is to work through an independent distributor like SC Distribution. SC Distribution was founded in 1997 to attempt to address this issue and provide collective clout to independent record companies. Over the last 15 years, SC Distribution has distributed music for over 50 labels, including the four Secretly Group labels. As mentioned above, whereas SC Distribution had until very recently relied on Warner's distribution arm ADA for digital distribution services (in connection with its previous physical and digital distribution agreement with ADA), this was only for the repertoire of the three labels Dead Oceans, Jagjaguwar and Secretly Canadian. For the other labels distributed by SC Distribution, digital distribution services were provided solely by SC Distribution, through its direct agreements with digital services. As such, through SC Distribution, I have seen what it is like to negotiate directly with digital music services.

Another way that independent record companies band together for digital negotiations is through MERLIN, a global rights agency that negotiates on behalf of the independent label sectors. MERLIN negotiates on behalf of over 20,000 independent label members in 39 countries. MERLIN offers digital services – including the negotiation of agreements to license digital sound recordings to digital music services – to its members, which include Secretly Group. Our collective hope is that by allowing MERLIN to negotiate on behalf of so much repertoire, it will improve the terms that an independent company could get negotiating on its own. The conventional wisdom is that when MERLIN is able to collectively represent many independents, then we are in a better negotiating position as independent companies than if we all tried to negotiate separate deals on our own. If MERLIN is able to reach an agreement with the service, MERLIN sends its members, including me, a Notice of Proposed Action describing the deal terms and giving each member label the opportunity to opt out of the deal. Each time Secretly Group receives such a notice, we consider the terms offered before deciding whether we should agree to those terms or opt out. In several cases, we have agreed to the terms of the MERLIN-negotiated deals.

Independent Record Companies and the Direct License Market

I am a strong proponent of the compulsory license for a number of reasons not the least of which is that it is our best hope of creating a level playing field among record companies. This is especially important because of trends I have observed in the direct licensing market.

Digital Breakage. The first trend is a shift to compensating record companies on the basis of unattributable income, which I have referred to when testifying before Congress as “breakage.” The issue of “breakage” is that some record companies may be receiving compensation for their sound recordings that is not readily transparent to others in the

marketplace. This compensation, however, *is* part of the value a company receives for the use of sound recordings even when expressed as “breakage.” The proper value of a license simply cannot be understood without including all compensation, including this “breakage” compensation. And, the overarching issue I have discussed elsewhere is that it can be difficult to negotiate in a market when one does not include all relevant consideration in understanding the marketplace.

Imagine that a digital service offers a licensing deal to a record company. There are a number of different ways in which the streaming service could offer important and valuable consideration to the record company, including a percentage of the service’s revenue, a per-stream royalty rate, a minimum payment per subscriber, an advance payment at the beginning of the term, a guarantee on the back end, some form of profit participation (e.g. an equity stake) and so on and so forth. Each of these are mechanisms that compensate a rights holder in the marketplace for the use of a product — here, sound recordings. In the negotiation, both the record company and service could try to change the mix of the consideration (e.g. add an equity stake) or the amounts of particular pockets of the consideration (shift to a larger guarantee). In many instances, the other party, whether it be a record company or a service, can be indifferent to the proposal because, after all, consideration is consideration and what we are really discussing here is the method of payment, not the payment itself.

Of course, the method of payment can make a difference to those who are represented by the record company in the negotiations – e.g. artists or independent record labels distributed through a major. They are potentially at risk if the negotiating record company chooses not to attribute income from what I have called “breakage.” And this is important because, in my view, breakage is valuable consideration that is included in a licensing deal as part of the total

compensation for a sound recording. To act otherwise would simply understate the value of the consideration received for the use of music.

There is another side to this “breakage” story. A licensing deal made between one record company and a service may well affect the deals that are offered to other record companies, especially independent record companies who are often approached after a service is well into negotiations with the majors. By pushing consideration in certain deals into less transparent mechanisms like equity stakes or advances that cannot possibly be recouped, a service may be able to push for a lower per-stream royalty rate with record company A. Then, when the service approaches record company B – often an independent company – the service can represent that company B is receiving no worse of a per-stream royalty rate than any of its other label partners.

While I do not know the terms of the major record company licenses with Apple for its iTunes Radio services, I suspect this is essentially what happened. Having already engaged the majors in negotiations, Apple put forward a “take-it-or-leave-it” license offer for iTunes Radio to independent labels, as an amendment to their existing iTunes agreements and in a manner utilizing an online click-through mechanism (i.e. an acknowledgement checkbox). Presented in such a way, in close proximity to the launch of the new iTunes Radio service and well after iTunes had concluded negotiations with the major record companies, there was no meaningful opportunity for independent companies to negotiate iTunes Radio terms with Apple. The license offer, which was published on an internet news site, included not only iTunes Radio but other Apple digital music services, including the iTunes Store. In other words, this was not just take-it-or-leave it on iTunes Radio, it was a take-it-or-leave-the download store offer. I highly suspect but do not know for sure that we were simply offered the same per-stream rates as the majors without any of the other breakage consideration they may have received.

PUBLIC VERSION

Indeed, with respect to other digital services, I have even heard discussions of a “negative most-favored nations” clause wherein the record company Bs of the world – often, independent record companies – must agree to provide rate relief in a deal if another record company agrees to a lower per-stream royalty. Thus, digital breakage often creates a situation where a focus only on per-stream rate parity does not reflect the total value of the deal. That creates a dangerous situation in which some music is devalued solely because of the identity of the rights holder. But, music is music and a sound recording from an independent record company is no less valuable than a sound recording from another record company, major or otherwise. The commercial value of the recording should stand and fall on its ability to resonate with consumers. It should not be based according to who has acquired the biggest bucket of rights or who has established the most control over distribution pipelines to consumers.

Importantly, digital breakage revenues are not just earned by major record companies, they are also earned by independent record companies, including MERLIN, which maintains equity stakes in some of its digital service partners. SC Distribution has itself done deals where the compensation through unrecouped advances and guarantees is expected to yield digital breakage. While apportioning breakage pro-rata based on actual performance on the service, a policy MERLIN and others have adopted and that I support, can address the attribution question between distributors, independent labels, and artists — and which mitigates to a large extent the dangerous situation discussed above where commercial value is not based on actual usage by consumers — , there is the separate issue of how breakage affects the negotiations for direct licenses. The only way I can see to avoid the distorting effects of breakage is to understand and consider all revenue received by a record company under a direct licensing deal, including digital breakage.

Pro-Rata Terms. When I was last before this Board, I explained that I am opposed in principle to a system in which the decision of what recordings are played is not based on the quality of or consumer interest in the recordings, but rather on the deal terms of a direct license. Unfortunately, this has increasingly become the direct licensing world we live in, as services seem to be offering additional plays or promotion within the service to particular rights holders to increase the rights holder's pro-rata share of plays – what I call “play-share incentives” – in exchange for lower consideration or rate relief. Without a strong statutory rate that allows record companies, whether major or independent, to reject play-share incentives, I am afraid this will become an inevitability.

My concern is that the use of play-share incentives will devolve into a race to the bottom in which you de-value your music just to have your songs heard. Moreover, deals that include incentives related to number of plays or pro-rata share weaken the market as a whole because they cannot be universalized to all rights holders as a digital service cannot promise an increase in pro-rata *share* to everyone. If someone gets the play-share benefit of signing on first, then someone else will be in the unenviable position of finishing last. It worries me that independent record companies, who often have the least leverage in direct negotiations, may be left with an impossible choice: either run to the front of the line to offer rate relief in exchange for plays or worry that we will be left out of commercially determined playlists dominated by the majors. Just three years since my last testimony, it feels like we are now cascading down that slippery slope I described and the bottom of the hill is one where access to the online word requires us to further de-value our music to overcome real, non-meritocratic obstacles.

The Importance of a Strong Statutory License Rate

Given what I have described above, it has never been more important to the independent record community to have a strong statutory license, particularly with a strong royalty rate.

A strong statutory license creates a level playing field. When repertoire is given equal value through an equal royalty rate, services have no incentive but to allow sound recordings to compete for the attention of their users and, royalty rates being equal, feature the sound recordings that are most likely to increase users and listening. Consequently, the compulsory license is the best if not only hope for this equal playing field because it is agnostic to the market position of the rights owner when determining the royalty required for a song.

This equal playing field is also important for independent record companies because the statutory license eliminates transaction costs that would be daunting if not prohibitive in the direct licensing market. Put simply, many independent labels do not have the resources to engage in direct licensing with the many digital services and webcasters so these labels have no practical option but to rely on the statutory license. For them, the statutory license is not a floor or ceiling to further negotiation because there will be no further negotiation, so the value of their music reflected in the statutory license is the value of their music they must accept. Notably, where independent record companies do negotiate directly, the statutory license still functions as a ceiling. It is hard for independent record companies to negotiate above whatever statutory rate a service may elect because the statutory license is compulsory and we have no right of refusal.

Nevertheless, the strength of the statutory license is significant for independent record companies in direct licensing negotiations as well. Much of the direct licensing world is opaque, whether because of digital breakage or otherwise, and independents are often the least well-

positioned to determine the true market value of a license for a service. The statutory license, by contrast, is transparent.

The growing influence of programmed play rates on digital music services, whether interactive or not, is yet another important reason for a strong statutory license rate. For instance, I recently rejected an offer by a long-standing digital partner, [REDACTED], requesting royalty relief on a “blended rate” of a tier of service that combined “radio plays” with “interactive plays.” The blended rate offer, which I have attached as an exhibit to my testimony, was at [REDACTED] cents per stream whereas the partner’s existing deal with SC Distribution pays us a [REDACTED] per interactive stream. While I did not accept the offer, it was a good example to me of the increasing consumer offerings of tiers that include both non-interactive and interactive streams as well as the effect of non-interactive streams on the per-play rates of other interactive services. In other words, I expect that the compulsory rate adopted in this proceeding will, in turn, drag down and therefore interfere with the rates offered to independent record companies by digital music services that offer interactive streams as well.

Finally, a strong compulsory rate is important for independent record companies today because more than ever we rely upon statutory royalties. With both CD sales and digital download sales declining, it is apparent to everyone that the future of the recorded music industry is in streaming, whether it be non-interactive or interactive. And that future is coming quickly to independent record companies because our business model requires us to break even on more of our releases – a daunting challenge in a world of sales decline. Thus, the only way we can expect to break even enough to keep releasing the important recordings of our artists is to receive significant per-stream royalties under the level playing field of the compulsory license.

SoundExchange As the Sole Collective

I have said before and continue to believe that SoundExchange has earned the right to continue serving as the sole collective to collect and distribute statutory royalties for copyright owners and performers. The organization is governed by and represents a balance of the interests of record companies, both major and independent label alike, and performing artists. In my experience, this organizational structure ensures that the interests of all constituents are heard and represented. Also, SoundExchange is a non-profit organization, which ensures that it operates to maximize royalties for all recipients, and has a good track record of doing just that through its administration and advocacy efforts on behalf of copyright owners and performers.

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

Date: October 6, 2014

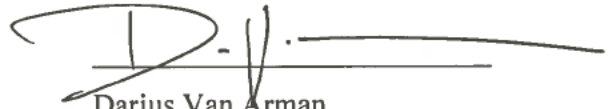

Darius Van Arman

Exhibit Sponsored By Darius Van Arman

Exhibit No.	Sponsored By	Description
SX EX. 007-DR	Darius Van Arman	Exhibit 1 - Offer Term Sheet

SX EX. 007-DR

**RESTRICTED — Subject to Protective Order in
Docket No. 14-CRB-0001-WR (2016-2020) Webcasting**