**Public Version**

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

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| In the Matter of:<br><br>Determination of Royalty Rates and Terms for Transmission of Sound Recordings by Satellite Radio and "Preexisting" Subscription Services (SDARS III) | Docket No. 16-CRB-0001 SR/PSSR (2018-2022) |

## WRITTEN REBUTTAL TESTIMONY OF

# Jonathan Bender

**Chief Operating Officer**
**SoundExchange, Inc.**

**February, 2017**

## INTRODUCTION

I am the Chief Operating Officer of SoundExchange, Inc. ("SoundExchange"). I previously provided written direct testimony in this proceeding, and refer to that testimony for a description of my background and qualifications. In this rebuttal testimony, I primarily address the terms and other regulatory language proposed by Sirius XM and Music Choice.

Sirius XM and Music Choice have adopted a similar approach to the terms and other regulatory language to be adopted in this proceeding, in that (1) each proposes that there should continue to be separate, repetitive subparts of 37 C.F.R. Part 382 addressing satellite digital audio radio services ("SDARS") and preexisting subscription services ("PSS"), and (2) the starting point for each of their proposals is the current regulations in its subpart. However, Sirius XM has proposed various changes to the regulations for SDARS, some of them ones that the Judges adopted in *Web IV*. Music Choice, for its part, proposes to change only the royalty rate in 37 C.F.R. § 382.3(a) (although presumably it would agree to conforming updates, such as to the various references to the years of the rate period).

This is a different approach than SoundExchange employed in formulating its proposed regulations. SoundExchange adopted as the starting point for developing its proposed regulations in this proceeding the restructured and revised regulations adopted by the Judges in *Web IV*, and then incorporated various provisions specific to SDARS and PSS. As a result of these different approaches, as well as the specific issues addressed in the direct cases of SoundExchange and Sirius XM, there are numerous differences in the regulatory language proposed by SoundExchange on the one hand and Sirius XM and Music Choice on the other. In this testimony, I describe the material differences, both as to structure and as to the regulatory

language addressing specific issues (to the extent I did not already do so in my direct testimony), and explain why SoundExchange's positions are the preferable ones.[1]

## DISCUSSION

### I. Structure of the Regulations

As noted above, in the *Web IV* proceeding, the Judges significantly revised the regulations embodying the webcasting rates and terms. These revisions were driven by the Judges' clearly-expressed desire both to (1) "reduc[e] the amount of repetition in the regulations" and (2) state the regulations in "plain language." *Web IV*, 81 Fed. Reg. 26,316 n.1 (May 2, 2016). The Judges also sought to address various drafting issues in the old regulations. *E.g.*, *id.* at 26,400 (addressing an "internal ambiguity" in the old regulations). SoundExchange supports the Judges' goals of reducing repetition, using plain language and cleaning up the drafting of the regulations. We are on the front lines of working with these regulations every day, and think all the stakeholders in the statutory license system benefit from having regulations that are clear, concise and easy to work with. We also believe that, in the end, the revised webcasting

[1] A primary focus of my previous testimony was explaining why the Judges should, in the regulations adopted in this proceeding, appoint SoundExchange as the sole collective for collecting and distributing royalties under the Section 112 and 114 licenses from preexisting satellite digital audio radio services ("SDARS") and preexisting subscription services ("PSS"). I was pleased to see that both Sirius XM and Music Choice agree that SoundExchange should continue in its role as collective, as demonstrated by the fact that neither proposed changes to the applicable regulations designating SoundExchange as collective (37 C.F.R. §§ 382.2, 382.11). Proposed Rates and Terms of Sirius XM Radio Inc., at 2 ("For the ~~2013-2017~~2018-2022 license term, the Collective is SoundExchange, Inc." (strike-through and underline in original)); Music Choice's Written Direct Statement, at 6 (apart from the royalty rate, "Music Choice proposes that no changes be made to the terms and other regulations applicable to the PSS license"). The participants also agree in substance concerning the minimum fees for SDARS and PSS and the treatment of ephemeral royalties. Accordingly, I do not address those matters further in this testimony.

regulations adopted in *Web IV* were mostly successful at achieving those goals. Having come this far, SoundExchange believes that the Judges should complete their revision project by adopting regulations in this proceeding that mirror the structure of the new webcasting regulations and incorporate the drafting improvements made in *Web IV*. It is for that reason that SoundExchange adopted as the starting point for developing its proposed regulations in this proceeding the restructured and revised regulations adopted by the Judges in *Web IV*.

There are significant operational advantages to having consistency of terms and other regulatory provisions across the various statutory license service types, unless there is good reason for an inconsistency. In its role as collective, SoundExchange is probably the heaviest user of the regulations setting forth statutory license rates and terms. We often field questions from licensees, copyright owners and artists about statutory license processes that must be answered with reference to the Judges' regulations. We also have our own processes for collecting and distributing royalties and registering payees that must be carried out in accordance with the regulations. Minor differences in the regulations, even nonsubstantive ones, require extra work by SoundExchange staff, because even in the case of provisions that are similar across services (*e.g.*, those relating to statements of account, confidentiality and audits), we need to consider whether answers to questions and implications of the regulations for our processes vary among service types, and in some cases may need to proceed differently depending on the type of service involved. Even a difference so nonsubstantive as having definitions at the beginning of the subparts of Part 382 and the end of Subpart A of Part 380 means that SoundExchange staff, and potentially licensee staff as well, will spend unnecessary time flipping through the regulations trying to find where the definitions relevant to a particular issue are located.

Consistency seems particularly useful for SDARS and PSS, because unlike most webcasters, the companies providing those types of services also provide business establishment services; engage in webcasting (although as to the PSS, there is an open question which rate structure applies to that webcasting); in the case of Sirius XM, operate a new subscription service delivered through cable and satellite television providers (what SoundExchange refers to as a CABSAT service); and in the case of Muzak, operate the legacy DMX business that SoundExchange believes should be classified as a CABSAT service (a question presently pending before the D.C. Circuit).

Of course, some inconsistency may be necessary due to functional differences in services or differences in rate structures. And other inconsistency must be tolerated, at least for a time. For example, given the staggered schedule of proceedings before the Judges, no generally-applicable terms could ever change without there being some inconsistencies in the regulations for a time. Inconsistency is also less of a practical problem for provisions that are invoked only occasionally (like audit provisions) than for provisions that apply to broad categories of activity on an ongoing basis. Nonetheless, consistency provides important simplification and operational efficiency when practicable, and there should be inconsistency only when there are important reasons for it.

Sirius XM provided the rationale for its proposed regulations in the testimony of Thomas Barry, its Controller. However, that testimony provides no rationale for starting with the current SDARS regulations. And it advocates a certain level of consistency across service types, by suggesting that various *Web IV* provisions be imported into the SDARS regulations to be "consistent with the Judges' decision in *Web IV*." Written Direct Testimony of Thomas Barry 2-3 (Oct. 19, 2016) (audit provisions) [hereinafter Barry WDT]; *see also id*. at 5 (treatment of

ephemeral recordings), 6 (unclaimed funds). Rather than cherry-picking a few bits of *Web IV* regulatory language to import into Part 382, the assumption should be that regulatory language that works for the more than 2500 statutory licensees that webcast – including Sirius XM – should also apply to the three services subject to the rates and terms to be set in this proceeding, unless there is a good reason it should not.

Music Choice addressed its regulatory proposal in two sentences of the testimony of David Del Beccaro, its CEO. The sole rationale that Music Choice provides for continuing the current regulations is that they have been "substantively unchanged, for many years," so the parties have experience operating under them without what he perceives as "problems sufficient to warrant any change." Written Direct Testimony of David J. Del Beccaro 47 (Oct. 19, 2016) (audit provisions) [hereinafter Del Beccaro WDT]. I understand that in *SDARS II*, Music Choice argued that proposals by SoundExchange to harmonize the PSS regulations with other applicable regulations would cause it "extreme inconvenience." Rebuttal Testimony of David J. Del Beccaro in Docket No. 2011-1, at 21 (June 27, 2012) [hereinafter Del Beccaro *SDARS II* WRT]. If Music Choice makes similar claims in this proceeding, they should be viewed with skepticism. More than 2500 webcasters, many of them smaller and less sophisticated than Music Choice, have coped just fine with the gradual evolution of the regulations governing their activities, including the major rewrite of their regulations in *Web IV*. SoundExchange is regularly in communication with licensees, and after *Web IV*, we experienced no flood of questions from licensees about what the Judges' new regulations mean, and heard no groundswell of protests from webcasters that they could not possibly internalize the many (mostly nonsubstantive) changes in the regulations. Music Choice also has experience with many of the improvements

that have been made in the regulations over the decades through the business establishment service regulations in Part 384, which apply to a material part of its operations.

Precisely because Music Choice has resisted any material changes to the PSS regulations for almost 20 years, the PSS regulations have fallen badly out of step with the incremental improvements made in the regulations applicable to other types of services. A music service of the scale of Music Choice should be able to adapt to clarifications and refinements of the regulations just like every other statutory service in the market. Where there is no specific feature of PSS service or the PSS rate structure that motivates a particular difference from the regulations applicable to other types of service, the PSS regulations should be conformed.

## II. Issues Raised by Sirius XM's Proposed Regulations

### A. Methodologies for Calculating Direct License and Pre-1972 Share and SoundExchange Distributions

Both Sirius XM and SoundExchange have proposed continuing the current basic construct of exclusions from the payable royalty based on Sirius XM's use of direct license and pre-1972 recordings. Both parties also agree that the internet performances on the so-called "reference channels" that are currently used to calculate those exclusions are not a perfect proxy for actual satellite listenership. And both parties have observed that, because Sirius XM has incorporated the methodology used to calculate those exclusions into its direct licenses,[2]

[2] *See* Written Direct Testimony of George White 14 (Oct. 19, 2016) [hereinafter White WDT]. This should be recognized as a choice made by Sirius XM. While the Judges determined in *SDARS II* that the total amount Sirius XM deducts from its payment to SoundExchange should be determined based on the overall percentage of performances of direct licensed recordings on the reference channels, the Judges did not order Sirius XM to "follow[] suit in determining payments to direct licensors." White WDT, at 14. As an operational matter, Sirius XM could pay its direct licensors based on satellite plays, just as it did in the past and as SoundExchange must.

differences between the exclusion methodology and the methodology that SoundExchange must use to calculate distributions of statutory royalties have effects on the incentives of copyright owners to enter into direct licenses. *See* White WDT, at 15. Both parties have proposed steps to harmonize the methodologies used to calculate the exclusions and distributions. *See* White WDT, at 16.

However, the parties have taken very different approaches to harmonizing the exclusion and distribution methodologies applicable to SoundExchange. SoundExchange proposes migrating toward actual satellite usage data as it becomes available, as published reports indicate is expected to happen during the coming rate period as Sirius XM introduces its new 360L radio platform (formerly known as SXM17). That would be the best way to address the problems with the webcast proxy that Mr. White identifies. *See* White WDT, at 14.

### 1. Use of 360L Data to Calculate Direct License and Pre-1972 Share and SoundExchange Distributions

According to published reports and the testimony of Sirius XM's CEO in this proceeding, its 360L radios will become available early in the coming rate period and will include 4G LTE capabilities, so Sirius XM will be in two-way communication with its subscribers, and will be able to collect what it has described as "valuable usage data."[3] SoundExchange believes that if

[3] *E.g.*, Sirius XM Holdings (SIRI) Q3 2016 Results - Earnings Call Transcript (Oct. 27, 2016), *available at* https://www.msn.com/en-us/money/companies/sirius-xm-holdings-siri-q3-2016-results-earnings-call-transcript/ar-AAjtGzz; Sirius XM Reveals More on New 360L Platform, Car News (July 27, 2016), *available at* http://www.ceoutlook.com/2016/07/27/siriusxm-reveals-more-on-new-360l-platform/; *see also* Meyer WDT, at 15-16; Sirius XM Holdings (SIRI) Q4 2016 Results - Earnings Call Transcript (Feb. 2, 2017) "we expect the first launch of 360L in-production vehicles to reach the market in early 2018"), *available at* http://www.msn.com/en-us/money/companies/sirius-xm-holdings-siri-q4-2016-results-earnings-call-transcript/ar-AAmyrzg; Brad Hill, Sirius XM CEO on Howard, Connected Cars, and Advertising Success, RAIN News (Feb. 3, 2016) (SXM17 "allows us to obtain usage data from the radio in the car"),

reasonably reliable actual satellite listenership data becomes available, using that data for the calculation of Sirius XM's royalty exclusions and also for SoundExchange distributions, as contemplated by 37 C.F.R. § 370.4(d)(2)(vii), would be the best, fairest way to ensure that each copyright owner and artist is compensated in a way that reflects the value of the usage of the recordings involved.

I understand that in voluntary license agreements between record companies and interactive services, a licensor record company's proportionate share of royalties is commonly determined by counting plays to individual users. This approach is similar to the concept of a "performance" as that term is used in the context of statutory webcasting. *See* 37 C.F.R. § 380.7. Counting plays to individual users is a fair way to allocate a percentage of revenue between usage covered by an agreement and usage not covered by an agreement, because a licensor will be paid in proportion to consumer demand for, and usage of, its recordings.

Data collected through 360L radios obviously will not be comprehensive, because it will take years for the entire installed base of SDARS receivers to be replaced by 360L receivers. However, the data does not need to be comprehensive for the limited purposes of calculating overall direct license and pre-1972 exclusions, and of assigning weights to usage in SoundExchange's distribution methodology. Sirius XM has been using the reference channel proxy for purposes of calculating the exclusions. Once Sirius XM has achieved sufficient penetration of 360L radios for them to constitute a reasonable sample of its overall subscriber population, that sample should, for the reasons cited by Mr. White (White WDT, at 14), provide a better approximation of actual listenership than the reference channel proxy. As the 360L

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*available at* http://rainnews.com/sirius-xm-ceo-on-howard-connected-cars-and-advertising-success/.

radios thereafter continue to roll out in new cars, the fit between the available listenership data and true satellite listenership will only improve.

### 2. Calculation of Direct License and Pre-1972 Share and SoundExchange Distributions in the Absence of 360L Data

Sirius XM has raised a question as to what methodologies should apply until actual satellite usage data becomes available. As to SoundExchange's distribution methodology, there is not a lot of choice. We need data to make distributions, and we do not currently have relative listenership data that reliably covers all Sirius XM channels at the channel level. That is why we distribute based on satellite plays consistent with 37 C.F.R. § 382.13(f)(1). However, SoundExchange's proposed Section 382.22(b) would permit (but not require) us to incorporate into the distribution methodology for SDARS royalties other usage data that may be available, if SoundExchange's Board was able to agree on fair adjustments that would incorporate usage data to some extent.

The more substantial question concerns the methodology to be used to calculate the amount that Sirius XM deducts from its payments to SoundExchange based on its use of direct licensed and pre-1972 recordings. Sirius XM has proposed that the Judges reverse the decision they made in *SDARS II* to base such deductions on performances on the reference channels. The reason Sirius XM offers is that "listening on the Internet may not closely track plays or listening on the satellite service. White WDT, at 14 (making no attempt to quantify these effects). I agree that one would expect *some* mismatch between the webcast proxy and actual satellite listenership due to differences in listening habits between the car and home, office or other mobile environments. However, like Mr. White, I would also expect this phenomenon to affect different channels and genres of music differently. *See id.* As a result, I do not agree with the conclusions

Mr. White draws from the possibility of such mismatch. Mr. White focuses on the effects of any possible mismatch on a particular record company. *Id*. at 14-15. But that is not how the exclusions are calculated under the statutory license. Under the formula prescribed in the regulations, the statutory license exclusions are calculated across Sirius XM's whole service. Thus, the effects that Mr. White describes (possible overindexing by webcasts of Hits 1 and The Highway, and possible underindexing by webcasts of bluegrass, Latin, comedy and kids' music) tend to balance each other out in the calculation of the statutory license exclusion. As a result, I would expect any differences between listening on the Internet and listening on the satellite service to be relatively minor across the whole service. Mr. White's indictment of the methodology based on listenership on the reference channels is really an indictment of the use of that methodology under his own agreements, not under the statutory license.[4]

The solution Mr. White suggests – switching to an exclusion methodology based on satellite plays – would be worse than the problem he purports to want to solve, because (1) there is a much worse fit between plays on the satellite service and satellite listenership; (2) switching from exclusions based on reference channel performances to ones based on satellite plays would result in an immediate jump in the amount deducted for the direct licenses that is unrelated to listenership; and (3) such a switch would create new opportunities for Sirius XM to increase its deduction even further by increasing use of pre-1972 and direct licensed recordings in slots with minimal listenership.

First, there must be huge variation in listenership to Sirius XM's various satellite channels, because Sirius XM offers narrow genre channels, and some genres of music are simply

[4] As noted above, that is a problem of Sirius XM's own making, because nothing required them to incorporate that methodology into its agreements.

more popular than others. For example, its "Hits 1" channel plays the latest popular hits; "40s Junction" and "Met Opera Radio" do not. Allocating royalties on the basis of plays would tend to allocate about the same amount of royalties to the most popular and least popular channels.[5] Given the likely very wide disparity in listenership between Hits 1 and 40s Junction, I would expect the mismatch between allocations based on plays and actual satellite listenership to dwarf any mismatch between overall reference channel listenership and overall actual satellite listenership.

Second, Mr. White says that direct licensed recordings accounted for approximately 6.4% of monthly plays. White WDT, at 2. However, using the reference channel methodology, Sirius XM's direct license deduction has historically been lower than that. Thus, it seems that the change in methodologies would immediately result in a transfer of value from artists and copyright owners whose works are used under the statutory license to Sirius XM and/or direct licensors without any change in listenership.

Finally, if the exclusion methodology were to be based on plays, Sirius XM would be highly motivated to reduce its overall royalty cost by playing a high density of pre-1972 and direct licensed recordings on less popular channels and in the middle of the night. It could easily do that without affecting the attractiveness of its service to subscribers and potential subscribers, because even if the excluded recordings were less popular ones, few people would hear those plays. If it did so, its use of direct license recordings in low-value slots would disproportionately reduce statutory royalty payouts to artists and copyright owners whose recordings were used in

[5] Differences in average recording length would cause some variation in the allocations to individual channels, because channels playing longer works play fewer works (and vice versa). However, for most genres of music, those differences are likely to be relatively minor.

the high-value slots on popular channels and during drive time. Sirius XM should not be able to use the statutory license to acquire rights to the more popular "hit" recordings it needs to draw subscribers to its service at a price that is artificially diminished by an excessive allocation of royalties to less popular recordings played when nobody is listening.

While using Sirius XM's webcasting of satellite channels as a proxy is an imperfect means of determining the overall relative value of statutory-licensed uses and directly-licensed uses on its satellite radio service, it nonetheless is much better than an approach that does not even attempt to take listenership into account. In the absence of actual satellite usage data, the Judges should reaffirm their decision in *SDARS II* to base the direct license and pre-1972 exclusions on listenership, as represented by performances on the reference channels.

### B. Interest on Over- or Underpayments Discovered in Audits

Sirius XM has proposed retaining current Section 382.13(d), which provides a late fee of 1.5% per month on underpayments of statutory royalties. However, it has also proposed adding a new Section 382.15(h), which provides for interest on over- or underpayments discovered during an audit at the post judgment interest rate in 28 U.S.C. § 1961, and is apparently intended as an exception to Section 382.13(d). As of February 10, 2017, the rate identified in 28 U.S.C. § 1961 was 0.81% per annum.[6] By contrast, SoundExchange proposed regulatory language concerning audit results that is substantively the same as the language the Judges adopted in *Web IV*. *See* 37 C.F.R. § 380.6(g). That language affirms that the generally-applicable late fee has applied and continues to apply to underpayments discovered in the course of an audit. Because

[6] https://www.federalreserve.gov/releases/h15/ (SoundExchange Exhibit 69).

Sirius XM's proposed change would effectively gut the incentives provided by the generally-applicable late fee in Section 382.13(d), the Judges should not make the change.

The statutory license operates on the honor system. Only licensees – not SoundExchange – have visibility into the use of recordings in their services, the extent of their reliance on the statutory license, and the revenues to be included in a percentage royalty base. We receive payments that are accompanied by only the most minimal rate calculations on licensees' statements of account. As a result, underpayments are not typically apparent to SoundExchange until it conducts an audit, at its own expense, and sometimes with a fair bit of resistance from the licensee. As described in my direct testimony, Sirius XM has been unwilling to provide more detailed accountings, and has also demonstrated repeatedly its willingness to adopt aggressive practices to reduce its statutory royalty payments. Moreover, as illustrated by the parties' current dispute that the Judges recently addressed in the reopened *SDARS I* proceeding, even once an underpayment is discovered, SoundExchange still may not receive a payment for years. Sirius XM should not be rewarded for its persistent underpayments and delaying tactics by being permitted to borrow the money from artists and copyright owners at the same low interest rate as paid by the U.S. Treasury on relatively short term borrowing.

Mr. Barry tries to justify this proposal by suggesting that all that is at issue are "good-faith" errors that "typically stem from inadvertent calculation errors or reasonable interpretive disagreements." Barry WDT, at 4. He even goes so far as to suggest that licensees may be afraid to take deductions that are entirely warranted out of fear that they might someday be questioned. Barry WDT, at 5. However, this testimony does not at all reflect our actual experience with Sirius XM, which I described in my direct testimony. Sirius XM has never shown any signs of fear when it comes to taking deductions from its royalty payments. To the

contrary, as SoundExchange Exhibit 1 makes clear, Sirius XM has made a long series of deliberate choices to, among other things, [ ]. The financial impact of these deliberate decisions far outweighs the impact of anything that might fairly be considered a good-faith calculation error. In effect, Sirius XM is seeking permission to continue these kinds of practices without material consequence, knowing that SoundExchange will be unable to discover them for years.

Sirius XM suggests that SoundExchange is dilatory in conducting audits. Barry WDT, at 4. However, that is not an accurate description of the way the audit process actually works. SoundExchange has no desire to draw out any audit process. It is in our interest to minimize the time spent by the auditor and to obtain results for artists and copyright owners as quickly as practicable. However, when the auditor finds possible issues, it frequently takes multiple rounds of inquiry, response and evaluation for the auditor to understand the issues and the licensee's position concerning them. In addition, SoundExchange often encounters licensee resistance at every phase of an audit, from objections to its choice of an auditor, to difficulties scheduling field work, to licensees' refusal to grant access to necessary information in the field, to licensees' failures or delays in providing follow-up information. Audits of Sirius XM are also very complicated due to the range of its offerings, the complex royalty calculations it has employed, and the pending litigation between the parties. It is for these reasons that audits can drag on for longer than anyone would like.

Licensees have a tool at their disposal to minimize the financial impact of the length of the audit process – payment. Even setting aside the potential to avoid aggressive royalty

calculations in the first instance, it is pretty common for our auditors to discover certain underpayments relatively early in the process that are not disputed by the licensee. An example would be an isolated error such as neglecting to include a particular stream of revenue in a royalty calculation for a particular month. If that stream of revenue was included in the ordinary course in other months, it would be pretty clear that royalties should be paid on that revenue when it is found in the audit. However, licensees under audit do not typically send us a check as soon as such errors are discovered. Instead, they tend to wait until the end of the audit and seek to discuss an overall settlement. If a licensee wants to minimize its late fee exposure, it should pay as soon as a calculation error is discovered.

The interest rate Sirius XM has proposed is extremely low. It is even lower than the late payment rate proposed by iHeartMedia, the NAB, and the NRBNMCLC in *Web IV*, which the Judges rejected. According to Sirius XM's recent securities filings, its recent borrowing history is as follows:

- 2016 Senior Notes at 5.375%
- 2015 Senior Notes at 5.375%.
- 2014 Senior Notes at 6.00%.
- 2013 Senior Notes at 5.875%, 5.75%, 4.625% and 4.25% (with varying due dates).[7]

Thus, Sirius XM's proposal of a rate that is currently under 1% would provide Sirius XM a source of funding much less expensive than its ordinary-course financing. As a matter of money management, it would be entirely rational for Sirius XM to underpay artists and copyright owners, in effect borrowing money from them at a much lower interest rate than applicable to its

[7] Sirius XM Holdings, Inc. Form 10-Q for the Quarter Ended Sept. 30, 2016, at 17; Sirius XM Holdings, Inc. Proxy Statement & 2015 Annual Report, at 15, F-22.

other debt. Its proposal would provide no incentive at all to pay statutory royalties on a timely basis, so long as it could evade detection until the time of an audit. And Sirius XM typically could avoid detection, because SoundExchange has almost no visibility into its calculations until an audit. This is clearly unreasonable.

It is also, in my experience, unprecedented. I have never heard of an agreement in the music industry providing a special low late fee for underpayments discovered in audits, nor any late fee of under 1% per year. In my experience, late fees in music industry agreements are most often 1.5% per month, with no special discount for underpayments discovered in audits.[8]

The interest rate proposed by Sirius XM would also be very difficult to administer. The interest rate referenced in 28 U.S.C. § 1961 fluctuates from day to day. It is not clear from Sirius XM's proposal whether it intends to lock in the late fee for each underpayment at the rate in effect on the date the payment was due, or whether it intends each underpayment to be subject to a late fee that varies from day to day. Either way, it would be extremely complicated to go back years after the fact in the context of an audit and determine what rate applied to which pieces of an underpayment. For efficiency, audits are typically conducted for three-year periods. *See* 37 C.F.R. § 382.15(b). Such a period typically encompasses 36 individual monthly royalty payments. Now suppose Sirius XM adopted one or more exclusion policies that resulted in improper reductions in its monthly royalty payments like the ones detailed in SoundExchange Exhibit 1. That would result in 36 separate underpayments over the course of an audit period, each accruing late fees at different rates, or perhaps at rates that vary from day to day, starting on

[8] Late fees in this range are at a level comparable to the rates applicable to credit card debt, rather than rates applicable to long-term corporate or government borrowing, to provide a strong incentive to prompt payment. Of course, credit card debt does not bear a lower interest rate just because the borrower has made a partial payment.

different days. If the application of the exclusion policy was discovered in an audit, computing the late fees would require calculating the underpayment for each month of the audit period and then applying the historical late fee percentages for all the days involved to each separate monthly underpayment. That would be an unnecessarily complex calculation.

Sirius XM also proposes that SoundExchange pay interest at this rate on overpayments discovered in audits. First, I should be clear that this is an imaginary issue. Discovering overpayments in an audit is rare, since calculating statutory royalties is generally a straightforward process; licensees are well motivated to calculate their royalty payments carefully; and licensees have proven far more likely to adopt policies that systematically reduce their royalty payments inappropriately than to make mistakes that result in overpayments. While, as part of the audit settlement process, we generally credit any isolated overpayments we find toward any underpayments, none of our audits has ever found a net overpayment.

Second, SoundExchange is not a bank. The Judges have tasked SoundExchange with distributing statutory royalties "promptly." 37 C.F.R. §§ 382.4(d)(1), 382.13(f)(1). We take that mission very seriously. Accordingly, we work hard at distributing royalties quickly, and succeed at distributing the vast majority of statutory royalties in the next distribution cycle after we receive a payment and the associated statement of account and report of use. Unlike Sirius XM, which can use its cash flow for its general corporate purposes (including paying refunds if it wishes), the royalties we receive are designated for distribution to the artists and copyright owners whose recordings were used by a licensee in a particular month, as indicated by the licensee's reports of use. We could not pay a refund out of royalties earned by different artists and copyright owners, and we do not hold statutory royalties in reserve against the possibility of

refunding them to licensees. *Cf.* 37 C.F.R. §§ 210.12(h), 210.14 (describing reserves permitted under the mechanical compulsory license when records are sold with a return privilege).

Thus, within a short time after we receive a licensee's payment, the full amount allocable to the artists and copyright owners we are able to pay is gone. If a licensee were to come to us a few months or a few years later and say "we goofed, we need 10% of that old payment refunded," we would not have that money. It is burdensome for SoundExchange to claw back royalties that have already been distributed to artists and copyright owners, and in some cases (such as where a payee does not receive a steady stream of royalties, or repertoire has been transferred to a new owner) it may simply be impossible. It would be grossly unfair to ask us to pay interest to licensees on overpayments when we have not been holding their money and may not even be able to recover the overpayment from the payees to which it has been distributed.

### C. Unclaimed Funds

Sirius XM has proposed conforming the unclaimed funds provision of Section 382.17 to the language adopted by the Judges in *Web IV*. The only justification Sirius XM provides for this proposal is one sentence in Mr. Barry's testimony explaining that Sirius XM would like "to avoid a rule that might preempt state law." Barry WDT, at 6. I do not understand why Sirius XM has that desire. It does not have any direct interest in whether unclaimed funds are used to support the statutory license system, thereby reducing costs to artists and copyright owners, or used to fund state budgets.[9] The Register has acknowledged as much. *Web I*, 67 Fed. Reg.

[9] *See, e.g.*, Matthew Albright, Settlement Watched for Impact on Delaware Budget, The News Journal (Aug. 8, 2016) (unclaimed property is the third-largest revenue source for Delaware state government, constituting about half a billion dollars annually), *available at* http://www.delawareonline.com/story/news/local/2016/08/08/unclaimed-property-settlement/88387730/; Jeff Mordock, 21 States Sue Delaware over Unclaimed Property, The

45,240, 45,267 (July 8, 2002) (accepting CARP finding that "Services ha[ve] no real stake in deciding [distribution] issue[s] because their responsibilities and direct interest end with the payment of the royalty"). I can only conclude that Sirius XM thinks the possibility of escheat might create budget pressure on SoundExchange and thereby diminish its ability to represent effectively the interests of artists and copyright owners in proceedings like this, in audits and enforcement litigation, and otherwise.

As I described in my direct testimony, this is a point as to which SoundExchange believes that a departure from the *Web IV* language is justified. The *Web IV* language eliminated the clear direction to SoundExchange to apply unclaimed funds to offset deductible costs under 17 U.S.C. § 114(g)(3), and the clear statement that the regime adopted by the Judges applies "notwithstanding the common law or statutes of any State," and replaced those directions with a less certain reference to other applicable law. The Judges should not replace the current clear rules concerning the disposition of SDARS (and PSS) unclaimed funds with ones that are less clear, and so may be susceptible to differing interpretations and the possibility of future disputes.

Current 37 C.F.R. § 382.8 and § 382.17 embody an appropriate disposition of statutory royalties that cannot be distributed. Artists and copyright owners have done a favor for licensees by creating SoundExchange to collect and distribute statutory royalties, as a result of services' advocating for the creation of an entity to relieve them of the burden of paying artists and copyright owners directly. 63 Fed. Reg. 34,289, 34,293 (June 24, 1998) ("the Services urged the Office to designate a single Collective," arguing that "the costs of direct service upon owners of

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News Journal (June 9, 2016) (unclaimed property constitutes about 15% of Delaware state government's annual income); *available at* http://www.delawareonline.com/story/news/2016/06/09/21-states-sue-delaware-over-abandoned-money-orders/85647708/.

the 10 million songs performed by each service annually would cripple them"). However, while SoundExchange is run very efficiently, it is not without cost to artists and copyright owners. Services such as Sirius XM, rather than artists and copyright owners, would have to bear these costs if Sirius XM was obligated to distribute its royalties directly to the proper payees, rather than having SoundExchange to perform that function for it. In the earliest days of the statutory license, the Copyright Office wisely decided that those costs should be mitigated through the use of unclaimed funds. The Judges have been tasked with setting rates and terms under the federal statutory license. There is no federal purpose under the statutory license to be served by any disposition of unclaimed funds that arguably might divert some of those funds to uses other than the federal statutory license system. The Judges should carry out their federal mandate by clearly prescribing a uniform federal disposition of statutory license royalties.

The Judges adopted their *Web IV* unclaimed funds provision "in abundance of caution." 81 Fed. Reg. at 26,400. If the Judges continue to harbor any doubts as to whether, pursuant to their delegated federal authority, they are empowered to adopt a uniform national rule for disposition of unclaimed statutory royalties as their predecessors did before them, the Judges should resolve those doubts by referring the issue to the Register of Copyrights. Otherwise, they should use statutory royalties for purposes of the statutory license, and continue to provide the clear direction expressed in the current regulations.

### D. Clarification of Applicable GAAP

Sirius XM has proposed modifying the definition of "GAAP" currently in Section 382.11 to specify that GAAP compliance is to be determined by the version of GAAP in effect at the time the licensee calculates and makes its royalty payment. SoundExchange does not believe

that it is important to address this point, but is not opposed to specifying that the version of GAAP to be used is the one in effect at the time the payment is *due*.

First, SoundExchange believes the proposed change is unnecessary. I inquired of the SoundExchange staff involved in handling licensee audits and disputes, and none of those individuals recalls any instance in which the resolution of a question concerning the amount of a disputed royalty payment depended on the particular GAAP provisions in effect at a certain time. With respect to Sirius XM specifically, while it is true that some royalty disputes with Sirius XM (including the pre-1972 royalty deduction issue recently addressed by the Judges in reopened *SDARS I*) have depended on application of GAAP, we again are not aware of any circumstance in which changes in GAAP during the pendency of an underpayment or dispute would have affected the calculation of Sirius XM's royalty liability. Thus, this does not seem to us to be an important issue for the Judges to address.

If the Judges are nonetheless inclined to address it, it seems like the right version of GAAP to be used is the one in effect on the date the payment is due. Sirius XM's obligation with respect to the payment of royalties is to make payments on certain dates, with those payments being determined with reference to GAAP. 37 C.F.R. §§ 382.11, 382.12(a), 382.13(c). It follows naturally that the payment due on date *X* should be calculated with reference to GAAP on date *X*. Under that natural interpretation of the current regulations, the licensee's liability is both knowable and fixed as of the date the payment is due.

That stands in contrast to Sirius XM's proposal, where the licensee's liability would not be conclusively known or fixed until the licensee decided to pay it. First, it should be recognized that Sirius XM has proposed determining GAAP compliance with respect to what are potentially two different dates – the date of royalty calculation and the date of royalty payment. If those

dates are not the same, they typically would probably only be somewhere from a few days to a couple weeks apart (depending on how long it takes the licensee to issue its payment and get it to us). However, those dates could potentially be separated by a long time, depending on what the licensee does, increasing the chances of a GAAP change in the interim. If the Judges wish to clarify the date on which GAAP compliance is to be determined, they should choose one date, not two.

Second, the date of royalty calculation would not necessarily be known to SoundExchange, meaning that we would not necessarily be able to assess GAAP compliance as of the date of royalty calculation, unless that was a date the licensee was required to disclose to us. Particularly if an issue was to arise only years later in an audit, it may be difficult to figure out what the date of royalty calculation was, unless it was memorialized in a record such as the statement of account.

Finally, the date of royalty payment depends on the licensee's compliance with its payment obligations. While one might expect the date of payment to be close to the date the payment is due, that often is not the case. And in the case of an underpayment that is eventually made good, Sirius XM's proposal seemingly contemplates the possibility of using different versions of GAAP to calculate the initial and final payments. A licensee's royalty liability for a particular month should not fluctuate over time based on changes in GAAP after the due date, and be finally determined only when the licensee finally chooses to make its payment.

For these reasons, if the Judges wish to specify the version of GAAP to be used, that version should be the one in effect at the time the payment is due.

### E. Auditor Independence

Sirius XM has proposed modifying the definition of the term Qualified Auditor to specify that the independence of the auditor is to be determined within the meaning of the AICPA Code of Professional Conduct. I want to be very clear that SoundExchange agrees with the principle that royalty verifications should be carried out by independent auditors.[10] That is set forth expressly in the definition of Qualified Auditor in SoundExchange's proposed Section 382.7. However, SoundExchange believes that Sirius XM's proposed change is unnecessary and conceptually problematic.

First, the change is unnecessary. I have provided a copy of the current version of the AICPA Code of Professional Conduct as SoundExchange Exhibit 70. Sirius XM's proposal seems to refer to the "Independence Rule" in Section 1.200 of the Code. Some aspects of that rule are obviously irrelevant here. For example, royalty verifications do not involve initial public offerings or representation in Tax Court (§ 1.200.010.13), and nobody owns a stake in SoundExchange (§ 1.200.010.16), because it is a nonprofit organization. Other aspects of the rule do not seem to add anything to what the Judges have previously said about auditor

[10] The regulations use the terms verification and audit interchangeably, and I follow that colloquial convention in this testimony. However, I am reminded by the SoundExchange staff who work with our auditors that a verification of statutory royalty payments is not what a CPA considers to be an "audit" when using that word as a term of art. As a matter of accounting practice, an audit is a very specific kind of engagement in which a CPA is asked to obtain assurance that a company's "financial statements as a whole are free from material misstatement" and express a professional opinion that "the financial statements are presented fairly, in all material respects, in accordance with an applicable financial reporting framework." AICPA Codification of Statements on Auditing Standards (AU-C) § 200.12(a). Such an audit is something that Sirius XM obtains so that public securities markets and others can have confidence that its financial statements fairly represent the company's overall financial condition. Such an audit is a very different thing from determining whether a statutory licensee has calculated its statutory royalty payments in accordance with the applicable regulations.

independence. For example, we have always understood that an independent auditor could not be someone who is an officer or director of SoundExchange (§ 1.200.010.15). But to the extent the rule has any additional significance, it already applies. The Judges have specified that a Qualified Auditor is to be a CPA, and no participant in this proceeding has suggested otherwise. It is my understanding that CPAs must abide by the Code. Thus, the proposed reference to the Code does not currently seem to add anything to the requirement that a Qualified Auditor be a CPA.

While one might conclude from the foregoing that there is no harm in adopting Sirius XM's proposal, SoundExchange believes that going down a road of selectively writing into the statutory license regulations an additional layer of federal regulation of a state-regulated profession is conceptually problematic. In this respect, Sirius XM's proposal seems similar to the *Web IV* language concerning local CPA licensure that I opposed in my direct statement.[11]

Public accountancy is a profession regulated by the states. That is why the Judges have determined that royalty verifications should be conducted by CPAs. The Judges' determination that royalty verifications should be carried out under the supervision of a CPA effectively incorporates by reference the whole body of state law concerning the regulation of public accountancy. Having done that, the Judges should leave regulation of CPAs to the AICPA and state regulators with expertise in that field.

State regulation of CPAs is complex and dynamic. Selectively incorporating into the federal statutory license regulations bits and pieces of the state law concerning the regulation of

[11] Fortunately, no participant in this proceeding has proposed that a CPA performing an audit be licensed in the particular jurisdiction involved. As I explained in my direct testimony, the addition of that requirement in *Web IV* seems to have been based on a misunderstanding of applicable state law regulating the field of public accounting.

CPAs risks creating a layer of federal regulation that is, or could become, inconsistent with the state regulation of CPAs. We saw that with the *Web IV* language concerning CPA licensure, which imposed a local licensure requirement that the states in recent years have chosen to move away from as they have implemented "CPA mobility" legislation. Having inconsistent bodies of federal and state regulation of CPAs involved in royalty audits risks complicating those audits even more than is already the case. Given that the Judges have decided that audits should be conducted by CPAs because they are a state-regulated profession, the Judges should resist the temptation to write into their regulations even innocuous-sounding aspects of state law concerning the regulation of CPAs.

### F. Certain *Web IV* Changes

In their rewrite of the regulations in *Web IV*, the Judges made various other changes that SoundExchange is proposing by working from those regulations as the starting point for its proposal, and that Sirius XM (and Music Choice) are effectively opposing by using their current regulations as the starting points for their proposals. Where not otherwise addressed by SoundExchange, the Judges should adopt these changes here for the reasons they adopted them in *Web IV*. I will point out just three of these.

First, in *Web IV*, the Judges expanded the attestation in Section 380.3(a)(8) and added the certification in Section 380.3(b). Those provisions may be even more important for SDARS (and PSS) than they are for webcasters. Most webcasters pay only the minimum fee, and even when webcasters pay running royalties, accounting for performances is more straightforward than accounting for revenues (which has been the rate structure for both SDARS and PSS in the past, and we propose continuing as part of the rate structure for SDARS). These certifications help ensure that licensees will take their statutory license payment obligations seriously, and that

goal is at least as important for SDARS and PSS as it is for webcasters. Moreover, these provisions apply to Sirius XM when it webcasts. The new attestation and certification should apply to Sirius XM's SDARS (and to the PSS as well).

Second, in *Web IV*, the Judges made significant changes in the provisions concerning audit results. *See* 37 C.F.R. § 380.6(g). Beyond the late fee issue discussed above, all aspects of this provision should apply to any audit of Sirius XM's SDARS (and to the PSS) just as it applies to an audit of Sirius XM's webcasting, because nothing in the nature of the various services provides any reason to believe that the results of auditing them should be treated differently.

Finally, in *Web IV* the Judges clarified the retention period for unclaimed funds. *See* 37 C.F.R. § 380.4(b). Language similar to that in the former more ambiguous webcasting provisions is in the current SDARS regulations at Sections 382.13(f)(2) and 382.17. It is also in the PSS regulations at Sections 382.4(d)(2) and 382.8. This ambiguity should be resolved here as it was in *Web IV*.

## III. Issues Raised by Music Choice's Proposed Regulations

SoundExchange's concerns with Music Choice's proposed PSS regulations are largely addressed by my direct testimony and the previous two parts of this rebuttal testimony. However, because Music Choice has proposed basing the PSS regulations to be determined in this proceeding on the current PSS regulations, and certain details of the PSS confidentiality and audit provisions differ from those applicable to SDARS and webcasters, our proposals concerning those topics differ as to those details. Accordingly, I address those details briefly below.

### A. Confidentiality

For historical reasons, the PSS confidentiality provisions are different from the *Web IV* confidentiality provisions in a few respects. However, there is insufficient reason to maintain these differences.

First, Section 382.5(a), in contrast to Section 380.5(a), includes in the definition of confidential information not only statements of account and certain information pertaining thereto, but also certain information designated as confidential in a separate confidentiality agreement. That is unnecessary, and confusing to the extent that it might suggest a different scope of use of such information than the parties may have agreed in a confidentiality agreement. If the parties enter into a confidentiality agreement, that agreement should apply in accordance with its terms. Contemplating the possibility of such an agreement in the regulations adds nothing to what might be agreed in the agreement.

Second, Section 380.5(b) specifies a limitation on SoundExchange's use of confidential information that does not seem to be contained in Section 382.5. While it is somewhat against our interest, we have proposed adding this provision for the sake of consistency.

Third, Section 382.5(b) uses somewhat different language than Section 380.5(c) to identify the persons that may be provided access to confidential information. These differences are unnecessary. For example, Section 382.5(b)(1) contains language addressing the possibility of SoundExchange employees, agents, consultants and contractors that are simultaneously employed by an artist or record company. However, the only confidential information that is provided to SoundExchange pursuant to this provision are statements of account, and disclosure of PSS statements of account to record companies and artists is permitted by Section 382.5(b)(3). Trying to keep statements of account away from record companies and artists in 382.5(b)(1)

when they can be provided under 382.5(b)(3) is just the kind of pointless complexity the Judges tried to avoid in their *Web IV* revision of the regulations. Likewise, Section 382.5(b)(2) goes out of its way to say that statements of account can't be provided to an auditor who is an employee of a record company or artist. But an employee of a record company or artist would not seem to be an *independent* auditor, and auditor independence is separately required by the regulations.[12] It is SoundExchange's practice to engage independent outside audit firms to conduct its royalty verifications.

In addition, Section 382.5 does not specifically mention use of statements of account in proceedings before the Judges, while 380.5(c)(4) does. Similarly, Section 382.5 does not specifically mention SoundExchange's outside counsel, while Section 380.5(c)(2) does (and we have separately proposed a change in their treatment). In both cases, the differences seem nonsubstantive. As to the former, the protective order applies. As to the latter, outside counsel are presumably among SoundExchange's agents, consultants and independent contractors. There is nothing special about PSS statements of account that would explain or justify a different treatment in this respect than applies to webcasters.

### B. Audit Process

[12] I understand that in *SDARS II*, Music Choice argued against a similar proposal by SoundExchange by pointing to some episode in which it agreed to be audited by an auditor who assertedly was somehow affiliated with a record company. Del Beccaro *SDARS II* WRT, at 23. I was not able to identify anyone on the SoundExchange staff with any knowledge or recollection of this alleged episode, so I do not know whether it involved activity inconsistent with the current regulations, or even occurred at all. Because we have conducted few audits of Music Choice, it must relate to the audit of Music Choice covering the years 2001 to 2003, which was closed long before the time of most current SoundExchange staff. However, to the extent there was a genuine auditor independence issue at that time, it seems from Mr. Del Beccaro's *SDARS II* testimony to have been the result of a waiver of the independence requirement that he granted and now regrets, rather than a problem with the regulatory provision requiring that auditors be independent.

There are likewise differences between the PSS and webcasting audit processes that are not justified by anything unique about PSS and should therefore be harmonized. Many of these differences arise from the Judges' major revision of the royalty verification procedures in *Web IV*. These include specifying that overpayments are within the scope of an audit, contemplating the possibility of settlement, and addressing the consequences of overpayments. See 37 C.F.R. § 380.6(g). Other differences are ones that have arisen from the gradual evolution of the SDARS and webcasting audit provisions over time, while the PSS audit provisions have remained largely in the form they were originally adopted in 1998. These include (1) specifying that audits may cover three-year periods (37 C.F.R. § 380.6(b)), while in the case of PSS, that is only implied by the three-year record retention requirement in Section 382.4(e); (2) specifying that the party under audit must endeavor to provide access to records concerning its activities that are maintained by third parties such as its contractors (37 C.F.R. § 380.6(e));[13] and (3) creating a process for the party under audit to provide input to the audit report (37 C.F.R. § 380.6(f). In the aggregate, and as to most of these differences individually, it is not clear that these differences favor one party over the other. But collectively they represent a 20 year effort by the Judges and

[13] I understand that in *SDARS II*, Music Choice argued that a proposal by SoundExchange to add a provision concerning access to third party records would be "incredibly burdensome, with a serious potential to adversely impact Music Choice[]." Del Beccaro *SDARS II* WRT, at 25. Any such hyperbole in this proceeding should be viewed with skepticism. Music Choice is already subject to the third-party records provision for its business establishment service. 37 C.F.R. § 384.6(d). There is no reason to think that extending this provision to its PSS offering would be any more problematic. Conversely, this is a very important provision as to some services. In a number of audits of services other than Music Choice, we have had significant disputes with licensees who have consciously chosen to leave most evidence of their use of recordings under the statutory license in the hands of their contractors, and refused to do anything to try to provide access to such records to enable verification of their royalty payments. It is not surprising that Music Choice is keen to retain a structure in which it has the option to hide its business records in the files of contractors and no obligation to even try to provide access to an auditor.

their predecessors to refine and clarify the audit process. There is nothing unique about PSS that suggests that the audit process for those services should remain forever frozen in 1998.

I do note, however, one instance in which the current PSS audit provision differs from the webcasting provision, and the PSS provision should be retained. Since 1998, the PSS provision has provided for shifting of audit fees upon a 5% underpayment. 37 C.F.R. § 382.6(f). Music Choice has not proposed any change in this arrangement. However, the webcasting provision shifts the audit fees only upon a 10% underpayment. 37 C.F.R. § 380.6(h). As I explained in my direct testimony, the 10% threshold can perhaps be justified as saving generally low-paying webcasters from the risk of having to reimburse audit fees that may be high relative to an underpayment of a few thousand dollars. However, the PSS (as well as Sirius XM) are among the services paying the highest levels of statutory royalties. Thus, even a 5% underpayment by them is a significant amount of money. Because the audit fee shifting provision is only relevant infrequently, having a difference between this aspect of the PSS provision and the provisions applicable to webcasting and SDARS is not a material operational complication. The 5% threshold currently applicable to PSS should continue to apply (and also apply to SDARS).

## IV. Webcasting by Music Choice and Stingray

Music Choice's direct case confirms that it makes Internet webcasts, including by providing 25 channels that are available over the Internet. Del Beccaro WDT, at 16. SoundExchange does not necessarily accept Music Choice's argument that it is permitted to make the webcasts it does under its PSS license, but it is not necessary to decide that question in this proceeding, because the purpose of this proceeding is to set rates for the activities that a PSS is permitted to undertake. Even if Music Choice is permitted to webcast under its PSS license,

that does not mean that it should get to make that use of copyrighted recordings at no additional charge beyond payment for its television-based service. Accordingly, SoundExchange proposes that when a PSS webcasts (to the extent it is permitted to do so under a PSS license), it pay a royalty for that privilege commensurate with the royalties paid by other services engaged in the same activity.

Music Choice's direct case also confirms that Music Choice views the CABSAT service provided by Stingray as a competitor of Music Choice. *See, e.g.*, Del Beccaro WDT, at 30-31. In view of that, I think it is important to clarify that when Stingray webcasts in reliance on the statutory license, [ ].[14]

[14] [ ]

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

Date: Feb 16, 2017

Jonathan Bender

# Exhibits Sponsored by Jonathan Bender

| Exhibit No. | Description | Designation |
|---|---|---|
| SX Ex. 069 | Federal Reserve Selected Interest Rates | Public |
| SX Ex. 070 | AICPA Code of Professional Conduct | Public |
| SX Ex. 071 | [Redacted] | Restricted |
| SX Ex. 072 | [Redacted] | Restricted |