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DISCUSSION DRAFT OF THE SECTION 115 REFORM ACT (SIRA) OF 2006

HEARING

BEFORE THE

SUBCOMMITTEE ON COURTS, THE INTERNET, AND INTELLECTUAL PROPERTY

OF THE

COMMITTEE ON THE JUDICIARY
HOUSE OF REPRESENTATIVES

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DISCUSSION DRAFT OF THE SECTION 115 REFORM ACT (SIRA) OF 2006

TUESDAY, MAY 16, 2006

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON COURTS, THE INTERNET,
AND INTELLECTUAL PROPERTY,
COMMITTEE ON THE JUDICIARY,
Washington, DC.

The Subcommittee met, pursuant to notice, at 4:05 p.m., in Room 2141, Rayburn House Office Building, the Honorable Lamar Smith (Chairman of the Subcommittee) presiding.

Mr. SMITH. The Subcommittee on Courts, the Internet, and Intellectual Property will come to order. It is nice to see a nice audience out here interested in such an important subject. I also was going to say, but maybe now don't need to say, that I wasn't expecting any other Members to be present because votes were canceled for tonight and there are no votes for tomorrow. We especially appreciate the attendance of other Members who are here, and actually, I am expecting a couple more in addition to the ones who are already present.

I am going to recognize myself for an opening statement, then the Ranking Member for an opening statement. Without objection, all other Members' opening statements will be made a part of the record, and after that, we will look forward to the testimony of our witnesses today.

Today, the Subcommittee continues its efforts to reform section 115 of the Copyright Act, which addresses mechanical licensing. However, instead of identifying the problems in the music industry, we will hear today about a possible solution that has been jointly suggested by the music publishers and the on-line music companies. They deserve great credit for the overall time and energy they have spent and for the progress that has been made to date.

The music industry has evolved from simple business models focused around the distribution of physical items, such as compact disks, to a dynamic digital marketplace where new business models evolve rapidly. The laws that set out the framework for the digital licensing of musical rights in this industry are outdated and, some say, beyond repair.

The discussion draft before the Subcommittee today creates a new blanket license for certain digital uses of music. Digital music is the future of the music industry. The laws that enable this industry to operate need to look to the future, as well.

In addition to creating a blanket license, the discussion draft creates competition among those who will issue such blanket licenses

to ensure that antitrust issues do not arise. For missing copyright owners, the draft also ensures that a license can still be issued for the use of their work and give the owners 3 years to step forward to be paid their royalties. The draft also enables direct licensing to occur.

When digital music services began, the lack of a legal framework for licensing became a major obstacle to meeting consumers' needs quickly. Online music companies made several millions of dollars worth of escrowed payments in order to obtain licenses for which rates had not been set. Those rates have still not been set, thereby preventing distribution of the royalties to the artists who, of course, deserve them.

Upon enactment of this legislation, this escrowed money and more will finally be distributed to the artists. Outdated laws that make artists wait years to be paid are currently not fair to anyone involved.

Although this discussion draft reflects agreement on many points between the Digital Music Association and the National Music Publishers' Association, there are a few areas in which agreement still has not been reached between the two parties. Two of the issues that remain outstanding between DMA and the publishers are, one, the cost of setting up and running a modern licensing system and who should bear those costs, and two, the proper definition of an interactive stream. The areas of disagreement are in bracketed text in the discussion draft that many of you all have in front of you.

There are other issues we will hear about today. For instance, some think that the scope of this proposal should be expanded to cover all works, digital and physical alike. With a limit of four witnesses, the Copyright Office cannot be here in person. However, they have provided written testimony for the record, which I will read a statement from, and without objection, their entire statement will be made a part of the record, as well.

Here is a quote from the Copyright Office. "The immediate benefit that the SIRA," that is the underlying draft legislation, "could bring to the music industry should not be delayed pending resolution of the other issues or bills, nor should the fate of the SIRA be tied to that of other legislation," end quote.

[The prepared statement of the Copyright Office follows in the Appendix.]

Mr. SMITH. There is no question about the need, but only how to reform American music licensing laws. Music licensing reform is necessary to pay artists and to make legal copies of music available to consumers.

That concludes my opening statement and the gentleman from California, Mr. Berman, is recognized for his.

Mr. BERMAN. Thank you very much, Mr. Chairman. Thank you for scheduling this hearing on the discussion draft of the section 115 music licensing reform.

We've come a long way from the initial piracy-laden version of Napster released in 1999. The IFPI, sometimes known as the International Federation of Phonogram and Videogram Producers, digital music report of 2006 notes the growth of digitally-delivered content in the music industry. Four-hundred-and-twenty million

single tracks downloaded in 2005 globally, double that of 2004—more than double. Three-hundred-and-fifty-three million single tracks downloaded in the U.S., up from 143 million. The number of subscription services, such as Rhapsody and Napster, increased from 1.5 to 2.8 million globally in 2005. In 2005, the number of legitimate music download sites reached 335, up from 50, 2 years ago. Digital sales in 2005 accounted for approximately 6 percent of global music sales based on the first half of the year.

Two-thousand-and-five was a landmark year for digital music. Just last week, The Washington Post reported that ring tones, once dismissed as nothing more than a passing fad, have become a $3 billion worldwide market. But the burden surrounding licensing often delays, if not prevents, certain music from getting to the consumer. Unfortunately, this inability to provide music at any time, at any place, in any format, may precipitate consumer migration back to unauthorized peer-to-peer services.

Two years ago, the Copyright Office suggested that reform of the 115 license should reflect a structure similar to that which is currently available for the 114 license, a designated agent which serves as a collector to administer a blanket license. I am encouraged to see that the discussion draft reflects that idea. I commend the publishers on their hard work. They have tried diligently to resolve the problems that the DiMA companies have illustrated, particularly the double-dip and one-stop-shop issues.

However, I am concerned that with an impending markup less than 2 weeks away, a number of important details of the bill have yet to be agreed upon. I will focus on some of those issues during the question and answer.

Furthermore, any solution can only be evaluated from a perspective of the scope of the problem originally identified. Two years ago at an oversight hearing on section 115, I posed two questions which I would ask again today. Does 115 facilitate or hinder the roll-out of new legal music offerings? And depending on the answer to the first question, what, if anything, should Congress do to change 115?

While this proposed legislation addresses many of the digital concerns, unresolved still are the many issues encountered in the physical market or in the area of hybrid services. The roll-out of new secure physical formats or high-quality formats oftentimes require additional reproductions. This roll-out has been sluggish. There is little resolution to the business model which provides preloaded content on devices. Finally, many definitional questions remain, such as whether the license includes ring tones or if a kiosk service is a reproduction of digital case or digital phonorecord delivery service. Some of these questions may require a purely economic analysis. Others may require reevaluation on the processed level.

So we have solved some issues. We have a potential solution to some issues. Other issues are not resolved. How we should handle that, I think is a question for this Subcommittee and I hope we can achieve greater clarity and further consensus as this bill moves forward.

[The prepared statement of Mr. Berman follows in the Appendix.]

Mr. SMITH. Thank you, Mr. Berman.

Before I introduce the witnesses, I would like to ask you all to stand and be sworn in, please. If you will raise your right hand, do you swear to tell the truth, the whole truth and nothing but the truth, so help you, God?

Mr. ISRAELITE. I do.

Mr. POTTER. I do.

Mr. CARNES. I do.

Mr. SHERMAN. I do.

Mr. SMITH. Thank you. Please be seated.

Our first witness is David Israelite, the President and Chief Executive Officer of the National Music Publishers' Association. Founded in 1917, NMPA represents American music publishers and their songwriter partners. From 2001 through early 2005, Mr. Israelite served as Deputy Chief of Staff and counselor to the Attorney General of the United States. In March of 2004, the Attorney General appointed him Chairman of the Department's Task Force on Intellectual Property. Mr. Israelite earned his J.D. from the University of Missouri in 1994 and received a B.A. in a double major of political science and communications from William Jewell College in 1990. David, we usually don't put in all those dates, but you got special attention today. [Laughter.]

Mr. SMITH. Our second witness is Jonathan Potter, who is the Executive Director of the Digital Media Association, DiMA, a position that he has held since DiMA was organized in June 1998. DiMA's goal is to represent the leading companies that provide online audio and video content to consumers. Mr. Potter appears frequently before this Subcommittee and has worked with David Israelite to develop the discussion draft before the Subcommittee today. Mr. Potter is a graduate of New York University School of Law and the University of Rochester. No dates there, Jon.

Our third witness is Rick Carnes, the President of the Songwriters Guild of America. Previously, Mr. Carnes has served as SGA Vice President and has represented SGA on numerous panels regarding contractual, technological, and legal issues affecting songwriters. A native of Memphis, Tennessee, Mr. Carnes and his wife, Janice, moved to Nashville in 1978. Soon after, they signed their first record deal with RCA Records, later recording for Warner Brothers and MCA Records. In 1983, Mr. Carnes wrote Reba McEntire's first number one hit, "I Can't Even Get the Blues No More," and co-wrote with Janice and Chip Harding three top ten hits for the Whites, "You Put the Blue in Me," "Hanging Around," and "Pins and Needles." Mr. Carnes is a graduate of Memphis State University with a B.A. in political science and a master's in elementary education.

Our final witness is Cary Sherman, who is the President of the Recording Industry Association of America. The trade group has more than 350 member companies that are responsible for creating, manufacturing, or distributing 90 percent of all legitimate sound recordings sold in the United States. The $14 billion U.S. sound recording industry is the largest market for pre-recorded music in the world. Mr. Sherman graduated from Cornell University in 1968 and Harvard Law School in 1971. An accomplished musician and songwriter, Mr. Sherman is an officer of the board of the Levine School of Music in Washington, D.C.

We welcome you all and look forward to your testimony, and Mr. Israelite, we will begin with you.

TESTIMONY OF DAVID M. ISRAELITE, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL MUSIC PUBLISHERS' ASSOCIATION (NMPA)

Mr. ISRAELITE. Mr. Chairman, Mr. Berman, Members of the Subcommittee, I appreciate this opportunity to appear before the Subcommittee to address music licensing in the digital age and the proposed Section 115 Reform Act of 2006.

Over the last year, we have been hard at work negotiating with the organizations represented at this table and with other music groups. The draft bill represents much progress from those negotiations. I would like to thank you, Mr. Chairman and Mr. Berman and your staffs for their hard work and your leadership on this issue.

No one involved in the music industry today will tell you that the way that the industry is structured makes sense. Today's music business is the result of a great deal of historical anomalies and unnatural evolution. Issues involving music licensing can be very complicated and very confusing, but underneath all of the legislative language and legal concepts, there are some very simple principles.

Every piece of recorded music contains two copyrights. One copyright belongs to the songwriter, represented by a music publisher, for the words and notes. The second copyright belongs to the artist, represented by a record label, for a recorded version of that song.

This is what is known as a piano roll, used in player pianos that were popular 100 years ago. Through the late 19th century, the music industry was dominated by music publishers. Their business was sheet music and later piano rolls. There was no such industry as the recording industry. Because Congress was concerned about a potential monopoly in the piano roll business, in 1909, Congress imposed a compulsory license on music publishers and songwriters.

The importance of recorded music grew in the early 20th century, and by the end of World War I, recorded music surpassed sheet music as the largest element of the music business. However, Congress never imposed a similar compulsory license on the copyrights owned by record labels. The result was the existence of two distinct, independent copyrights, one governed by a compulsory license and one free from Government regulation and control.

I have had the honor of representing music publishers and their songwriter partners for a little more than a year. I have explained to a large number of people what a music publisher does and how the music business is organized. When I explain that every song contains two copyrights, one representing the songwriters' efforts and one representing the recording artist's efforts, the response is one of understanding. But when I explain that what a record label charges for the artist's copyright is determined in a free market but that the Government tells a songwriter how much money he or she will make on every song sold, the response is one of confusion and bewilderment.

In the past, this system of unequal copyrights worked because music licensing involved music publishers licensing their copyrights

to record labels. Those record labels then sold the music containing both copyrights to the consumer in the form of an album, an eight-track, a cassette, or a CD. But in just the last few years, the emergence of new technologies in the digital world has revolutionized the music industry.

Most new entrants into the music business are third parties, like the companies that Mr. Potter represents, who do not own either copyright but wish to sell the copyrights owned by others. The result is that these third parties must engage in two different licensing processes, one with record labels, where the record labels can negotiate in a free market, and the second with music publishers, where the Government sets the terms and conditions.

Put simply, the current process of licensing copyrights that are treated unequally under the law to third parties doesn't work. NMPA supports eliminating the compulsory licensing regime. We would prefer to bargain with third parties in a free market, as our friends do at the record labels. But until that is possible, music publishers are willing to help create a new licensing system for digital uses under section 115. And again, we support these changes based on some very simple principles.

First, we must not allow the perfect to be the enemy of the good. Congress will never be able to address all of the historical issues of the music industry in one piece of legislation and it should not slow real progress on music licensing just because consensus cannot be reached on everything. The physical licensing process has been in effect for close to a century and it is not broken. Physical products are licensed on a song-by-song basis, such as CDs and albums, and the vast majority of such products are, of course, already licensed. Unlike digital music providers, record labels are not in the position of suddenly needing licenses for a million different CDs.

Second, the copyright of the songwriter and music publisher deserves no less respect and consideration than the copyright of the record label. Once a blanket licensing system is created, there is no good reason why music publishers and songwriters should not be able to license directly their property to third parties who wish to sell their property. The proposed legislation ends pass-through licensing and this is critical to our support of the bill.

Third, this legislation must clarify, as it does in its current form, what Congress intended all along with respect to interactive streaming, that it constitutes a digital phonorecord delivery and is licensable under section 115.

We thank you, Mr. Chairman, Mr. Berman, and the entire Committee for your work on this important issue and for your efforts on behalf of the songwriter and music publishing community.

Mr. SMITH. Thank you, Mr. Israelite.

[The prepared statement of Mr. Israelite follows:]

PREPARED STATEMENT OF DAVID M. ISRAELITE

Testimony of David M. Israelite
President and Chief Executive Officer
National Music Publishers' Association
Before the House Judiciary Committee
Subcommittee on Courts, the Internet & Intellectual Property

May 16, 2006

Good afternoon, Mr. Chairman, Mr. Berman and Members of the Subcommittee. I appreciate this opportunity to appear before the Subcommittee today to address music licensing in the digital age and the proposed Section 115 Reform Act (SIRA) of 2006. I testified before this subcommittee a little over a year ago on digital concerns. At that hearing, I committed to work diligently to find solutions to the problems that have emerged with digital music licensing. Over the last year, we have been hard at work negotiating not only with the organizations represented at this table today, but also with other music groups. I am pleased to report that we are close to agreeing on a monumental reform of Section 115 that is supported by both the licensees and licensors in the digital world. I would like to thank you, Mr. Chairman and Mr. Berman, for your leadership on this important issue.

HISTORY

For those not familiar with Section 115 of the U.S. Copyright Act and music publishers, let me provide a quick overview.

A music publisher is a company or, in some instances, an individual, that represents the interests of songwriters by promoting their songs and by licensing the use of their songs for reproduction and distribution on CDs, over the Internet and for public performances, and by exercising the other rights available under copyright law. Music publishers are often involved at the very beginning of a songwriter's career. After

signing a writer to a publishing deal, a publisher will do everything from helping the writer find co-writers to securing artists to record the writer's songs. Often when a songwriter enters into a relationship with a publisher, the publisher will advance desperately needed money to the writer to help pay living expenses so the writer can focus on what he or she does best – write music.

Nearly a century ago, a new technology emerged that changed the music publishing industry forever by leaving a lasting impact on the law. That new technology was the piano roll — essentially long perforated sheets that operated a player piano's keys. To make sure that musical compositions were widely available for reproduction as piano rolls and in other forms, Congress in 1909 enacted the Section 115 mechanical compulsory license. This statutory mechanism allows anyone who wants to make use of a musical work to obtain a license to reproduce and distribute phonorecords of the work, in exchange for paying a royalty set by statute, as long as the terms and conditions of Section 115 are followed.

In the original 1909 Act, Congress set the statutory rate for reproducing and distributing musical works at 2 cents per song. Remarkably, this rate did not change for almost 70 years, until 1976 when Congress added a rate-adjustment mechanism for the statutory rate. Since that time, the statutory rate has increased only a few pennies — usually by industry negotiation — and today stands at 9.1 cents per song. If the mechanical statutory rate had increased commensurate with the Consumer Price Index, the rate today would be *40 cents* per song.

On the other side of the coin, the record industry has been able to thrive over the years in the marketplace and negotiate freely without suffering under the burden

of a compulsory license regime. When it comes to the use of master recordings to make and distribute CDs or digital downloads, there is no compulsory license indeed, no obligation to license whatsoever. For example, exercising their unfettered right to license their master rights for reproduction and distribution, record labels have negotiated licenses with digital subscription services that call for payments of 50% or more of the services' gross revenues for the use of sound recordings, while in many cases the songwriters who wrote the songs in those recordings, and the music publishers who represent them, have yet to be paid a penny. This is because no statutory rate has been set for the use of musical works by digital subscription services, and publishers have been unable to reach voluntary agreements for a fair share of royalties in an environment where they are forced to license their works anyway.

This legal regime has placed songwriters and music publishers at an inherent disadvantage in negotiating mechanical rates, especially for new digital services where no mechanical rate has been established.

CHALLENGES OF DIGITAL LICENSING

The emergence of new technologies in the digital world is revolutionizing the music industry. The most significant change is the ability to distribute phonorecords electronically over the Internet. According to the International Federation of the Phonographic Industry (IFPI) World Sales 2005, global digital music sales nearly tripled in 2005. We know that digital music is the future of the music business. Indeed, music publishers have every economic incentive to issue as many licenses to as many new, legitimate Internet music services as possible. It is only through such license agreements that music publishers and songwriters are compensated. For this reason, the songwriting

and music publishing communities have consistently worked with new businesses to promote broad public access to their works. However, the influx of new online music companies that want immediately to offer a million or more tracks has put enormous strain on the music publishing industry in licensing mechanical rights. Despite the continued assistance music publishers have provided to foster the development of online music distribution, music publishers recognize the need to reform Section 115 of the Copyright Act for the digital delivery of music.

Online music services have expressed concern regarding the availability of licenses for their services. In order to offer a track through a digital music service, the music provider must obtain a license for both the sound recording and the underlying musical work. The music provider obtains the sound recording license from the recording industry, at a price negotiated in a free market. And the same music provider obtains the musical work license from the publishing industry, at a price controlled by the government through Section 115.

Online music services may obtain the musical work license from the music publisher directly, from the Copyright Office, or through The Harry Fox Agency. Obtaining a mechanical license from each music publisher directly or being forced to go through the Copyright Office when the music publisher cannot be located is expensive and burdensome and is by no means a real option for digital music services that seek to offer a million plus tracks over the Internet.

Most digital services therefore use The Harry Fox Agency to obtain mechanical licenses. Founded in 1927, The Harry Fox Agency, Inc. (HFA) is a subsidiary, and the licensing affiliate, of the NMPA. It provides an information source,

clearinghouse and monitoring service for the licensing of copyrighted musical works, and acts as licensing and collection agent for more than 27,000 music publishers, which in turn represent the interests of over 160,000 songwriters. With its current level of publisher representation, HFA licenses the largest percentage of physical and digital uses of music in the United States — on CDs, tapes and records and by digital services. However, even though HFA represents most commercially relevant musical works, it does not currently represent all music publishers or all musical works, and, therefore, digital music services cannot receive all the licenses they need from HFA.

PROPOSED SECTION 115 REFORM ACT (SIRA)

NMPA continues to support eliminating the compulsory license regime, but until Congress is ready to do this, music publishers are willing to help create a new licensing system for digital uses under Section 115.

In his testimony before this subcommittee in March 2005, Jonathan Potter, Executive Director of the Digital Media Association (DiMA), stated that the solution to the problem with Section 115 is to create a simple, comprehensive statutory blanket license that can be triggered on one notice. This is exactly what NMPA has offered to DiMA, as reflected in the proposed SIRA legislation. NMPA has agreed to establish a common industry agent, or General Designated Agent, to represent music publishers and their musical works, and to provide blanket licenses for the use of those works by digital music services.

The blanket license reflected in the SIRA draft would cover all digital uses subject to compulsory licensing under Section 115, including full downloads, limited downloads and interactive streaming. The statutory royalty rates for these uses would be

set by the Copyright Royalty Judges. In addition, the SIRA legislation would grant DiMA royalty-free licenses to make the server and temporary copies of musical works that are required to engage in noninteractive, radio-style streaming.

Right now, under the statutory provisions of Section 115, the administrative burden is on users to obtain song-by-song licenses at their own expense. The blanket license in the draft SIRA would shift the administrative burdens of the licensing process to music publishers and songwriters. The draft bill therefore includes a provision under which digital music providers who are benefiting from the new system will contribute to the costs of getting the new blanket system up and running, and to its continued administration. If music publishers take on the responsibility of creating and maintaining a common designated agent administering over a million works, the digital music providers who will benefit from the new system should make a financial contribution to that effort. We are pleased that the DiMA companies have committed to do that.

The proposed SIRA legislation solves many problems for digital music providers. It also needs to resolve two critical concerns of songwriters and music publishers.

First, the legislation must clarify — as it does in its current form — what Congress intended all along with respect to interactive streaming: that it constitutes a digital phonorecord delivery and is licensable under Section 115. This is vital to the future of songwriters and music publishers, who will increasingly depend on the royalties earned by digital distribution of their works — whether as full downloads, limited downloads or interactive streams. All of these are substitutes for the sale of physical

products. Songwriters and music publishers are technology neutral – they want their works distributed in the way the public wants to receive them. If the world moves to an all-streaming model rather than a download model because that's what consumers want, copyright law should accommodate this. The draft legislation therefore confirms music publishers' and songwriters' right to collect mechanical royalties for interactive streaming – but leaves the royalty rates for this activity to be set by the Copyright Royalty Judges based upon a fair review of its economic value.

Songwriters and music publishers also want to end the practice of pass-through licensing of musical work copyrights by the record labels. The proposed SIRA legislation ends pass-through licensing, and this is critical to our support of the bill. There is no reason that the record labels should continue to act as middlemen or bankers when the digital service provider can take a license and pay the music publisher directly. In addition to speeding up the payment of royalties to the music publishers and songwriters who have earned them, ending pass-through licensing will increase the transparency of the royalty payment process and allow publishers to conduct royalty examinations of digital services to ensure they are complying with their obligations.

There are some in the music industry who may oppose digital licensing reform because it does not also radically transform the licensing regime for CDs and other physical products. This does not seem logical to us. The physical licensing process has been in effect for close to a century and is not broken. Physical products are licensed on a song-by-song basis as CDs and albums are released – and the vast majority of such products are, of course, already licensed. Unlike digital music providers, record labels are not in the position of suddenly needing licenses for a million different CDs.

There are also those who may view this as an opportunity to expand what the universe of what is subject to compulsory licensing under Section 115. While songwriters and music publishers are ready and willing to help facilitate the efficient licensing of musical compositions as contemplated by the proposed legislation, we would strongly oppose any attempt to expand SIRA to impose still more government control over publishers' and songwriters' copyrighted works – or create an even less level playing field for musical work copyright owners. Just as we know that the record labels would never agree to a compulsory license for those uses for which they enjoy the ability to negotiate in a free market, nor can we.

We thank you, Mr. Chairman, Mr. Berman and the entire Committee, for your work on this important issue and your efforts on behalf of the songwriter and music publishing community.

Mr. SMITH. Mr. Potter.

TESTIMONY OF JONATHAN POTTER, EXECUTIVE DIRECTOR, DIGITAL MEDIA ASSOCIATION (DiMA)

Mr. POTTER. Mr. Chairman, Mr. Berman, Members of the Subcommittee, on behalf of America's digital music innovators, I'm pleased to testify today to announce DiMA's agreement with NMPA in support of a new section 115 statutory reproduction rights license that will dramatically improve the digital music service's ability to compete against piracy and deliver more royalties to all industry creators.

For several years, DiMA members, including AOL, MSN, Yahoo!, Real Networks, and Napster, have sought to streamline the licensing of musical works' reproduction rights so that the process mirrors the licensing of performance rights. Simple, efficient administration with assurances that infringement risk has been eliminated if a company takes a reasonably standardized license and pays a fair royalty.

DiMA welcomes today's discussion draft as it is intended to accomplish precisely what we have requested, to update a 1909 statute for the digital era. DiMA and NMPA have agreed on many significant legislative goals that are reflected in the discussion draft bill. Everyone in the music industry wins, digital services, music publishers, songwriters, record labels, recording artists, and retailers, if the following changes become law and digital services can compete more effectively against piracy.

One, legal clarify. The discussion draft ensures that investors and innovators will know what rights are implicated by new digital music services, and as a result, the services will spend less money on lawyers and more on product development and marketing.

Number two, blanket license coverage. No longer will transaction costs and legal risk associated with song-by-song licensing undermine investment in new digital music offerings.

Three, flexible licensing alternatives. The draft authorizes the Copyright Royalty Board to decide the right royalty rate and the right royalty structure for each type of business activity that is licensed. The CRB will decide whether substantive and economic evidence supports a penny rate, a percentage of revenue rate, or something completely different.

Four, technologically neutral rights and licenses. The draft does not establish or limit rights, royalty standards, or obligations based on a services method of transmission technology or a consumer's choice of device. Uniform standards apply equally to cable, satellite, and internet services, as well as to PCs, mobile phones, and portable music devices.

Five, internet radio parity with broadcast radio. The discussion draft promotes fair competition by providing internet radio with effective royalty-free parity with broadcast radio with respect to server and incidental reproductions that facilitate a stream.

There are several provisions in the discussion draft that represent significant concessions by DiMA members. Quite significantly, DiMA members are willing to end years of dispute with NMPA by conceding the existence of reproduction rights in association with streaming services. DiMA and NMPA have agreed to split

our differences, which the discussion draft reflects in its provision of a royalty-free license for reproductions that facilitate internet radio and a potentially royalty-bearing license for reproductions that facilitate interactive streaming.

We agree that the legislation should not set a value for this or any other reproduction right, but rather that future negotiation or arbitration will determine the royalty rate. Moreover, we agreed that the legislation should leave open the possibility that the value of a reproduction right in some context might be zero.

DiMA disagrees, however, with the discussion draft's characterization of the interactive streaming reproduction right as a delivery or a distribution right. DiMA agrees with the Register of Copyrights that digital bits streamed to render a performance should not be deemed a legal distribution or delivery.

DiMA has also conceded to share in the costs music publishers will incur in modernizing their existing song-by-song licensing system in order to manage the new blanket license. This is a first, as such costs are typically covered by or deducted from royalty payments themselves. No other statutory or compulsory license imposes cost-sharing obligations on licensees, but as NMPA has absolutely insisted, we have agreed.

Finally, DiMA is caught in the decades-old battle between record companies and publishers regarding the draft's effective elimination of contractual controlled composition provisions as applied to digital licensing. DiMA understands both points of view. On one hand, the traditional sublicensing model has worked well for licensing digital phonorecord deliveries and legislative change is not necessary. On the other, publishers are demanding to license DiMA services through their own designated agents so as to remove intermediaries between their rights and their licensees and they have called this issue a deal breaker.

Mr. Chairman, these disagreements are meaningful and important, but not nearly as significant as our agreements. We believe the disagreements should be manageable in the context of moving forward on this legislation.

Once again, I thank Chairman Smith and Representative Berman for your leadership and for the opportunity to testify today. We look forward to working with you and your staffs to resolve remaining differences and to refine this discussion draft so it can become law in this session of Congress.

Mr. SMITH. Thank you, Mr. Potter. I appreciate that.

[The prepared statement of Mr. Potter follows:]

PREPARED STATEMENT OF JONATHAN POTTER

Mr. Chairman, Mr. Berman and Members of the Subcommittee:

I am pleased to join you today and announce the Digital Media Association's agreement with the National Music Publishers Association in support of a new, improved Section 115 statutory reproduction rights license that will dramatically improve the legal and business environment for digital music services. If stakeholders and the Subcommittee collectively can overcome some final hurdles and gain enactment of the conceptual agreements I will discuss, the result will be more innovation and competition among digital music providers, expanded music choice for consumers, and fair compensation to songwriters and music publishers.

As you know, DiMA represents America's leading digital music service innovators. Our member companies provide Internet radio, music download and music subscription services to millions of consumers nationwide. Offerings from AOL Music, Yahoo! Music, MSN Music, RealNetworks, the iTunes Music Store, MTV, Napster

and many more DiMA members are the marketplace solution to music piracy. As the new generation of music performance, music enjoyment and music retail services gain traction in the marketplace, our members' consumer-friendly innovations, feature-rich offerings, attractive pricing and passion for music will persuade American consumers that legal services are not just safer and smarter than illegal ones—they are better.

For several years DiMA members have sought to streamline the licensing of musical works' reproduction rights so that the process mirrors that of licensing musical works' performance rights—efficient, low-cost administration and assurances that infringement risk has been eliminated if a company takes a reasonably standardized license and pays a fair royalty. Today, I am hopeful that we are taking a giant step toward that outcome. For nearly two years, with this Subcommittee's encouragement and support, DiMA has negotiated with NMPA to develop a new reproduction rights licensing structure for digital music services. At various points, our negotiations also included several additional organizations and industries, including RIAA, NARM, BMI, ASCAP, SESAC, the Songwriters Guild of America, Nashville Songwriters Association, and the Recording Artists Coalition. But DiMA and NMPA determined that a narrower agreement among our two industries was most attainable this year, so we focused on what was possible.

Today I am pleased to report that DiMA and NMPA have agreed jointly to support several major amendments to the Copyright Act, including:

1. the creation of a statutory blanket license that will enable royalty-paying digital music services to gain all necessary musical work reproduction rights licenses from one or a handful of collective licensing organizations;
2. the clear provision of reproduction rights associated with digital radio services, including a royalty-free reproduction rights license for non-interactive digital radio; and
3. flexible, technologically-neutral rights, licensing processes, and reporting requirements.

Agreement to support this combination of amendments did not come easily to either digital music services or music publishers. But after years of disagreement and many difficult months of negotiations, DiMA and NMPA recognized our prevailing common goal—developing a healthier, stronger, broader-based and more dynamic digital music marketplace.

Legal Clarity and Simple Licensing Processes. Digital music services offer an extraordinary array of alternatives for consumers to enjoy: pre-programmed radio and paid downloads are most like traditional means of enjoying music—broadcast radio, and CDs sold at retail, respectively. In addition, digital services include:

- On-demand streaming, where a consumer creates a playlist and listens only to pre-selected songs
- Subscription downloads, which are essentially all-you-can-enjoy music rentals paid for with one monthly fee.

Unfortunately, not all these services fit neatly into the current reproduction rights legal regime, so well-intended DiMA members that have launched digital services have been in legal limbo for several years.

To reduce legal uncertainty and permit new types of services to launch, NMPA and The Harry Fox Agency, on behalf of HFA's publisher principals, agreed in 2001 to collectively license new digital music services to the extent legally possible, so long as the services paid agreed-upon advances against royalties (with a rate to be agreed in the future or determined by the Copyright Royalty Board). However, questions were raised as to whether the agreements actually accomplished the parties' goals and whether they could do so absent clarifying legislation. Fortunately, today's discussion draft and DiMA's agreement with NMPA are intended to provide the necessary clarification and ensure the effectiveness of these agreements, and to pave a clear path to similar agreements in the future.

By clarifying when reproduction rights apply and how those rights must be licensed, legislation will enable digital services to seek capital, innovate and build businesses with legal certainty. As I have testified before, the combination of legal uncertainty and statutory copyright damages chokes investment and innovation, which all too often leaves piracy as the most compelling consumer alternative.

Blanket license coverage. Under current law originally enacted in 1909, the right to reproduce or distribute a composition that is incorporated into a sound recording is compulsory, but song-by-song approvals by copyright owners are required. In the era of digital music, this song-by-song process has created enormous transaction costs for parties wishing to utilize the compulsory license, as new services require

more than 1 million songs for an offering to be competitive, and each song must be licensed again for each new service that is introduced.

The Harry Fox Agency can play an important role in streamlining the process, but only for publishers that authorize the agency to act on their behalf and only on a song-by-song offering-by-offering basis. Unfortunately HFA's well-intended effort to license compositions to new subscription services has fallen short, as many publishers have not signed up for the program. Highlighting this lack of uniformity, recently a DiMA member was sued for copyright infringement with respect to the activities and musical works that the service understood to be licensed by HFA.

The discussion draft changes this song-by-song license process and limits future risk of this type by ensuring that all copyrighted musical works are licensable on a blanket basis through one of a small number of collective licensing organizations referred to in the draft as Designated Agents. Like the SoundExchange system for sound recordings that are webcast and the ASCAP, BMI and SESAC systems for musical works' performance rights, the Designated Agent system enables simple, streamlined licensing processes and substantially reduces legal risk. If this agreement becomes law, digital music services will be able to access all necessary rights to all musical works and to thereby offer consumers a complete catalog of copyrighted sound recordings. In the words of NARAS President Neil Portnow, digital music services must compete against pirate networks by offering consumers access to all the music. This legislation will be a giant step forward in this regard.

Flexible Licensing Alternatives. As DiMA testified previously in this Subcommittee, consumer tastes are fickle and competing against piracy is challenging, so music pricing must be dynamic. Dynamic retail pricing must be supported by flexible pricing of rights, and this is permitted under the discussion draft. In this discussion draft, the Copyright Royalty Board is not bound to set penny-rate royalties, unit-rate royalties or percentage-of-revenue royalties, nor is the royalty rate pre-determined. Rather the CRB has the flexibility to do whatever seems most sensible for each business model, based on the evidence it hears from licensors and licensees.

Internet Radio Parity with Broadcast Radio. As the Subcommittee is aware, throughout DiMA's 8-year history we have urged Congress to implement technologically-neutral copyright policy. Today, we are pleased that NMPA has agreed to provide Internet radio services—or non-interactive webcasters—with effective legal parity as compared to our terrestrial broadcast competitors with respect to server copy reproductions. The discussion draft provides for royalty-free reproduction rights licenses to cover the server and incidental network cache copies of Internet radio services, so long the radio service is not taking affirmative steps to promote consumer recording of the radio programming. It differs in form from the terrestrial radio ephemeral copy exemption from copyright, but its effect is to essentially equalize how the law treats Internet radio compared to broadcast radio. We applaud this progress.

Technologically Neutral Rights and Licenses. DiMA is also pleased that the discussion draft does not provide different rights, royalty standards or obligations based on a service's method of transmission (e.g., cable or satellite or Internet) or the device used to convert digital bits into audible music (e.g., a PC or a mobile telephone or a stand-alone portable device). Rather, the discussion draft appropriately creates a set if rights and licensing processes that is technologically agnostic, and that avoids unnecessary and problematic attempts to classify technology by focusing instead on the proper issue—fair payment for the exploitation of copyrighted works, regardless of the particular medium or means of the exploitation.

DiMA Concedes Regarding Interactive Radio Rights Licensing; Though Royalty Rates to be Negotiated or Arbitrated. NMPA for several years has asserted that on-demand and interactive radio performances are more likely to substitute for consumer purchases and music subscriptions than are traditional pre-programmed radio, and thus justify a "mechanical" right payment which is traditionally associated with distributions of music that are actually possessed by a consumer. DiMA members, in contrast, hold to the principle that consumers experience music in one of two ways—either by enjoying a *performance* that is heard and then is no longer available; or by possessing music (permanently or temporarily, through ownership or subscription "rental") which occurs as a result of a *distribution.* In simple terms, the consumer's experience justifies either a performance right and royalty or a distribution right and royalty, but not both.

However, to reach a compromise that will support business certainty and growth, DiMA members have agreed that legislation should clarify that interactive streaming implicates a reproduction right, in addition to its implication of the performance right. DiMA and NMPA have agreed that the legislation should not set a value for this (or any other) reproduction right, but rather that future negotiations or perhaps

arbitration will determine the royalty rate. Moreover, we are agreed that the legislation should leave open the possibility that the value of the reproduction right in some contexts might well be zero, and that the mere existence of the right should not ensure a final determination that a royalty is due.

Licensees to Contribute Financially. Recognizing that a modern 115 license will benefit licensees, DiMA has agreed that licensees will share with publishers the costs associated with a new General Designated Agent though this concession violates all precedents associated with statutory and compulsory licensing. Music publishers insist that cost-sharing is a deal-breaker, and so DiMA members have agreed conceptually but in the absence of a agreed formula, we support the Discussion Draft's referral of this issue to the CRB.

It is important that the Subcommittee recognize the uniqueness of the situation before you, and clarifies that licensee cost-sharing is not appropriate in any other compulsory or statutory license contexts. In other situations compulsory and statutory licenses are associated with rights that are newly created, or licensors' collective organizations are voluntary. Only in Section 115 has Congress historically imposed costs on licensees, and today's Discussion Draft merely continues that policy.

DiMA disagrees with the way the discussion draft implements certain concepts I have outlined above. Specifically, DiMA believes that the reproduction right associated with on-demand or interactive streaming should be characterized as a reproduction right rather than as a "digital phonorecord delivery," which suggests that a distribution has occurred. As discussed above, DiMA members do not believe that performances implicate distribution rights.

DiMA firmly agrees with the Register of Copyrights' conclusions in the 2001 Copyright Office Report on Section 104 of the DMCA and with the Register's written testimony today. To accomplish enactment of legislation our members are willing to accept the existence of a reproduction right incidental to streaming performances, but it is substantively and analytically incorrect to characterize a transmission of streaming digital bits for the purpose of rendering a performance as a "delivery" or "distribution." Similarly, the reproductions of the musical work that must reside on servers controlled by the music service or within the network might technically be characterized as reproductions, but are not reasonably characterized as either "deliveries" or "distributions" of a phonorecord. Rather, we propose that the Subcommittee characterize this right as a "reproduction" right pursuant to Section 106(a) of the Copyright Act, and create a new Section 115A to implement the compulsory license associated with this right.

This disagreement by no means should diminish what is otherwise a significant agreement with NMPA. DiMA members have conceded that streaming radio services implicate a reproduction right and that our efforts should focus on determining the economic value of that right in context. DiMA members pledge to work to reach agreement on words that will accurately convey our more meaningful agreement about rights.

Finally, DiMA is concerned that the discussion draft's proposed elimination of record companies' option to sublicense musical works' reproduction rights to digital services is causing such consternation among our members' record company partners. As the subcommittee knows, controlled composition clauses, which are contractually agreed to between recording companies and recording artists, have for many years been a flash point in relations between the recording and music publishing industries. DiMA services are now caught in the middle of this battle. DiMA members are ready, willing and able to pay publishers through their own designated agents for the value of the musical works that they own and that were created by songwriters. However, it is true that the traditional sublicensing model for physical sound recordings and for digital downloads is not broken, and does not require legislative repair.

We are hopeful that our partners in the recording, publishing and songwriting communities can reach a prompt and satisfactory resolution of this issue, and we are available to assist if the parties or the Subcommittee would find it helpful.

Once again, I thank Chairman Smith and Representative Berman for your leadership and for the opportunity to testify today. We value your continued encouragement as we iron out these remaining, albeit significant differences, and refine this discussion draft so it can become law in this session of Congress.

Mr. SMITH. Mr. Carnes.

TESTIMONY OF RICK CARNES, PRESIDENT, SONGWRITERS GUILD OF AMERICA (SGA)

Mr. CARNES. Chairman Smith, Ranking Member Berman, and Members of the Subcommittee, thank you for the opportunity to provide comments on behalf of the Songwriters Guild of America on draft legislation entitled Section 115 Reform Act of 2006. We greatly appreciate your invitation.

My name is Rick Carnes and I am President of the Songwriters Guild of America. The SGA is the nation's oldest and largest organization run exclusively by and for songwriters. We represent approximately 5,000 songwriter members and the estates of deceased songwriters. SGA provides royalty collection and audit functions for its members as well as music licensing. This year marks our 75th anniversary. We were born in New York City the same year as the Empire State Building. And I'm proud to say that although we're old, we're both still standing tall.

I want to begin my comments by commending the efforts of David Israelite of NMPA and Jonathan Potter of DiMA for their earnest attempt to negotiate a deal. This legislation is a real balancing act and you've got a lot of affected parties here with a lot of conflicting interests. But this draft legislation has some important components that songwriters can and will support.

First, the SGA fully supports the overall objective of simplifying the rules and procedures of section 115 to facilitate the licensing of all digital deliveries of musical works. We are fully committed to this process.

We also strongly support the attempt to resolve the record company as gatekeeper problem and encourage that the bracketed language on page 42 of the bill be included. We realize that the record labels want to continue to interpose themselves between the digital music distributors and the songwriters and music publishers so they can, among other things, continue to enforce the controlled composition clauses, which allow them to pay songwriters and artists 75 percent of the statutory rate.

But here is what that means to songwriters. Currently, after I divided my royalties with my publisher and my recording artist co-writer, I only earn on average about $22,750 per song on a million-selling CD. Then when the 75 percent controlled composition rate is enforced by the record label, I only get $17,000. If that is the one recording I get this year, then the difference controlled composition makes is that it actually places my earnings $2,000 a year below the poverty line. For one million sales, I am eligible to receive a platinum award from the RIAA, but it is cold comfort when I can't afford a house to hang it in.

Controlled composition clauses are unfair and need to be ended. The record labels should no longer be the gatekeepers and we applaud the idea of direct payments from digital music services to music publishers and songwriters.

We are also pleased to see that the draft legislation confirms that interactive streams of music are recognized as digital phonorecord deliveries, as this clarification is essential to any legislative effort on this topic.

The tradeoff here is the requirement to provide royalty-free licenses for server copies of musical works for the purpose of facili-

tating non-interactive streaming. The elimination of rights for all server copies clearly reduces the rights of music copyright owners and under current law would reduce the economic returns for songwriters and music publishers. While this will mean convenience and higher profits for the DiMA companies, it also might mean that I can't afford to send my daughter to college. We hope to hear more about the ways this bill can strike the proper balance in this area.

We do not oppose the principle of establishing a general designated agent to collect digital royalties. However, if songwriters are to lose some of their rights by having them bound by the licensing decisions of a statutory agency, this loss of rights should be balanced by gaining the right to meaningful participation in the governance of these entities.

Mr. Chairman, to paraphrase a real estate broker, the three essential features of an effective designated agent bill are transparency, transparency, and transparency. We believe there is no reason for this bill to limit distribution of audit data solely to music publishers, even though publishers collect such payments on behalf of songwriters. In fact, newer music publishing contracts often provide songwriters up to 75 percent of the royalty payments. In this instance, there is no doubt that the songwriter is an interested party entitled to information from the designated agent on the extent and amount of payments received from the digital music providers. To this end, we have included in our written testimony some suggested language that would help address this issue as well as the crucial issue of meaningful participation.

As we stated at the beginning, SGA supports the objectives of this legislation and desires to take a constructive role going forward. We seek to understand the benefits better so that we can balance them against the negative aspects of the bill to our members.

Mr. Chairman and Members of the Subcommittee, we seek to work with you to ensure that the legislation strikes that proper balance and will be beneficial to the songwriters upon whom the entire music industry relies. Thank you for your attention and consideration of these views.

Mr. SMITH. Thank you, Mr. Carnes.

[The prepared statement of Mr. Carnes follows:]

PREPARED STATEMENT OF RICK CARNES

STATEMENT OF RICK CARNES, PRESIDENT
THE SONGWRITERS GUILD OF AMERICA
BEFORE THE SUBCOMMITTEE ON COURTS,
THE INTERNET AND INTELLECTUAL PROPERTY
OF THE HOUSE COMMITTEE ON THE JUDICIARY

"The Section 115 Reform Act of 2006"
May 16, 2005

Chairman Smith, Ranking Member Berman, and Members of the Subcommittee, thank you for this opportunity to provide comments on behalf of The Songwriters Guild of America on draft legislation entitled "The Section 115 Reform Act of 2006". We greatly appreciate your invitation.

Founded in 1931, the Songwriters Guild of America (SGA) is the United States' oldest and largest organization run exclusively by and for songwriters. SGA is an unincorporated voluntary association representing approximately 5,000 songwriter members and the estates of deceased SGA members. SGA provides royalty collection and audit functions for its members, as well as music licensing.

My name is Rick Carnes and I am President of SGA. I am a working songwriter and have lived in Nashville since 1978. I have been fortunate to have had a modicum of success in my career-- including co-writing number one songs for Reba McEntire ("I Can't Even Get the Blues") and Garth Brooks ("Longneck Bottle") along with songs for Steve Wariner, Alabama, Pam Tillis, Conway Twitty, and Dean Martin among others.

Economic State of Songwriters

Let me begin by putting this legislation in perspective. Songwriters today are struggling to make ends meet. Revenues are diminishing throughout the industry. The small percentage of royalties that previously trickled down to the creators of the music – on whose creative output the entire music industry rests -- has been on the decline over the past several years. A substantial number of songwriters have left the profession entirely despite artistic success, because they simply can no longer support themselves or their families on dwindling royalty income. We therefore approach any proposed legislation with the following questions: (1) will the legislation do any harm to those songwriters who still make this artistic calling their profession; and (2) will the legislation improve the economic opportunities for those who wish to pursue the craft of songwriting full time?

I am reminded constantly of the perilous existence that all of us who have chosen songwriting as a profession labor under daily. Let me give you the painful facts. When I was a young songwriter, like every aspiring music creator I dreamed of having one of my songs on a million selling album. That, I imagined, would be the very pinnacle of success, assuring my financial security. A closer look at the real numbers illustrates just

how naïve I was to place my faith in the current system.

Under the present compulsory licensing provisions, a songwriter is to receive 9.1 cents per song on any CD ("phonorecord") manufactured and distributed, or legally downloaded, in the United States. So, if one of my songs appears on a million selling album, I am theoretically due $91,000 by statute. However, I split that money half and half with my music publisher by contract. That leaves me $45,500. Then I must split that in half again with the recording artist who co-wrote the song with me, leaving me with $22,750. Practically every artist now co-writes every song on his or her album with the primary songwriter, because the record labels have included a controlled composition clause in every new artist's contract that makes it financially ruinous for the artist to record more than one or two tracks that he or she did not co-write. The reason the record companies do this is so they can pay the artist, and his or her co-writer, 75% of the statutory mechanical royalty rate. Because of the controlled composition clause, and with transaction costs deducted, my royalty income is reduced by thousands more dollars.

Thus, after all is said and done, I end up making less than $17,000 for having a song on a million selling CD. Of course, given that the retail charge to consumers for a CD may be as high as $18, a million sales will generate up to $18 million for someone.

As Register of Copyrights Marybeth Peters observed last year, the current system of compensating authors under Section 115 is "antiquated". No songwriter could possibly argue with such a conclusion other than to insist it was an understatement.

How did American songwriters reach this economic nadir? The most obvious reason is the astonishing fact that the U.S. statutory mechanical royalty rate was not raised from the 2 cent level for 69 years from 1909 to 1978. And for the last 27 years, modest increases to 9.1 cents have not addressed that longstanding, bedrock inequity. The reason I am making less than $17,000 on a million sales is that I am getting 1936 wages in 2006! That truly is "antiquated" compensation. More and more songwriters simply can no longer afford to continue to expend the time and energy required to practice their craft, while attempting to support their families. And as we suffer personally, American musical culture --long a source of enormous national pride, international prestige, and positive trade balance-- is endangered along with us.

General Policy Issues Raised by Legislation

The SGA supports the general objective of simplifying the rules and procedures of section 115 to facilitate the licensing of all digital deliveries of musical works. We are pleased that the draft legislation confirms that "interactive streams" of music are digital phonorecord deliveries, as this clarification is essential to any legislative effort on this topic. We also strongly support the draft's apparent resolution of the record company "gatekeeper" problem, provided that certain bracketed language is included.

We do not object to the principle of establishing a general designated agent with the authority to bind all copyright owners of nondramatic musical works to digital music

licenses, ***provided,*** that songwriters are treated fairly through meaningful participation in the governance of these entities, that on balance the legislation will provide greater economic benefit than economic harm, and that songwriters will have full access to all financial records related to this arrangement.

It is a commonly held legislative principle that Congress cannot guarantee the economic consequences that a party will experience from a piece of legislation. When dealing with large companies or their representatives, this perspective is understandable. But the position of songwriters is unique. Many are at the end of their economic tether. Most are sole proprietors or small businesses. ***And without songwriters, there are no songs, no music, and nothing to digitally deliver.***

The possibility of economic damage to songwriters exists because music copyright owners would be bound by the licensing decisions of a designated agent in which they have no voice, and because limitations are placed on the exclusive rights that music copyright owners currently possess to exploit their artistic creations – in this particular instance, the server copies of streamed musical works. The question we ask ourselves is, "what economic benefits are included in the legislation that would be balanced against the potential for economic damage?" The clarification that interactive streams are within the "digital phonorecord delivery definition" is clearly an economic benefit. So is the resolution of the record-company "gatekeeper" problem, which appears to be resolved in the draft bill but is not certain. What other benefits does the legislation provide?

We look forward to working with the Subcommittee to ensure that, on balance, this legislation is good for songwriters and music copyright owners.

Specific Comments on Draft Legislation

The draft legislation is a sincere attempt to address many of the challenges to easier licensing of the digital delivery of music. We appreciate the spirit in which it is drafted. We nonetheless believe that certain changes are important to making this legislation worthy of approval by the subcommittee. These changes include the following:

1. Songwriter Participation in Designated Agent.

It is imperative that songwriters have a meaningful role in the governance process of any designated agent with the power to bind unwilling copyright owners of nondramatic musical works The inclusion of songwriters in the designated agency dispute resolution process (found at page 34 of the draft bill) is a good start, but it alone is not sufficient. First, the disputes that may be resolved under the bill do not include the initial setting of license rates and terms (particularly for new services where an interim rate might be sought), nor presumably do they include the ability to influence Designated Agent administration fees. Second, if royalties due to songwriters are improperly withheld, the songwriter or its music publisher may not have sufficient resources to contest the issue after the fact. It has been the sad history of the music industry that the most powerful actors can use their economic advantages to win wars of attrition against songwriters and

other less affluent copyright owners. It is imprudent to defer the question of licensing rates and terms and administration fees to a dispute resolution process. Instead, these issues should be considered upfront with at least one representative of songwriters present.

In order to cure this problem and ensure upfront that songwriters interests are not compromised, we suggest for example that page 14, lines 13-16 of the draft bill be amended to read as follows:

> "(III) The General Designated Agent shall be governed by a board of directors consisting of representatives of at least 4 music publishing entities, and of at least one representative with a fiduciary duty to the songwriting community and with no such duty to any other interested party under this section."

This change will help ensure that the rates and terms of digital licenses do not inadvertently worsen the current economic condition of songwriters, and that all major policy discussions regarding the licensing of new modes of digital music delivery and the setting of the agent's administration fees include the perspective of the songwriting community.

The issue of the fairness of license rates and terms to songwriters cannot be underestimated. There is no issue about which songwriters feel more passionately. For example, will the designated agent deviate substantially from the statutory rate when granting a license to a new digital music service? Is there a floor rate below which it will not sink? How will it address any residual record company "gatekeeper" issues that plague the attempts by music copyright owners to obtain a fair share of the revenues from popular music download services such as iTunes? Will it confirm that the actual rates provided for works created after June 1995 are in fact free of limitations imposed by controlled composition clauses, as required by the 1995 legislation? Without a songwriter member on the board of the general designated agent, we fear these issues will not receive full consideration. And if these issues are not properly considered, then the goals of this legislation are likely to be compromised, to the ultimate frustration of all parties to this proposal.

2. Elimination of Gatekeeper Problem.

A critical part of the industry compromise to make this legislation possible is elimination of the current ability of record companies to authorize the digital distribution of nondramatic musical works embodied in a sound recording. This current practice allows record companies to be the "gatekeepers" of the copyrighted works held by another party – music publishers and songwriters. We believe that this reform is a long time in coming and will substantially improve the transparency and fairness of royalty distribution to music copyright owners.

We are support the "blanket license" language starting on page 3 of the draft bill, but were surprised that the language to conform this change to the current law on page 42, lines 6-7, is found in brackets. From SGA's perspective, elimination of the brackets around this reform is essential. Creation of a designated agent with authority to bind all copyright owners under section 115 will be meaningless if the record companies can bypass the process and license the musical works on their own. Absent inclusion of this language, the necessary practical reforms and industry compromises are not clear.

We further wish to clarify that the effect of the bill's "gatekeeper" reform should be to render previously issued licenses pursuant to the record companies' pass-through licensing power null and void as of the effective date of this legislation. The musical composition rights in a substantial number of today's most desired nondramatic musical works have already been licensed by record companies to a number of popular music services. Failure to bring this regime to an end immediately, or at least by a date certain, will render this provision meaningless as well. Given the "blanket license" nature of the designated agent proposal, however, such an approach should not be a significant inconvenience for digital music companies that had previously obtained a musical composition license from a record company. We pledge to be sensitive to the administrative requirements for phasing out all vestiges of the gatekeeper function, but this is a provision whose prior effect and future practice must be ended.

3. Server Copy Licenses.

We understand that, in order to obtain agreement that interactive streaming is a digital phonorecord delivery, certain changes were necessary to clarify liability for server copies that facilitate streaming. We are concerned, however, about the proposal to provide royalty-free licenses for server copies of musical works for the purpose of facilitating noninteractive streaming. We also wish to note an ambiguity in the draft bill's language that could be read to provide for a mechanical license, only, for server copies used to facilitate interactive streaming.

First, the elimination of exclusive rights for all server copies clearly reduces the rights of music copyright owners under current law. The U.S. District Court for the Southern District of New York determined in *Rodgers and Hammerstein Org. v. UMG Recordings Inc.*, No. 00 Civ. 9322 (JSM), 2001 U.S. Dist. LEXIS 16111 (S.D.N.Y. 2001), that server copies for streaming services are outside of the statutory mechanical license and are among the exclusive rights held by music copyright owners. The provision granting a royalty-free license for server copies of noninteractive services would reduce the economic returns to songwriters and music copyright owners and provide a corresponding benefit to digital music companies. The "license facilitation" purpose served by this provision is minimal -- it serves more as a transfer of revenue from songwriters and music copyright owners to large corporations. We do not object to ensuring that server copies may be licensed, provided that interactive streaming is clarified as being a DPD. But at the very least, if license facilitation is the objective, then server copies for noninteractive streams should be included in the rate-setting process for

the similar copies that facilitate interactive streams, rather than found to be without economic value, because that is not the case.

Second, the bill's language can be read to include server copies within the mechanical rate for interactive streams, thus creating the possibility of economic loss. When clarifying that interactive streams constitute a "DPD," we believe that a corresponding limitation of exclusive rights to the server copies for such streams can be justified. But the current language creates the possibility that a server copy will receive a mechanical royalty only. There is no question that the actual economic value of such copies is well in excess of 9 cents per song. And we are troubled by the linkage of server copies to "other incidental reproductions" necessary to facilitate the streaming of the musical work, as this implies that Congress gives the two comparable value, which is certainly not the case in the market place. We therefore recommend that the legislation give clear directions to the Copyright Royalty Board that previous rates negotiated for server copies under current law have significant precedential weight in determining the statutory rate for such server copies, or that the rate-setting process for the entire interactive streaming process consider this as a factor when establishing the proper rate.

The position we take here is consistent with positions taken by the Copyright Office. In its Section 104 Report, the Copyright Office argued that copies without intrinsic economic value, such as incidental reproductions made to facilitate streamed music, should not be subject to mechanical royalty obligations. In this case, there is clear evidence that server copies ***DO*** have intrinsic economic value. As such, the draft bill should not impose a "royalty-free license" requirement on noninteractive-stream server copies, nor should it fail to recognize the value of interactive-stream server copies. We respectfully request that these provisions be amended.

We should emphasize that giving up exclusive rights to server copies for interactive streams is not insignificant. It is not simply a question of money – it is also an issue of control over the works before they leave our hands. Music copyright owners need to identify and track the usage of the songs that are digitally delivered, in order to collect and distribute the royalties in a fair and accurate manner. When we give up the exclusive right to the server copy, we give up the ability to insist on collection of appropriate data on usage of these works by licensees. As you are probably aware, the scope of "metadata" included in each song is an important but unresolved topic among owners and users of digitally distributed music.

In summary, in exchange for confirmation that an interactive stream is a DPD, the exclusive rights currently held in server copies may be incorporated into the statutory license, but the legislation should ensure that a fair rate is set for such server copies – as they currently have economic value that should not be disregarded or eliminated.

4. Audit Procedures.

The establishment of sound and reasonable audit procedures are critical to ensuring that the new section 115 licensing process is transparent to all parties. Mr. Chairman, to

paraphrase a real estate broker, the three essential features of an effective designated agent bill are "transparency, transparency, transparency."

We are initially troubled by the sparse language describing the information that digital music provider licensees are required to provide to designated agents. Page 22, line 22 of the draft bill states that "each licensee under this subsection shall, on a monthly basis and in electronic format, report its usage of musical works under the license, and make royalty payments by reason of such usage . . ." There is no other language of substantive effect, and we find this standard to be insufficient. We believe that the concepts from the section 115(c) requirements should be imported here, including detailed cumulative annual statements of account from all licensees. These statements should be certified by a public accountant and then attested to by the digital music provider as complete and accurate. And the usage data transmitted by the licensee should include the name of the composition and the principal authors of the work, to minimize administrative costs to music copyright owners and to ensure proper accounting.

We are also concerned by the language on page 23, line 5, that places "Limitations on Disclosure" of audit information from a designated agent to a recipient of royalty payments from a digital music company licensee. We believe there is no reason to limit disclosure of royalty and audit information "to musical works owned or controlled by the recipient" (page 23, lines 10-12). This would appear to limit distribution of audit data in many cases solely to music publishers, even though publishers collect such payments on behalf of songwriters and split the proceeds with them under various contractual arrangements and in varying ratios. Newer music publishing contracts often provide songwriters up to 75% of the royalty payments. In this instance, there is no doubt that the songwriter is an interested party entitled to information from the designated agent on the extent and amount of payments received from digital music providers. We therefore suggest that the sentence on page 23, line 6 be amended to read as follows:

> "A designated agent may disclose information received under clause (i) to a recipient of royalty payments made by a licensee only with respect to musical works owned or controlled by the recipient, and shall ensure that any such disclosure be made available as well to the party in privity with such recipient with respect to such musical works."

The audit procedures in the draft bill are complicated, and the current audit practices in the music industry are fraught with controversy. We therefore request additional time to review the bill's provisions to determine whether we have additional comments on this critical topic.

Additional Legislation Is Relevant to Songwriter Interests

Finally, we wish to point out that we are not looking at this draft legislation in a vacuum. There is other legislation pending that would have an economic effect on songwriters, and we would weigh this legislation in conjunction with the other bills.

One such bill is the draft Senate legislation to amend section 114 to address new technologies and copying capabilities to be offered by satellite radio services. We support the principles of the Feinstein legislation, because it addresses an important question in the digital delivery of music. But the theory behind the section 114 legislation is relevant to section 115 parties as well. The new satellite radio services are likely to displace the retail sale of phonorecords. To the extent this occurs, then the rights of music copyright owners in section 115 are clearly implicated. In fact, the legislative history behind the 1995 amendments that created the "digital phonorecord delivery" definition makes this precise point. When digitally delivered music results in diminished sale of phonorecords, compensation to owners of nondramatic musical works is required. Without consideration of this problem, songwriters will once again face a reduction in their royalty income.

Conclusion.

As we stated at the beginning, SGA supports the objective of the legislation and desires to take a constructive role going forward. We are currently reviewing the positive aspects of the legislation to ensure they outweigh the negative aspects. There are clearly positive aspects, particularly the clarification that interactive streams of music are within the digital phonorecord delivery mechanism. And there are benefits that we hope will be confirmed shortly, such as the elimination of the "gatekeeper" problem, which is essential to the compromise that this legislation seeks to obtain.

We seek to understand the benefits better, so that we can balance them against the negative aspects of the bill to our members, which include the ability of a designated agent which currently has no meaningful songwriter input to bind all of our members to digital music licenses to which they may object. Mr. Chairman and Members of the Subcommittee, we seek to work with you to ensure that this legislation strikes the proper balance and will be beneficial to the individuals on which the music industry relies – the songwriters.

Thank you for your attention and consideration of these views.

Mr. SMITH. Mr. Sherman.

TESTIMONY OF CARY H. SHERMAN, PRESIDENT, RECORDING INDUSTRY ASSOCIATION OF AMERICA, INC. (RIAA)

Mr. SHERMAN. Thank you, Chairman Smith, Ranking Member Berman, and other Members of the Subcommittee for giving me an opportunity to testify on music licensing reform. As you know, new technology, new formats, and new business models have presented new opportunities to offer consumers new products and services and lure them away from the illegal services with which we must compete. But we've been frustrated by an antiquated mechanical licensing system that makes it difficult for us to respond to marketplace demands.

As new formats and business models have proliferated, uncertainty and disagreements have paralyzed the licensing process and the existing one-size-fits-all licensing system is ill-suited to the many new business models we're trying, like digital music services, ring tones, multi-session disks, locked content, preloaded content, music videos, and hybrid offerings, such as in-store kiosks. Each has presented new mechanical licensing challenges and there is no process for resolving them.

Believe me, we understand the complexities of resolving these issues, and Mr. Chairman, we are especially grateful to you as well as to Mr. Berman for continuing to focus on this issue and trying to find a way through the morass.

Unfortunately, the current draft of SIRA, which represents a deal between the music publishers and digital music services, does not resolve most of the problems we face. While we are heartened by the efforts that have been made to arrive at a reform package and we congratulate NMPA and DiMA for their earnest efforts to arrive at a solution, SIRA addresses only about 5 percent of the market's recorded music. What about the remaining 95 percent? Are we to ignore the pressing need for reform for the overwhelming majority of the existing marketplace?

In our view, SIRA represents a missed opportunity. We're also concerned that it introduces new inefficiencies, requiring digital music services to replicate the royalty payment infrastructure that record companies have built up over decades. But more troubling still is that the few changes it does make are at the expense of record companies.

SIRA nullifies thousands of contractual agreements negotiated by record companies with artist songwriters over many decades and will cost record companies and services many millions of dollars each year in additional royalties to the benefit of the music publishing companies. This is unfair because it undoes a principle that we, the publishers, committed to in 1995, that changes in contracts, such as controlled composition provisions, should be prospective only. SIRA would retroactively eviscerate a key provision on which the overall economic terms of contracts with artist songwriters were premised.

I am confident that music publishers would be very upset if key economic terms of their contracts with their songwriters were simply abrogated by Congress, fundamentally rewriting the deals on which they based their decisions about advances, royalty rates, roy-

alty splits, and the like. We simply want our contracts with our artist songwriters to be honored, just the way music publishers want their contracts with their songwriters to be honored.

Importantly, the effect would be to transfer millions of dollars from record companies, whose revenues have been decreasing, to music publishers whose revenues have been increasing. This makes no sense.

SIRA also requires that record companies pay administrative costs as both licensors and licensees. In an unprecedented change, SIRA would shift costs of distributing section 115 royalties from music publishers to their licensees. We are not opposed to cost sharing, but if that is going to be the rule when record companies are licensees, it ought to be the rule under sections 112 and 114 when record companies are licensors.

There are several other problems we see with the discussion draft and I refer you to my prepared statement for details on those.

To improve SIRA and achieve real reform, we propose that the blanket license be extended to all products and services covered by the mechanical compulsory license, including physical products and hybrid physical online offerings. This would go a long way toward solving the problems I have just highlighted and we would be happy to work with the Committee to bring about that reform in a manner that is fair to all the parties.

Failing that, we urge you to limit the blanket license to subscription services. We think that this would represent incremental progress and something that can be achieved quickly. That way, you can achieve reform in an area where it would do some good and where the Copyright Office identified a specific need without hurting record companies and digital music services. Downloads are one of the few bright spots in the bleak mechanical licensing picture. It would be terrible to jeopardize a business that is working well and add new costs and confusion. If comprehensive reform is not to be, we should experiment with limited reform for subscription services. If a line is to be drawn, it is important to draw it in the right place.

Should you go forward with legislation on subscription services, there are a few modest improvements that you can make in the current system that would help address our problems. These are detailed in my written statement, but the most important is to create a dispute resolution mechanism. Every new format and business model has raised questions concerning the interpretation of section 115. A fair and expeditious mechanism to resolve these questions would facilitate licensing and entry into the marketplace.

We wish we could be more supportive of SIRA, but at this point, we worry that it would cause more harm than good, at least for us, and we don't feel like record companies should bear the financial and business burdens of very limited reforms that do not address our needs. But we are certainly prepared to work with the Committee, the Copyright Office, NMPA, DiMA, and any others to improve the proposal to the point where it provides the real benefit that is so badly needed.

Let me thank you again for your efforts on this. We think this really is important and we are very grateful for your efforts on our behalf.

Mr. SMITH. Thank you, Mr. Sherman.
[The prepared statement of Mr. Sherman follows:]

PREPARED STATEMENT OF CARY H. SHERMAN

Statement of Cary H. Sherman,
President
Recording Industry Association of America, Inc.

Before the Subcommittee on Courts, the Internet, and Intellectual Property
Committee on the Judiciary
U.S. House of Representatives

"Section 115 Reform Act (SIRA) Of 2006"

May 16, 2006

I am Cary Sherman, President of the Recording Industry Association of America ("RIAA"), the trade group that represents the U.S. recording industry, and I am grateful for the opportunity to present our views today concerning an issue we've been raising in Congress for years – problems with the mechanical compulsory license provided by Section 115 of the Copyright Act. I would like to begin by thanking the Subcommittee, under the leadership of Chairman Smith and Ranking Minority Member Berman, for its continuing interest in trying to address these difficult problems.

I last testified on this subject before the Subcommittee in March of 2004. Larry Kenswil, President of UMG/eLabs, testified on this subject before the Subcommittee in March of 2005. Both times, we said that the mechanical licensing system was broken and needed to be fixed.

This is both an exciting time and a challenging time in the music industry. It is an exciting time because new technology has brought new formats, new business models, new revenue sources, new abilities for consumers to control their listening, and more places and more ways for people to find a broader array of music. However, piracy aided by new technology has led to declining sales, deprived the public of creative new music, and cost thousands of jobs. Record companies have tried to lure customers back through a range of exciting new product and service offerings. However, at every turn record companies have been frustrated by a mechanical licensing system that does not let them respond quickly or efficiently to marketplace demands. The result is that consumers, artists, record companies, songwriters and publishers alike lose out. Some of the difficulties we have brought to the Subcommittee's attention include the following:

- As physical, online and hybrid formats and business models have proliferated, uncertainty and disagreements have paralyzed the licensing process.

  New technologies have presented so many opportunities: not just online music services, but also ringtones; DVDs, DualDiscs, and other kinds of multisession discs; locked content; music videos; and hybrid offerings that combine physical and online elements – including kiosks and bundled offerings. Because Section 115 is a relic of a different time, every one of these has presented new mechanical licensing challenges, and our ability to resolve them and get products into the market is falling behind.

- There is no process for resolving these disputes.

  Questions of law that ought to have an answer – such as whether publishers are entitled to be paid multiple times for a multisession disc – have been hanging over our heads for years. For the compulsory license to be workable in a dynamic environment, we need a process for the timely resolution of disputes concerning new types of products and services.

- The number of musical work copyright owners is vast, and ownership of works is typically split among several owners.

  There are tens of thousands of music publishers and countless individuals who own musical work copyrights. And because of split ownership, it is common for a record company to need to deal with dozens of copyright owners to clear a single album's release.

- The mechanical licensing system entails enormous transaction costs.

  Record companies and services both must obtain or verify rights to vast numbers of musical works. Work-by-work, configuration-by-configuration licensing just does not make sense when the number of tracks that need to be cleared is large and the return from any individual track often low.

- The mechanical licensing system entails enormous waste.

  Licensing transactions require effort by both licensors and licensees, and everybody must maintain redundant databases

linking musical works to licenses to recordings. This duplication of effort unnecessarily takes money out of everyone's pockets.

- The cents rate is inflexible and poorly suited to the modern marketplace.

  The market for music has changed, and a one-size-fits-all cents rate royalty simply does not work any more. When a product or service presents a different value proposition than the sale of traditional products, the mechanical royalty should reflect that.

- These problems are even worse for uses outside the scope of the compulsory license.

  The future of the music industry increasingly lies in offerings outside the scope of the compulsory license – such as paid distribution of music videos. Broken as the compulsory license is, it at least provides some framework for licensing. Outside the scope of the license, licensing for new uses is even more difficult.

I'm sorry to say that during the two years since I last testified on this subject before this Subcommittee, the situation has not improved much. There are lots of new formats and business models that are potentially interesting to pursue. But record companies continue to face difficult mechanical licensing challenges every day. And the compulsory licensing system simply is not helping get new types of products and services into the marketplace.

We've been trying to change the situation. Individual record companies and music publishers have negotiated agreements for licensing of multisession discs, locked content, ringtones and video services. These agreements have permitted record companies to make available ringtones and video offerings that otherwise might have been unavailable to the public.

In some respects, things have gotten worse. We have heard from companies that are interested in launching new subscription services that publishers are refusing to let them go into business unless they agree to a royalty rate in advance, even though the publishers had previously committed to allow such services to get into business so long as they paid advances, with royalty rates to be determined later. Yet even though royalty rates will be set by arbitration (or negotiation) very soon, the publishers have chosen now to discontinue licensing new services on the

same basis as they had in the past. In that respect we have taken a large step backward over the last year

So we're still in need of reform.

We're heartened by the efforts that have been made to date by NMPA and DiMA to arrive at a reform package. However, the proposal that has emerged so far and that is embodied in the discussion draft of the "Section 115 Reform Act" or "SIRA" represents a terrible missed opportunity to address the far larger problems facing the music industry today. According to RIAA's 2005 shipment data, the online download and subscription music business presently accounts for 5.3% of total shipments. It's that 5% that SIRA would address. What about the remaining 95%? Are we to ignore the pressing need for reform for the overwhelming majority of the existing marketplace?

Let's consider how the current draft of SIRA would address the problems described in our testimony in each of the last two years and summarized above:

As physical, online and hybrid formats and business models have proliferated, uncertainty and disagreements have paralyzed the licensing process	Improvements for digital music services – but NO SOLUTION for physical and hybrid products
There is no process for resolving these disputes	NO SOLUTION
The number of musical works/ copyright owners is vast, and ownership of works is typically split among several owners	Improvements for digital music services so long as there is only one designated agent, but complex administration when there are multiple designated agents; and NO SOLUTION for physical and hybrid products
The mechanical licensing system entails enormous transaction costs	Improvements for digital music services – but NO SOLUTION for physical and hybrid products
The mechanical licensing system entails enormous administrative waste	NO SOLUTION – It creates new intermediaries without eliminating any existing duplication of effort

The cents rate is inflexible and poorly suited to the modern marketplace	NO SOLUTION
The problems are even worse for uses outside the scope of the compulsory license	NO SOLUTION

Not only does SIRA represent a missed opportunity, but the few changes it makes are at the expense of record companies:

1. SIRA removes record companies from the digital music value chain.

   As a condition of providing a blanket license for digital music services, the publishers have insisted that only digital music services or what the discussion draft calls "digital music providers" can be licensees. This condition has been explained as addressing publishers' desire for direct financial reporting and audit rights. However, those concerns easily could be addressed by targeted provisions requiring direct financial reporting and granting audit rights.

   Instead, SIRA would yank record companies out of the value chain of which they've been a part since the beginning of recorded music, and prohibit them from selling a final product with all rights included – sound recording rights AND music publishing rights. At present, for example, record companies sell downloads through digital music services like Apple's iTunes, and the record company provides Apple a complete product with all the necessary rights. Under the proposed change, Apple could no longer get all rights from the record companies – even if it wanted to do business that way. Instead, it would be required to secure one or more separate licenses from the music publishers and develop its own business processes and information systems to account for which fractions of which works are in the repertoires of which designated agents. In other words, SIRA would mandate that an efficient one-stop process for licensing be turned into a less efficient two-stop process. How is that beneficial?

   It is one thing for digital music services to have the option they currently have of taking their rights in a single bundle from a record company, or in separate bundles from the record companies and the music publishers. But it is quite another to affirmatively prohibit record companies from conducting business in the same manner as they have been conducting business for generations and in a manner

that many digital music services may prefer because it is more efficient.

We not only object to being told that we can no longer offer our sound recordings this way, but we have no idea of how the system would transition from the current model to the new one. Record companies have deals in place with numerous digital music services, under which the digital music services pay a wholesale price to the record company and the record company is responsible for paying royalties to music publishers and songwriters (in addition to artists, producers, and other stakeholders). All of those deals were negotiated in the marketplace, and there are undoubtedly many different variations in the many contracts that have been negotiated. Wholesale prices were based on the assumption that the labels would pay royalties to music publishers and songwriters. How will the prices and payment flows change to accommodate the new approach reflected in the discussion draft?

2. SIRA nullifies license agreements negotiated by record companies.

A second problem is that, in the guise of simplifying the blanket licensing system, the publishers claim that services must take the blanket license on an "all or nothing" basis, and all musical works must be paid at the same rate. As a consequence, they would undo the compromise with respect to controlled compositions that we negotiated with the music publishers in 1995 in connection with the Digital Performance Right in Sound Recordings Act. At that time, as part of the legislative process, we agreed that controlled rates would not apply to online uses on a going-forward basis, but we agreed to grandfather all pre-existing contracts containing such clauses. SIRA would effectively nullify record company rights under many thousands of agreements negotiated in the marketplace, costing record companies and services millions of dollars in additional royalties.

This is not only unfair, but it is also helping and hurting the wrong people. Between 1999 and 2004, U.S. record company revenue *declined* by over 15%. The music publishing industry has stopped publicizing its revenue numbers, but we believe that during that same period, U.S. music publisher revenue *increased* by over 11%. In other words, as our fortunes have declined, the publishers' fortunes have improved. Yet SIRA would take more money away from ailing record companies and transfer it to music publishers who have weathered the storm of online piracy relatively unscathed. That makes no sense.

Ironically, were it not for these controlled composition clauses, record companies would not have been able to do what we have done in bringing new products and services to market. A controlled composition clause is simply a license granted in an artist's contract with a record company. As publishers have refused to grant licenses for new kinds of products and services, controlled composition clauses frequently were the only licenses available. For example, consider the DualDisc format. Claims by publishers to separate payments for each side of the disc prevented record companies from issuing new products for which there was consumer demand that could have helped everyone in the music industry sell more physical goods. As a result, at least until recently, most DualDiscs that have made it to market contained songs by artist-writers where a controlled composition clause was the only way the record company could get the necessary rights. The same is true for ringtones and digital video services.

3. SIRA would prohibit licensing of record company online activities.

A collateral effect of the implementation of these points in SIRA seems to be that record companies will be unable to get the licenses they need for their own online activities. Record companies function as digital music providers when they distribute music through their own or artist websites on either a paid or promotional basis. To the extent that they merely stream recordings for promotional purposes, that has not previously been generally agreed to involve distribution, but SIRA would sweep these activities into Section 115. Having done that, it is not clear that proposed Section 115(e)(2) would allow record companies to obtain a blanket license for that kind of use, but even if it did, that probably would not make sense as a business proposition.

Normally, record companies would rely on voluntary licenses for such uses. However, as part of SIRA's "all or nothing" approach to reform, proposed Section 115(e)(9)(E)(v) seems to prohibit voluntary online licenses for less than all of a copyright owner's works. Thus, for example, a record company would be prohibited from obtaining a license from an artist-writer or the artist's publisher to use some of the artist's songs online to promote the artist's next album. I hope it was not anybody's intention that SIRA shut down record company online promotional efforts, but even assuming that this was just an unintended consequence, it illustrates the need for careful and unhurried study of this complex proposal by everyone who is affected by it.

4. SIRA requires that record companies pay administrative costs as both licensors and licensees.

   Under every compulsory license, copyright owners pay for the costs of distributing royalties among themselves. For example, record companies and recording artists have borne a huge investment in SoundExchange to distribute royalties under Sections 112 and 114, and its ongoing costs are deducted from the royalties paid by licensee services. Likewise, most music publishers now pay The Harry Fox Agency a commission of 6.75% to collect and distribute mechanical royalties. Publishers also bear the costs of mechanical royalty distribution in other countries.

   SIRA reverses this longstanding structure and shifts the costs of royalty distribution to licensees. Under proposed Section 115(e)(12), copyright users would make cost-sharing payments to offset the kinds of costs traditionally covered by the Fox commission.

   We are not opposed in principle to having licensees contribute to the costs of distribution, but there is no reason that Section 115 should be different in this respect from every other compulsory license. If cost sharing is going to be the rule when record companies are licensees, it ought to be the rule under Sections 112 and 114 when record companies are licensors.

I have identified in an addendum to my statement several additional more technical concerns we have about SIRA based on our expedited review of the bill. But I respectfully request an opportunity to submit additional comments after we have had more of an opportunity to review the discussion draft more thoroughly.

So what can be done to improve SIRA and make it real "reform"? We have informed NMPA of our views on this over the past year, and we repeat them today. We propose the following:

1. Extend the blanket license to ALL products and services covered by the mechanical compulsory license, including physical products and hybrid physical/online offerings.

   A blanket license for all of Section 115 would go a long way toward solving the problems I have just highlighted. And centralizing the royalty distribution function in a single industry agency would produce efficiencies and cost savings that could be shared among all the stakeholders.

2. Failing that, limit the blanket license to subscription services.

I think of there being at least four main types of offerings within the scope of Section 115:

- physical products;
- services offering downloads for sale;
- subscription services offering limited downloads and on-demand streams; and
- hybrid offerings that don't fit cleanly into one of the other categories – like services that transmit recordings to a kiosk, from which physical products are distributed to the consumer.

SIRA only includes two of these four categories, and then sweeps into Section 115 certain streaming transmissions that have not previously been generally agreed to involve acts of distribution. That is clearly inferior to a blanket license covering all categories. However, if we are only going to cover some of these categories, we should make it subscription services, not download services.

The download business is working. Apple's iTunes music store offers consumers a library of over three million recordings; record companies are providing sound recordings to new digital music services all the time; and mechanical licenses for downloads are being issued every day. Downloads are one of the few bright spots in the bleak mechanical licensing picture. It would be terrible to jeopardize a business that is working well and add new costs and confusion without the offsetting benefits of addressing the full range of pressing mechanicals issues.

By contrast, new subscription services are being denied licenses. If comprehensive reform is not to be, we should experiment with limited reform for subscription services.

3. Create a dispute resolution mechanism.

Proposed Section 115(e)(11)(C) has a process for resolution of a limited class of disputes between publishers, but it does not

address the kinds of disputes that most need to be resolved. As I explained earlier, every new format and business model has raised questions concerning the interpretation of Section 115. Are the products sold through kiosks physical or online? Are ringtones in or out? Do publishers get paid twice for multisession discs? But there has been no place to go to get binding interpretations of Section 115 that would facilitate new business models.

SIRA would not answer these questions, and even in the brief opportunity we have had to review SIRA, it is clear that it would engender a host of new questions. Can bonus tracks made available online to purchasers of a physical product be licensed at all? And if so, how, and by whom? Do advertiser-supported streams involve a direct economic relationship with an end user? When do changes in an online offering represent a new type of activity that requires re-licensing?

Nobody benefits from having years of uncertainty precede a tentative launch of a new format or other offering. We need a way to get answers and to get them promptly.

4. Create an antitrust exemption to allow industry negotiation for uses outside the scope of the compulsory license.

   Both record companies and services need to be able to license lots of music, to do so quickly, and to do so while holding the line on transaction costs. One way to do that would be by extending the scope of the compulsory license, but we understand the publishers' reluctance to do that. An alternative would be to permit voluntary negotiation of industry-wide deals for uses such as the video content or lyrics on DVDs, facilitating the launch of products into the marketplace. The system would be voluntary, so no one would be forced to license these new uses under a compulsory license system.

5. Codify agreed-upon resolutions of current issues.

   We have been talking to the publishers for a long time about licensing the current generation of new products, and we have made some progress. For example, there seems to be conceptual agreement that multiple mechanicals should not be payable for multisession discs – at least when they are distributed for copy-protection purposes. And we likewise have

agreement that a full mechanical royalty should not be payable for locked content until it is unlocked. Any reform legislation enacted at this time should embody these and other resolutions of the current generation of issues.

We wish we could be more supportive of SIRA as it has been advanced, but it does too little, and at too high a price, for us to endorse it. At this point, it is at best a gesture – and at worst a money grab – rather than a real solution. But we are certainly prepared to work with NMPA, DiMA and others to improve the proposal to the point where it provides the real benefit that is so badly needed. This is a critical time for everyone in the music industry. Without new products to excite consumers, we risk losing an entire generation of music lovers to piracy. We're hopeful that with your encouragement we will be able to address the current pressing issues just as we have resolved other differences in the past.

I thank you for your time and would be happy to take your questions.

Addendum

I am identifying in this addendum several additional concerns we have based on our brief opportunity to review the discussion draft of SIRA. It is a very long and complex statute that makes significant changes in a complex area of law and business practice, so it is likely that we will have additional points to make as we continue to review the discussion draft.

1. Timing of proceedings. The Copyright Royalty Board ("CRB") has commenced a rate setting proceeding under Section 115. Proposed Section 115(e)(8)(C) contemplates that there could be a new proceeding following right on its heels to set rates for certain streams and perhaps some other things, or that the CRB might consolidate the two proceedings. Either approach is likely to be expensive and disruptive. In principle, we favor there being only one proceeding for the next five-year rate period, although the further into the case we get, the harder it will be to add new subject matter.

2. Accounting requirements. Record companies have spent millions of dollars over decades to develop the royalty accounting systems and databases they use to keep track of which publishers own which interests in which works. That puts them a long way ahead of the services that SIRA will force to develop such systems as soon as there is more than one designated agent. However, if record companies are able to rely on SIRA's blanket license for some of their online activities, reengineering of their royalty accounting systems probably will be necessary to pay online royalties to designated agents, and mechanisms will also be required to change the designated agent for a copyrighted work should the owner choose another agent, while at the same time, physical royalties will be paid to publishers using a separate, parallel system. Certainly any consideration of cost sharing should take into account the costs and disruption that SIRA would impose on licensees.

3. Use of databases. Proposed Section 115(e)(9)(H) wisely requires that designated agents make databases of their works available. Such databases would be beneficial for all Section 115 licensing, but it appears that record companies are prohibited from using them for any purpose other than perhaps licensing their own online distributions.

Audits. Proposed Section 115(e)(10)(B) authorizes audits by each designated agent. The procedures provided, however, are not fairly balanced. For example, there is no requirement of protection for confidential information accessed in an audit. The audit process extends the statute of limitations period, without any assurance that an audit settlement with a designated agent is binding on copyright owners. While audit results are routinely disputed, if a user does not pay the amount that an agent claims in an audit within 30 days after demand, the license arguably terminates. And audits are not expressly limited in scope to the blanket license.

Mr. SMITH. Let me say to you all, I think this is the first panel I can ever remember where all witnesses have stayed within the time limit. Maybe that has to do with your sense of rhythm, I don't know, but nevertheless, it's appreciated.

Mr. Israelite, let me start off with my questions directed toward you, but also let me say we're probably going to have a couple of rounds of questions because I know all the Members here have much they want to discuss.

One initial question, just to get this on the record, you favor keeping the legislation like it is, limiting it to digital music, not expanding it to include physical copies of music. Why is that?

Mr. ISRAELITE. Yes, Mr. Chairman, that's true. We believe that the method by which we license physical product isn't broken. It's been in existence for nearly 100 years, and as I explained in my opening statement, it's a transfer with our copyright to the label's copyright to the consumer. That seems to work. The problems have arisen with regard to when third parties want to come in and obtain a massive amount of licenses and that's why we think we're best focused in the digital arena. We're talking about a third party that doesn't own either copyright, doesn't have a background in the music industry, and is looking to obtain millions of copyrights in a very short period of time, and that's why we've proposed it for just the digital space.

We think that if it's going to be in the digital space, however, it ought to be in all of the digital space and not just limited to subscription services. I think one of the reasons you'll hear a desire by some to limit this to just subscription services is because record labels do not pass through our licenses currently in subscription services. They pass through our licenses in other digital services, like Apple iTunes.

And so we've tried to make this very broad to include things like kiosks, like cell phone delivery, like all the products that Jon's clients want to offer, and we think that that's probably the best first step. It is still a small part of the market, about 6 percent of the worldwide market, but in the last year, it's grown 300 percent, and I think most people think that the future of the music business is going to be digital, and therefore, if we can fix licensing for that new type of service, we think it'll fix the music industry licensing process for a long time to come.

Mr. SMITH. Thank you, Mr. Israelite.

Let me go to one of the concerns that I mentioned a minute ago and I'm going to be addressing the same type of question to Mr. Potter, as well, and this goes to the definition of interactive stream as a DPD. Number one, why is that so important to you? Number two, how do you explain the Copyright Office taking a different view?

Mr. ISRAELITE. It's important to us for a couple of reasons, Mr. Chairman. First of all, it's important to us for its practical effect. Part of the beauty of this agreement, in my opinion, is that we agreed that we would leave fights that didn't need to be fought in this arena to other arenas. So, for example, when it comes to the value of the section 115 right for on-demand streaming or interactive streaming, we have agreed that we will have that fight during the Copyright Royalty Board proceeding, not as a part of this

bill. It's important to us, therefore, on a practical level, that when we argue about the value of the rate in the CRB, we are arguing the value over a DPD, something that everyone understands.

It's also important to us, very important to us, in terms of the policy reasons. We believe that these interactive streams constitute a DPD under section 115. We believe that the legislative history supports that. We believe that our current contracts with several of Mr. Potter's members support that. And we believe it was part of the deal that we made when we agreed to offer a gratis license for server copies for pure streaming services. We thought that that was an exchange we made as a business arrangement. So we believe the law supports it, but even if the law didn't, we think it was part of a business arrangement that we came to a conclusion about.

Mr. SMITH. Okay. Thank you, Mr. Israelite.

Mr. Potter, let's go back to that definition of interactive stream. It's my understanding that in the existing contracts with the publishers, interactive streams—under the definition of an interactive stream as a DPD already is in writing in those contracts. Why shouldn't that continue in the current legislation as we go forward since it already exists in the current contracts?

Mr. POTTER. Mr. Chairman, we have testified about those agreements several times in this Subcommittee as well as before the Copyright Office. We have some member companies that signed licenses that were essentially take it or leave it licenses under the threat of litigation or essentially not entering into this business. Candidly, they could have made some of those choices back then and they chose to engage in a license, to sign that license.

So the fact that they were willing to concede a point of legal principle that suggested an interactive performance was actually a delivery or a distribution should not reflect public policy, and I think that the Register has also testified several times that she does not endorse and the Copyright Office does not endorse the comment—the interpretation that was in that license.

We believe it's fairly simple. There are reproductions that are associated with the delivery of a performance, but it is a performance that is being delivered, not a reproduction that is being delivered, and therefore, we would—it is plain and simple terms in the Copyright Office what is a reproduction and we don't see a reproduction ultimately being distributed here. We see a performance being delivered, a performance being distributed.

Mr. SMITH. My time is up, but nevertheless, that's the clear language of the current contracts that you have with publishers.

Mr. POTTER. That's the clear language of—and the precedent has been set, has it not? I would—there is precedent in a few contracts signed by a few companies. There is legal precedent here that is arguably more important both domestically and internationally about the Congress deciding what is and is not a distribution.

Mr. SMITH. Congress can decide that and contracts can change. I recognize that. I was simply going to the existing language, but thank you for your answer to that question.

Mr. Berman, you are recognized for your questions.

Mr. BERMAN. Thank you very much, Mr. Chairman.

Let me just jump to that issue for a second. Why isn't an interactive stream the 21st century functional equivalent of a delivery

of a phonorecord? I mean, in other words, if I can press a button and hear anything I want at any time, that's easier than sticking the CD in the machine or getting that record to go down over that thing. I mean, I get it whenever I want it. It's like, why would I ever want to buy a record?

Mr. POTTER. I am not taking a position that an on-demand stream might be substitutional and, in fact, entirely substitutional for sales of CDs. If we have on-demand access to our music collection or a music collection at any time, any place, then it may be the case that that activity is entirely substitutional. The question is whether that activity is an on-demand performance or whether it is a distribution and we already pay, ASCAP and BMI——

Mr. BERMAN. Everything is both. I listen to a CD at home and I hear somebody performing some music. Now we're talking about an individualized on-demand ability to get the music out of one essentially instantaneously with my desire to have it.

Mr. POTTER. There were several months of negotiations, as you're aware, that included the PROs and the Harry Fox Agency and the NMPA and the Songwriters about whether we should have a unilicense that would recognize the integration or convergence of the performance and distribution rights and would set up a single system for licensing all of the rights in the bundle.

Mr. BERMAN. I'm not sure I'd go back there.

Mr. POTTER. Those negotiations did not succeed. In this context, we have conceded to the idea of a reproduction right that supports the delivery. The question is whether the reproduction is or is not what is actually delivered or what is actually distributed and we take a position that the performance is what is delivered. It is the reproduction that facilitates the delivery of that performance.

Mr. BERMAN. That sounds like 20th century.

Mr. POTTER. Actually, I think it's quite 21st century.

Mr. BERMAN. This is to the entire panel. These guys want a revision of the physical, the mechanical, in the context of a physical. Your proposal restricts it to digital. Is that a bright line these days? Is it clear that we would always know whether something was physical or digital? What are kiosk services? What are ring tones?

Mr. SHERMAN. Is that for the panel, because——

Mr. BERMAN. Yes.

Mr. SHERMAN. I'm very glad you raised that question because when we refer to physical, we're not just referring to old-fashioned CDs. We're referring to the fact that nobody knows what the distinction is between physical and digital anymore. When we sell a CD that has locked content on it that can only be unlocked by going to a website and then downloaded, what is the licensing system for that CD? Is it partly the old-fashioned license and then a new blanket license for just locked content? What about if we put pre-loaded content onto an iPod or the hard drive of a computer, 2,000 songs? It's a physical disk that is being sold, a physical portable device. Is that physical or is that digital?

We don't have the answers to any of those questions and I didn't see anything in SIRA that would help us resolve those issues, yet that is key to how these things have to be licensed. So I think you've put your finger on a very important problem.

Mr. BERMAN. So this could be both, metaphysical and meta-digital? [Laughter.]

Mr. SHERMAN. Exactly.

Mr. BERMAN. Anybody else?

Mr. ISRAELITE. First of all, if there's a question about whether something is covered by section 115 or not, which I think some of your examples, that's the debate where it falls, that's a debate to be held in the Copyright Royalty Board, not as a part of this bill.

If it is something covered by section 115, then I think the bill does a very good job——

Mr. BERMAN. What are the tools the Copyright Royalty Board has? What are the standards they use to make a decision?

Mr. ISRAELITE. We're in a CRB process right now, and when we get to the actual proceeding, I have no doubt that all of the parties here at this table will make arguments about whether something is or isn't covered by section 115. There are procedures for that. There are processes for that.

One of the things about this bill that I think was very wise is it leaves those fights for that forum. Instead, in this forum, it's just a licensing process, and I think the bill does a very good job of defining what digital delivery means. It does mean kiosks. It does mean a lot of the new products where, in effect, the consumer gets it from a digital delivery. It pretty much leaves out the traditional CD, record, eight-track, cassette, because that's a process that, number one, is declining, but number two, we have a working licensing system that's been in place for 100 years.

Mr. BERMAN. Mr. Chairman, my time is up. I see we've worn out the other Members of the Subcommittee, so—we will have more rounds.

Mr. SMITH. Let me go to the second concern that I raised in my opening statement, Mr. Israelite, and that has to do with overhead costs and who should pay for them. Mr. Potter, this question will be going your way, as well.

I don't expect you all to negotiate in open court, but could you at least give me a range of—an acceptable range that you all might consider, either a percentage or dollar amount, whatever it might be? I do think it's resolvable by all the parties involved, but I'd like to hear your take on it now.

Mr. ISRAELITE. Sure. Mr. Chairman, as I referenced in my opening statement, we still continue to believe we'd like to get rid of section 115. But part of the problem is that along with a compulsory licensing system, there are pros and cons. One of the things about the current compulsory licensing system is that anyone who chooses to use it must pay 100 percent of the administrative fees. So if you are a user that wants to invoke section 115, you have a choice. You can pay directly the copyright owner the full amount every month, or you can go to the Copyright Office if you can't find the person and drop $12 per title for them to do it. If we are going to fix the compulsory licensing system instead of going to a free market system that we favor, we've asked that we go back to the intent of compulsory licensing, which is the user help pay the administrative fees.

In terms of a dollar amount, I don't have a number to give you, but I would hope that it would be something based on a percentage

system where we believe it would be a shared cost. We're not asking for a 100 percent contribution. We're just wanting to make sure that publishers and songwriters aren't asked to finance a new system that really is designed for the users, and if we're not able to resolve this issue among ourselves, the bill, I think, wisely sends it to a process to be resolved, which is the CRB, and we've accepted that as a compromise.

Mr. SMITH. Okay. Mr. Potter, what is your solution to the problem of who pays the overhead costs? Are you happy to go to the Royalty Board, as well?

Mr. POTTER. Mr. Chairman, this is something that we have agreed to share the burden in. We have agreed if we are unable to agree how to share the burden, I think we are comfortable sending it to the CRB. I should share with you that Mr. Israelite's staff, or the staff of the Harry Fox Agency, the technology staff, and several technology folks from my companies have spent many hours over the course of several weeks sitting in a room trying to determine what type of system needs to be put in place so that we can report music usage accurately and they can distribute royalties accurately on an ongoing basis.

Mr. SMITH. Are you closer now than you were several weeks ago?

Mr. POTTER. The answer is, yes, we are closer. There have been fits and starts, as there always are with multi-party negotiations. But the answer is, yes, we're closer to answers. We still don't have firm price tags, but we are closer to answers.

Let me share one point that is responsive to one of Mr. Sherman's points. We don't think that setting up this designated agent system will duplicate our company's administration costs for license reporting or music reporting. We have worked out, and we think we will work out in a final form a music reporting system with the publishers that essentially is almost redundant. We will be providing to the publishers almost the exact same data, if not the exact same data, that we provide to the record companies, and therefore, in fact, we don't think the costs of the ongoing reporting process will be significantly different than the costs that we already have reporting to the record companies.

Mr. SMITH. Okay, good. Thank you, Mr. Potter.

Mr. Carnes, I want to go back to the point that you made or the triple point you made, transparency, transparency, transparency. That seems to make sense. However, you can understand that someone else might not want to reveal all of their business model, how their profit is always determined. They may not want competitors to know all their privileged information. So what kind of a compromise can we have there whereby you could be satisfied that no one was trying to take advantage of you, at the same time, protecting the proprietary interest of other parties?

Mr. CARNES. Well, first, we're very early on in this process. I mean, I just got this bill Friday at 4:30, so I really can't—I don't want to say more than I know. I probably already have. But basically, what I would like to say is, for instance, with the case of the administration fees, we would like to have some input on that or at least see what's going on. We're not asking for a seat on the Harry Fox Board or something, but if there's going to be a designated agent set up by statute, we feel like that's a rights-taking

thing and a blanket license where they take our rights. The general designated agent, of course, gets to take everybody's rights and I think the tradeoff for that is some sort of transparency for us, some ability on the front end to have input on what the rights might be.

Mr. SMITH. Mr. Israelite, what do you think about that?

Mr. ISRAELITE. Well, I certainly appreciate what Rick is trying to do and I think it's a shared goal of making sure that writers and publishers are comfortable with the transparency of the system. There are a lot of what are called singer songwriters that do their own publishing, and for those people, they, in effect, are their own publishers. They can run for our board. In fact, we have them on our board.

Other writers choose to assign their copyrights to a publisher, and when they do that, that is a private contractual arrangement. They're not forced to do it. They can administer it themselves. But those who choose to assign their copyright to a publisher have entered into a business relationship, and one of the principles we've tried to keep intact in this bill is to not have more Government interference into the private contractual arrangements among parties.

And so we've proposed, for example, establishing a dispute resolution committee as a part of the DA that would be made up of half songwriters, half publishers. We've been in very productive negotiations with Rick's group and other songwriter groups about how to make this work. But I think as a principle, publishers believe that when songwriters assign their copyrights and enter into private contractual arrangements, those truly are not the proper place for Government to interfere, and so we hope we can work this out without there being more Government mandates on how publishers do their job.

Mr. SMITH. Okay. Thank you, Mr. Israelite.

Mr. Berman?

Mr. BERMAN. Two sort of whimsical comments. The first is you don't want your contracts with the publishers providing for controlled compositions to be abrogated. You don't want your contracts with the songwriters to be abrogated. And I'm a Democrat and I live to abrogate contracts. [Laughter.]

Mr. BERMAN. The other one that comes to mind is that old thing of, I've got friends on one side and friends on the other and I'm with my friends. [Laughter.]

Mr. BERMAN. So, as you try to work through this, because unfortunately in this business we can't always indulge all our friendships, and shouldn't, the Songwriters Guild, Mr. Carnes, talks about what happens to him under controlled compositions. It reminds me that underlying this somewhat, this may be a fight about money. So I start to think, what if we could deploy, as they finish with the border, we deploy the National Guard to deal with the piracy problem, make the pie much bigger, and you don't need controlled compositions and percentages are an easier substitute. I'm trying to find a dynamic.

The RIAA would like a much broader coverage. If you're going to reform 115, notwithstanding when Mr. Israelite says it works, I've heard record company executives tell me it impedes their abil-

ity to put new technologies on the market because of the way the existing 115 operates and their ability to do that.

What's the dynamic by which record companies' traditional role in conveying publisher rights along with sound recording rights can be given up in the context of a new system, and at the same time, we deal with the broader issue of how to reform and modernize 115? And what is the dynamic that turns this into a broader conversation? I know there's a lot of conversations, but a broader effort? So that's one question. I have one more.

Mr. SHERMAN. Well, our feeling really is to the extent it's not broken, we shouldn't be fixing it. And the one thing in the digital area that is not broken is the download market. The system has worked efficiently and well.

Mr. Potter said that we wouldn't be duplicating the music reporting system and there wouldn't be any additional burden on the music services, and perhaps I'm wrong about that, but I'm under the impression that when there are multiple designated agents, it'll be up to the licensee to figure out to whom to send those royalty checks for publishing. That is not the information that they currently have in their database. They're going to have to figure out year by year who gets what fractional share of what copyrighted musical work, depending on what use was made that year, and that is going to be a very intensive administrative process which we already do for free for the digital music services because we have an infrastructure built up for it.

So if we're going to experiment with something and we want to try moving into a new world, let's start with subscription services and move from there. But I don't think that if we move to the entire digital market that we're going to do much good because the next thing we're going to be arguing about is what's digital and what's physical and where do multi-session disks fit in and everything else and we're just going to have a new set of issues to resolve and not even know how to license them.

Mr. BERMAN. So you're basically saying, go all the way or take just a very small step?

Mr. SHERMAN. Precisely.

Mr. BERMAN. And your reaction?

Mr. ISRAELITE. I think it's a difficult position to take to say that the DPD market of licensing works just fine, but we ought to fix physical. The truth of the matter is is that if you can put out a CD in a physical format, you can license through a DPD store. The truth of the matter is, licensing works just fine with physical formats, and the truth is, licensing works pretty well with DPDs, too. The reason why if we create a new blanket licensing structure it should be applied to all digital is because it doesn't make any sense to build us a brand new Cadillac but tell us we can't drive it out of the driveway.

This new system will give DiMA what it wants. They've asked for blanket licensing. They've asked for one-stop shopping. And so we think it makes perfect sense to cover all digital products.

Mr. SHERMAN. If I can just respond——

Mr. SMITH. Let me yield the gentlemen a couple additional minutes because this is a question I was going to ask, as well, so we're getting double-dancer here.

Mr. SHERMAN. It isn't that our feeling is simply that we ought to have one system, that we're creating artificial boundaries, drawing artificial lines in a world of convergence where next week, we're going to have a new product and we're not going to know whether it's physical or digital. We shouldn't be having parallel systems for licensing when we could have one system, and we'd love for it to be a blanket licensing system, but this isn't a question of whether physical is working well enough. It's creating a new blanket licensing system for all of us for everything.

Mr. BERMAN. I'd like to hear Mr. Potter and Mr. Carnes get into this issue, and let me just also interrupt. Is there a phase-in process, you do one thing right away and one thing in a couple of years? Is there a way of sort of creating that kind of a transition period that makes sense?

Mr. POTTER. We clearly have partners in business on both sides of me, even on all three sides of me, if we were sitting at a square table.

Mr. BERMAN. And you're with your partners.

Mr. POTTER. I'm with my partners, because we don't own anything. We just license it from everyone. It's a tough business to be in.

As I said in my testimony, there's a fair amount of righteousness that the DPD system works, but Mr. Israelite acknowledges the DPD system works. There's a need for modernizing the entire system, both for certain physical products and hybrid products. There's a need for modernizing the entire system so it takes care of the innovative digital products. We certainly went into this in the, I guess it was 2 years ago in the intensive negotiations, thinking we were going to take care of subscription service products and that would cover the hybrid products and things have changed. There's a lot of ways we can support progress. Transition provisions are certainly something we would be willing to talk about.

I will say, however, that it is intriguing for us to hear Mr. Sherman's concern about what is digital and what is physical. Particularly if somebody hands you an iPod with preloaded songs, there's a whole lot of ways to define what's digital and what's physical, what's inside a license or what's outside of the license. When Mr. Sherman's group in the interactivity debate is trying to figure out what's inside or outside the box, they look for infringement litigation and sue our companies and deal with that in the court of law. When they are on the licensee side of the misunderstanding or the box that they're not sure whether they're inside or outside of, they look for a dispute resolution mechanism inside the statutory license to keep them out of court as defendants.

So I would only say if we're going to create a dispute resolution mechanism to figure out if we're inside or outside the box, we'd like to do that for 114 as well as 115.

Mr. BERMAN. On the discussion draft bill, the Chairman and I got into an area that the partners seemed to going in different directions on and that's how to turn this interactive delivery, and I guess the question I have is whether—I mean, if this draft were a bill and it were coming up for a vote, do you support this draft, Mr. Potter, given how that issue is framed in this discussion draft?

Mr. POTTER. I think these issues are manageable. I'm not prepared to negotiate these issues out in public, but I think these issues are manageable.

Mr. BERMAN. Do you?

Mr. ISRAELITE. I would support the current draft bill.

Mr. BERMAN. But do you think the issues are manageable?

Mr. ISRAELITE. As long as Jon would support the current bill, I think the issues are manageable. [Laughter.]

Mr. ISRAELITE. That is as far as you are going to get right now, I think.

Mr. BERMAN. Mr. Carnes, are you suggesting we actually legislate in the area of this transparency at this point, or are you saying there's a process——

Mr. CARNES. Well, there's a process——

Mr. BERMAN.—to work with the publishers on to try and——

Mr. CARNES. There's a process going on right now with the publishers where we discuss this. The reason why in my written statement we gave you the language and everything was because we wanted to put a marker down that we feel that this principle is correct. But I certainly would rather solve this in negotiations with——

Mr. BERMAN. So you want to at least threaten to legislate.

Mr. CARNES. Absolutely. [Laughter.]

Mr. BERMAN. All right. Thank you, Mr. Chairman.

Mr. SMITH. Thank you, Mr. Berman. That was a good ending, and it's frankly encouraging for me to hear that you all are still trying to iron out the last couple of remaining wrinkles. We have a deadline and we're trying to get this done in the next few days and you all know that, but I do think progress is being made and that's good to hear. It's good for the industry, it's good for the future of music, and it's good for us, as well.

So I appreciate all your contributions and hope that you all will continue working together. Make sure that all parties are involved, if you all will, and we can get to a successful conclusion. Thank you again. We appreciate your testimony.

The Subcommittee is adjourned.

[Whereupon, at 5:09 p.m., the Subcommittee was adjourned.]

APPENDIX

MATERIAL SUBMITTED FOR THE HEARING RECORD

PREPARED STATEMENT OF THE HONORABLE HOWARD BERMAN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA, AND RANKING MEMBER, SUBCOMMITTEE ON COURTS, THE INTERNET, AND INTELLECTUAL PROPERTY

Mr. Chairman,

Thank you for scheduling this hearing on the discussion draft of Section 115 music licensing reform.

Over the past couple of years, this Subcommittee has analyzed the compulsory licensing scheme for mechanical rights both as described in the statute and the alternative provided for by the Harry Fox Agency. With the development of new technologies for music distribution, we recognize that neither model is sufficient to meet consumer's demand for music.

And this demand is rising: We have come a long way from the initial piracy-laden version of Napster released in 1999. IFPI's *(International Federation of Phonogram and Videogram Producers)* Digital Music Report of 2006 notes the growth of digitally delivered content in the music industry.

- 420 million single tracks were downloaded in 2005 globally - more than double the number downloaded in 2004 (156 million).
- US: 353 million single tracks downloaded (up from 143 million) [Nielsen SoundScan]
- The number of users of subscription services, such as Rhapsody and Napster, increased from 1.5 to 2.8 million globally in 2005.
- In 2005, the number of legitimate music download sites reached 335, up from 50 two years ago.
- Digital sales in 2005 accounted for approximately 6% of global music sales based on the first half of the year. 2005 was a landmark year for digital music.
- Just last week the Washington Post reported that "Ringtones, once dismissed as nothing more then a passing fad, have become a $3 billion worldwide market."

However, the burden surrounding licensing often delays, if not prevents certain music from getting to the consumer. Unfortunately, this inability to provide music at anytime, any place, in any format may precipitate consumer migration back to unauthorized Peer-to-Peer services.

Two years ago, the Copyright Office suggested that reform of the 115 license should reflect a structure similar to what is currently available for the 114 license—a designated agent which serves as a collective to administer a blanket license. I am encouraged to see that the discussion draft reflects that idea. I commend the publishers on their hard work. They have tried diligently to resolve the problems that the DiMA companies have illustrated - particularly the "double dip" and "one-stop-shop" issue. However, I am concerned that with an impending mark-up less then two weeks away, many important details of the bill have yet to be agreed upon. I will focus on some of those issues during the Q &A.

Furthermore, any solution can only be evaluated from the perspective of the scope of the problem originally identified. Two years ago at an oversight hearing on Section 115, I posed two questions which I will once again ask today: 1) Does 115 facilitate or hinder the roll-out of new legal music offerings? and 2) depending on the answer to the first question, what if anything should Congress do to change 115?

While this proposed legislation addresses many of the digital concerns—unresolved, are the many issues encountered in the physical market or in the area of

hybrid services. The roll-out of new secure physical formats, or higher quality formats, often times require additional reproductions, has been sluggish. Furthermore, there is little resolution to the business model which provides pre-loaded content on devices. Finally, many definitional questions remain such as whether the license includes ringtones, or if a kiosk service is a reproduction in the physical sense or digital phonorecord delivery service. Some of these questions may require a purely economic analysis—others may require a re-evaluation on the process level.

I hope though that we can achieve greater clarity and further consensus as this bill moves forward.

SEPARATE STATEMENT OF SESAC, INC.

SESAC, Inc. ("SESAC") appreciates the opportunity to submit this statement to the Subcommittee regarding the discussion draft of the Section 115 Reform Act of 2006 ("SIRA"). In addition the comments contained in the contemporaneously submitted joint written comments of the three performing rights societies, SESAC submits these additional comments:

1. SESAC understands that, as a compromise solution between the NMPA/HFA, on the one hand, and DiMA, on the other hand, those parties propose that, in exchange for DiMA's acknowledgment that the reproduction right is implicated in interactive streaming, NMPA/HFA is willing to grant digital music services a royalty-free compulsory mechanical license for "the making of server and incidental reproduction to facilitate non-interactive streaming." Although SESAC understands the motivation for this compromise to accomplish the broader purpose of formulating a bill acceptable to DiMA and NMPA/HFA, it is concerned that music services might at some time incorrectly deduce from this provision that, by the same token, SESAC should be willing to grant royalty-free public performance licenses for so-called "full" or "limited" downloads. SESAC's position on this topic has remained constant: Under the Copyright Act, all digital transmissions, including such downloads, constitute performances justifying royalty payments. In light of DiMA's continued insistence, as reflected in Mr. Potter's testimony at this hearing, that a given digital transmission implicates "either a performance right and royalty or a distribution right and royalty, but not both," DiMA should not be heard to argue in the future that SESAC's support of this compromise solution concerning mechanical rights in any way suggests that SESAC has acquiesced in DiMA's position. In short, NMPA/HFA has the right to make such decisions on behalf of its own members, and SESAC maintains its positions on behalf of its affiliates.
2. SESAC understands that the 15 percent of market share requirement was included in SIRA to address DiMA's concerns that, if it were required to deal with too many designated agents having small market share, the efficiency benefits of blanket licensing would be lessened or lost. And, SESAC acknowledges that this is a proposed compromise solution between NMPA/HFA and DiMA only for licensing the mechanical right in digital media and to facilitate and maintain efficiency under this new proposed Amendment to Section 115 relevant to mechanical licensing. SESAC believes the record should be clear that this 15 percent market share criteria is relevant only to mechanical licensing and not to public performance licensing, where over the course of history one or more of the three performing rights organizations mentioned in the copyright law (ASCAP, BMI and SESAC) have not enjoyed a 15 percent market share. Although SESAC acknowledges that it does not control a 15 percent share, the public performance market place as divided among the three performing rights organizations has served as the gold standard of music licensing for over seven decades. As stated by Mr. Potter of DiMA in his testimony at the hearing, "the ASCAP, BMI and SESAC systems for musical works' performance rights" enable "simple, streamlined licensing processes" that substantially reduce legal risk." In short, SESAC's agreement with the 15 percent threshold is limited to mechanical licensing as embodied in this proposed legislation.

Finally, like NMPA/HFA, SESAC believes as a matter of general principal that, in a perfect world, the licensing of all musical rights be accomplished solely by fair marketplace dynamics. Nevertheless, SESAC understands the particular historic problems attendant to the present compulsory mechanical licensing scheme, particularly in the digital realm, and supports the efforts of NMPA/HFA and DiMA to craft a blanket mechanical licensing system that will facilitate greater legitimate music

uses to the benefit of music publishers and songwriters, who are also SESAC's constituents. SESAC would be happy to expand on these comments, answer any questions raised, and otherwise be of assistance to the Subcommittee in its consideration of this proposed licensing reform.

PREPARED STATEMENT OF THE U.S. COPYRIGHT OFFICE

STATEMENT OF
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Before the

SUBCOMMITTEE ON COURTS,
THE INTERNET AND INTELLECTUAL PROPERTY
OF THE HOUSE COMMITTEE ON THE JUDICIARY

109th Congress, 2nd Session
May 16, 2006

Oversight Hearing: The Discussion Draft of H.R. _____,

The "Section 115 Reform Act (SIRA) of 2006"

The Copyright Office appreciates the opportunity to submit these comments to the Subcommittee regarding the progress that appears to have been made towards reforming section 115 of the Copyright Act, which governs the licensing of the reproduction and distribution rights for nondramatic musical works. As the Subcommittee has heard at a number of hearings, the existing section 115 does not comport with the realities of the digital environment in which music creators, distributors and users now operate. The draft Section 115 Reform Act of 2006 ("SIRA") represents a significant advancement towards modernizing the Copyright Act to facilitate digital audio transmissions of music while balancing the interests of songwriters, music publishers, and online music services, as well as the consuming public.

Overview

The draft legislation reflects an understanding and appreciation of the many difficulties facing the music industry today with respect to the digital environment.[1] The most critical and time-sensitive issue is the current unavailability of an efficient and reliable mechanism whereby legitimate music services are able to clear all of the rights they need to make large numbers of musical works quickly available by an ever-evolving number of digital means while ensuring that the copyright holders are fairly compensated. During the years of negotiations that have ensued to explore a possible statutory mechanism via section 115, the various interested parties have voiced concerns regarding numerous additional issues that face the music industry as well, some of which the Office understands may be addressed by other legislation. Although these additional issues are no doubt legitimate, the sheer number and complexity of them ultimately render a holistic solution improbable, if not impossible, and the immediate benefit that the SIRA could bring to the music industry should not be delayed pending resolution of the other issues or bills, nor should the fate of the SIRA be tied to that of other legislation.

The SIRA appropriately focuses on those issues absolutely necessary to establish a functional licensing structure to enable legitimate music services to provide, and the consuming

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[1] For a detailed account of these difficulties as well as a comprehensive history of the section 115 compulsory license, please refer to the Register of Copyrights' written statements to this Subcommittee on June 21, 2005 and March 11, 2004. *See Oversight Hearing on "Copyright Office Views on Music Licensing Reform": Hearing Before the Subcomm. on Courts, the Internet, and Intellectual Property of the House Comm. on the Judiciary*, 109th Cong. (2005) (statement of Marybeth Peters, Register of Copyrights) (available at http://www.copyright.gov/ docs/regstat062105.html); *Section 115 of the Copyright Act: In Need of an Update?: Hearing Before the Subcomm. on Courts, the Internet, and Intellectual Property of the House Comm. on the Judiciary*, 108th Cong. (2004) (statement of Marybeth Peters, Register of Copyrights) (available at http://www.copyright.gov/ docs/regstat031104.html). *See also Music Licensing Reform: Hearing Before the Subcomm. on Intellectual Prop of the Senate Comm. on the Judiciary*, 109th Cong. (2005) (statement of Marybeth Peters, Register of Copyrights) (available at http://www.copyright.gov/docs/regstat071205.html). These statements also describe the Copyright Office's involvement with inter-party negotiations on these matters.

public to enjoy, vast quantities and varieties of music through the digital delivery of music online. It is also appropriate that the SIRA leaves undisturbed the structure established by section 115 for the reproduction and distribution of nondramatic musical works in physical formats (*e.g.*, compact discs, vinyl records and cassette tapes), a structure that has worked well for that marketplace.[2] Finally, the Office understands that the SIRA has received initial support and input from a variety of interested parties, which is crucial for its success.[3] As the past few years of negotiations have demonstrated, the field of music licensing is a highly complex architecture supported in part by relationships, split rights, side agreements and historical antiquities that are inextricably woven into current business models. Therefore, for any legislation to benefit and foster the industry, it must take these realities into account.

The SIRA addresses three principal concepts - blanket licensing, designated agents and royalty rates - each of which is separately addressed below. We caution that given the complexity of these issues and the interrelatedness of the various copyrights implicated in the digital delivery of one song, our comments today focus only on concepts. The Office has not had the opportunity to conduct a careful review of the draft legislative language, but will do so and provide further advice to the Subcommittee within the next several days.

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[2] We are aware that the recording industry has expressed an interest in amending section 115 to address issues relating to licensing of musical works in physical formats. Whether or not the amendments sought by the recording industry are worthy of consideration, it would be a mistake to jeopardize the progress that has been made in resolving issues relating to online music licensing by tying it to the unresolved issues relating to physical formats.

[3] Specifically, we understand that the draft SIRA is based on concepts discussed and tentatively agreed to by the National Music Publishers' Association ("NMPA") and the Digital Media Association ("DiMA"). However, we recognize that because these organizations have apparently not reached agreement on all relevant issues and others have yet to provide their input, it may be premature to conclude that the SIRA represents a solution acceptable to all stakeholders.

Blanket Licensing

The Copyright Office commends this Subcommittee for adopting a blanket licensing approach to the digital reproduction and distribution of musical works, and believes that such an approach is necessary for successful reformation of section 115. Speed is the hallmark of the digital age. If legitimate music services are not able to clear rapidly and relatively easily the rights to the music that they wish to distribute and the consuming public wishes to obtain online, then consumer demand for prompt access to music upon its release will likely encourage and sustain unauthorized distribution. The blanket licensing proposed in the SIRA attacks this problem in two ways.

First, by simply filing one license application – or in the case of multiple designated agents or a change in digital uses, a limited number of applications – a legitimate music service can obtain a license to utilize all musical works[4] in the digital environment, rather than having to locate the various copyright owners of those works and clear the rights with each of them. Requiring the license to be available to all comers and deeming it to be automatically granted upon the filing of a proper application makes this licensing processing as instantaneous as possible. A key component is that the new compulsory license governs all nondramatic musical works and does not permit copyright owners to opt-out, which would otherwise jeopardize the efficiency of the entire blanket licensing structure. Additionally, we note that the SIRA appropriately does not preclude a copyright owner from entering into a direct licensing agreement with a particular digital music service, thus preserving multiple licensing options for

[4] That is, all musical works that have been distributed in the form of phonorecords to the public in the United States under the authority of the copyright owner. The SIRA would not alter the current provision in section 115 that limits the scope of the compulsory license to musical works that have already been recorded and released.

copyright owners and licensees.

Second, the proposed blanket license covers all intermediate copies (*e.g.,* server, cache and buffer copies) necessary to facilitate the digital delivery of music and applies to streaming and limited downloads.[5] Presently, there exists much confusion and controversy as to whether these copies and uses must be separately licensed, which the Office understands can result in protracted negotiations and delays. By resolving these issues, the SIRA clears the way for the legitimate music services to focus on rapidly delivering music to the consuming public and developing new technologies to make delivery even faster, regardless of whether such technologies involve additional intermediate copies or not.

Based on the foregoing and our involvement in discussions on these issues over the past several years, we anticipate that the blanket licensing approach would be welcomed by, or at least be acceptable to, the various interested parties. Furthermore, we note that blanket licensing has proven successful with respect to the section 114 compulsory license for sound recordings, and would expect it to function similarly in the section 115 context.

However, the Copyright Office strongly urges that the SIRA not characterize streaming as a distribution or as a form of "digital phonorecord delivery," or DPD. A stream, whether interactive or noninteractive, is predominantly a public performance, although the various reproductions such a transmission requires makes it appropriate to address in section 115. A stream does not, however, constitute a "distribution," the object of which is to deliver a usable copy of the work to the recipient; the buffer and other intermediate copies or portions of copies

[5] As defined in SIRA, a "limited download" is "a digital phonorecord delivery of a sound recording of a musical work that is only available for listening for (i) a definite period of time (including a period of time defined by ongoing subscription payments made by an end user); or (ii) a specified number of times."

that may temporarily exist on a recipient's computer to facilitate the stream and are for all practical purposes useless (apart from their role in facilitating the single performance) and most likely unknown to the recipient simply do not qualify. Similarly, a stream should not be considered a DPD as that term is presently defined by 17 U.S.C. § 115(d), because it most likely does not result in "a specifically identifiable reproduction by or for any transmission recipient of a phonorecord." The Office recognizes that the SIRA proposes to amend the definition of DPD to specifically incorporate streaming, but such an amendment is problematic because a DPD is generally understood – and should be understood – to be a distribution in and of itself. Characterizing streaming as a form of distribution is factually and legally incorrect and can only lead to confusion in an environment where the concept of distribution by means of digital transmission is already the subject of misguided attacks.[6] The Office therefore suggests that the SIRA's proposed section 115(e) apply to both digital phonorecord deliveries (which would not include streaming) and streaming (as a form of transmission distinct from digital phonorecord deliveries), and that the definition of "stream" be reexamined in light of the foregoing discussion. The Office does, however, support the SIRA's conforming amendment to subparagraphs 115(c)(3)(C) and (D) that deletes the reference to reproductions or distributions of phonorecords "incidental" to a transmission. This undefined term which lacks any legislative explanation has been the source of much confusion and has prevented the establishment of rates for these actions.

Additionally, we note that the SIRA resolves complaints by online music services about

[6] *See, e.g.*, Brief of *Amici Curiae* Computer & Communications Industry Association and US Internet Industry Association in connection with Defendant's Motion to Dismiss the Complaint, *Elektra Entertainment Group, Inc. v. Barker*, No. 05 CV 7340 (S.D.N.Y., filed Feb. 24, 2006).

what they characterize as "double-dipping" in one context, providing for a royalty-free license for intermediate copies in the context of noninteractive streaming, but does not resolve other situations involving arguably duplicative payments demanded by copyright holders' representatives for both the performance as well as the reproduction and distribution rights when a musical work is delivered by a mechanism which is not clearly solely a distribution or a performance. Although these other situations involve important issues, it is not necessary to resolve them at this time to make the SIRA an effective piece of legislation. Its absence from the SIRA may even prompt the interested parties to resolve it on their own. In fact, because the resolution of that issue is so difficult due to the positions taken by music publishers and performing rights organizations, it is actually a virtue of the SIRA that it defers resolution of that intractable issue to another day.

Designated Agents

1. *Conceptually*

As the Register of Copyrights has previously testified, collective administration of the copyrights in musical works has proven successful both domestically in the context of the American Society of Composers, Authors and Publishers ("ASCAP"), Broadcast Music, Inc. ("BMI") and SESAC, Inc.'s administration of performance rights, and internationally for both performance as well as reproduction and distribution rights.[7] The three domestic performing rights societies collectively are able to license public performances of virtually all nondramatic

[7] Collective administration has also proven successful with respect to the section 114 statutory license for sound recordings. The section 114 license is slightly different from the proposed section 115(e) license in that the former is a true statutory license wherein SoundExchange simply administers all royalties paid for this license, and the latter would be a compulsory license whereby the statute grants the authority to and mandates designated agents to issue the relevant licenses, albeit subject to statutory requirements and rates set by the Copyright Royalty Board.

musical works and do so on a blanket basis. Currently, no similar mechanism exists with respect to the reproduction and distribution of phonorecords of nondramatic musical works, because the main licensing agent for these rights – the Harry Fox Agency, Inc. ("HFA") – is unable to license a significant percentage of these works.

The SIRA creates this type of collective licensing structure for online music services to obtain the digital reproduction and distribution rights for musical works through the use of designated agents. It relieves licensees of the difficulties in locating someone who is authorized to license the reproduction and distribution of a particular song. The Office supports this licensing structure, and notes the following features that will help ensure its effectiveness.

Digital music services need to be able to obtain licenses to cover all the musical works that they wish to make available. The SIRA addresses this issue by including a default provision that grants statutory authority to the General Designated Agent ("GDA") to license any works not specifically represented by an additional designated agent. Since each agent is required to make available a list of the musical works it is authorized to license for digital uses and any works not affirmatively identified may be presumed to be covered by the GDA's license, a licensee is not only assured that it has the ability to secure rights to all musical works, but it also has the necessary information to determine from whom to secure rights for a particular work as well.

It is also important that a licensee should not have to secure licenses from an unmanageable multiplicity of designated agents in order to make available all of the works it desires; otherwise the efficiency of the blanket licensing approach is undercut. By limiting additional designated agents to those who represent at least a significant percentage of relevant

market share, the SIRA avoids the potential for the proliferation of designated agents.

2. *Logistical Issues*

The creation and administration of designated agents necessarily raises a number of logistical issues, including: the process by which to select the General Designated Agent; funding sources for the designated agents and their databases; copyright owners' selection of a designated agent to administer the digital reproduction and distribution rights for their works; designated agents' communication to potential licensees of their available catalogues and licensing procedures; licensees' use of the agents' databases; royalty reporting and compliance procedures; disclosure and use of royalty data; the default administration procedures should any designated agent cease operations; royalty dispute resolution; and disposition of unclaimed royalty funds.[8] In order to create a licensing structure that can remain sufficiently flexible to adapt to changing technologies and the necessary conforming changes to business platforms, it would be helpful for the legislation to focus on the legal rights of various parties, and leave the majority of the logistical issues to regulatory action.

Additionally, the Copyright Office has some concerns regarding designated agents' authority to collect and expend administrative fees. The SIRA appears to give designated agents too much discretion to use these fees - and even royalties collected under the license - to

[8] In the current draft of the SIRA, it is unclear whether the "reasonably diligent" search a designated agent must make for copyright owners of unclaimed funds, *see* proposed subparagraph 115(e)(11)(B)(i), would require more than "reasonably diligent efforts to publicize the existence of the unclaimed funds and the procedures by which copyright owners may claim such funds from the designated agent." *See* proposed subparagraph 115(e)(11)(B)(ii)(I). As the Subcommittee knows, current discussions regarding possible legislation addressing orphan works would require users of orphan works to engage in a reasonably diligent search in good faith to locate the owner of the infringed copyright in order to enjoy the benefit of the proposed limitation on remedies. It may not be unreasonable to impose a similar requirement on designated agents who have collected royalties belonging to unlocatable copyright owners.

inappropriately fund tangential activities. The Office believes that the designated agents should be permitted to use such moneys only for activities directly related to licensing music works under section 115 and the collection and distribution of royalty fees. Administrative fees collected from licensees should not be used for other purposes, such as "industry negotiations, rate setting proceedings, litigation, and legislative efforts," as provided in proposed subparagraph115(e)(9)(D), and it is also questionable whether it is appropriate to apply royalty collections to those activities, rather than simply distribute those royalties to copyright owners after deducting the actual costs of collecting and distributing the royalties.[9] Consideration should be given to limiting the use of the administrative fees, and perhaps the royalties as well, for "licensing administrative costs" as defined in proposed subparagraph115(e)(15)(G). Moreover, while we understand the reasons why licensees might be expected to share in the costs of establishing the General Designated Agent's infrastructure for licensing and royalty collection and distribution, we do not understand the rationale for the SIRA's apparent requirement that licensees pay for the establishment and maintenance of additional designated agents as well. *See* proposed subparagraph 115(e)(12). Furthermore, we have some concerns that the designated agents seem to be the sole judges with respect to the auditing of whether a licensee has underpaid an agent. If a designated agent determines that a licensee has underpaid royalties by 10 percent or more, the licensee must bear the cost of the designated agent's royalty compliance examination. There are obvious problems with an arrangement that give the designated agent the sole discretion to make such a determination. The regulatory provisions

[9] It is also unclear what relationship, if any, there is between the activities provided in proposed subparagraph 115(e)(9)(D) and the "other administrative costs" defined in proposed subparagraph 115(e)(15)(J). It is possible that proposed subparagraph 115(e)(15)(A) means that the fees charged to licensees might be used in part to fund those "other administrative costs."

with respect to other compulsory licenses entrust those determinations to independent auditors, which seems to be a more appropriate structure. As part of the refining of the draft SIRA, the Office would suggest that the issues of cost sharing. administrative fees and auditing either be more fully fleshed out in the legislation or be subject to a regulatory process and oversight.

Royalty Rates

The SIRA establishes a royalty-free rate for the making of server and other intermediate copies necessary to facilitate noninteractive webcasting. As the Register of Copyrights has previously testified,[10] intermediate copies made in the course of streaming a licensed public performance of a musical work should be subject either to an exemption or to a statutory license. The Office believes that the SIRA's proposal to create a royalty-free compulsory license to address this situation is a major step in the right direction, primarily because we understand that several of the interested parties have preliminarily agreed to this term and we believe it is a reasonable solution which resolves the "double-dipping" scenario at least in this context. However, we believe that a less burdensome and equally effective approach would be to grant a statutory exemption for this activity. Establishing an administrative apparatus and charging an administrative fee for the issuance of a royalty-free license would offer little or no benefit over an exemption, while creating costs and burdens for both licensees and the designated agent.

The SIRA appropriately assigns responsibility for rate setting to the Copyright Royalty Board ("CRB"). It is important that both the SIRA and the parties recognize that the CRB has discretion to determine that some statutorily licensed uses, such as the reproduction of

[10] *Section 115 of the Copyright Act: In Need of an Update?: Hearing Before the Subcomm. on Courts, the Internet, and Intellectual Property of the House Comm. on the Judiciary*, 108th Cong. 22 (2004) (statement of Marybeth Peters, Register of Copyrights) (available at http://www.copyright.gov/docs/regstat031104.html).

intermediate copies for interactive streaming, may have a value of zero depending on the given context and evidence presented. Similarly, the CRB should be at liberty to establish different rates for various digital uses of works licensed pursuant to this new compulsory license.

Another key component to ensure the effectiveness of any legislation is to make the acquisition of a compulsory license independent of the status of rate setting proceedings. In other words, even if an interim or final rate for a particular digital use of musical works has not been established, the music services must be able to obtain a license and the corresponding legal certainty for that use if they are to compete effectively with illegal distribution. By providing that a license shall be effective upon the filing of an application, while also providing for the setting of interim rates and for retroactive adjustments once a final rate has been set, the SIRA accommodates the needs of music services and music publishers.

Finally, the SIRA appears to omit a provision governing one of the most significant and necessary aspects of any blanket licensing scheme: there is no provision that addresses how royalties are to be distributed by designated agents to copyright owners.[11] Clearly, a designated agent should not have unfettered discretion to determine how the royalties it collects should be allocated among copyright owners. The statute should prescribe guidelines to ensure that royalties are distributed in a fair and equitable fashion, giving each copyright owner the royalties to which it is entitled based on the uses licensees make of that copyright owner's works. It may

[11] It is also unclear how a licensee would allocate royalty payments among designated agents, if additional designated agents are certified under proposed subparagraph 115(e)(9)(C). While the mechanism for allocation might be simple if royalties continue to be calculated as a "penny rate" – *e.g.*, the current royalty for each phonorecord delivered is 9.1 cents – the method of allocation would be unclear if royalties are set on a basis such as a percentage of the music service's revenues, a basis that both the current section 115 and the proposed revision to section 115 appear to (and ought to) permit. If a digital music service is required to pay a royalty of *x* percent of its revenues, how would it determine what percentage of that royalty is to be paid to each designated agent?

be appropriate to delegate responsibility for crafting such guidelines to the Register of Copyrights or the Copyright Royalty Board, but the statute should address this issue in some respect. We note that the statutory license in section 114 also offers no guidance as to how royalties should be distributed among copyright owners, and as a result, the Librarian of Congress had to issue regulations, as part of the Copyright Arbitration Royalty Panel rate-setting process, governing SoundExchange's distribution of royalties.[12]

Conclusion

From the information the Copyright Office has received thus far, the SIRA appears to be a productive step forward in modernizing section 115 of the Copyright Act for the digital age. Although there are undoubtedly many drafting subtleties to be vetted and logistical issues to be addressed or referred to the regulatory process, the Office supports the fundamental concepts on which the SIRA is based. We are especially encouraged that the SIRA is based upon principles agreed to by both music publishers and online music services, and we commend both sides for the progress they have made in overcoming what once seemed to be insuperable obstacles to reaching a workable and beneficial solution. While we understand that some obstacles to complete agreement remain, we encourage the parties to resolve all outstanding differences and we encourage the Subcommittee to complete the process of crafting legislation based on the working draft of SIRA that will make fair and efficient licensing of musical works for online

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[12] *See Determination of Reasonable Rates and Terms for the Digital Performance of Sound Recordings*, 63 Fed. Reg. 25394, 25412, 25414 (May 8, 1998); *see also Recording Indus. of Am. v. Librarian of Congress*, 176 F.3d 528, 531, 535 (D.C. Cir. 1999). Not only does section 114 not set forth any guidelines regarding allocation of royalties by the collective that receives the royalties, it is also silent with respect to how royalties are to be collected and distributed to copyright owners. The mechanism of one or more collectives to receive royalty payments and disburse them to copyright owners was a necessary creation of the regulatory process in the Copyright Office and the Library of Congress.

services a reality.

As always, the Copyright Office welcomes the opportunity to assist this Subcommittee as it completes its work on this important issue.