TESTIMONY OF

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Washington, D.C.

Before the
COPYRIGHT ROYALTY JUDGES
Washington, D.C.

QUALIFICATIONS

My name is Cary Sherman, and I am the President of the Recording Industry Association of America, Inc. I have been at RIAA since 1997, originally as Senior Executive Vice President and General Counsel. Prior to joining RIAA, I was a senior partner and head of the Intellectual Property & Technology Group at the law firm of Arnold & Porter. During my over 25 years at Arnold & Porter, I specialized in copyright law, particularly as it related to the recording industry, and served as RIAA's outside counsel on copyright issues. Among other things, I worked with RIAA to secure passage of various copyright laws, including the Copyright Act of 1976 and Digital Performance Right in Sound Recordings Act of 1995 ("DPRA"). I was also part of the litigation team that represented RIAA in the only previous proceeding to set royalty rates under Section 115 – a proceeding before the Copyright Royalty Tribunal in 1980-1981. I graduated from Cornell University in 1968, and Harvard Law School in 1971.

INTRODUCTION AND SUMMARY

All of the parties to this proceeding, in one way or another, depend upon songs - the notes and lyrics that make up what the Copyright Act calls "musical works."

The Recording Industry Association of America ("RIAA") is the trade association that represents the U.S. recording industry. Its members create, manufacture and/or distribute approximately 85-90% of all legitimate sound recordings produced and sold in the United States. This proceeding is important to RIAA and its member companies because songs are a key component of our companies' products. It is imperative that songwriters be encouraged to create new songs, and they should be fairly compensated for their efforts, because their success is our success.

However, the song is only one component of a recorded music product. Just as record companies could not create recordings without songs, songwriters and music publishers could

not realize significant income from their songs without the creative and technological contributions and huge investments made, and the risks taken, by artists and record companies. We have a symbiotic relationship as parts of one music industry. And as the music marketplace we grew up with continues to be transformed over the next statutory royalty rate period, we will all succeed or fail together depending on whether we can create, record, and deliver music that the public will love in forms that the public will pay for.

The purpose of this proceeding is to set the statutory "mechanical" royalty rate. Mechanical royalties are the payments record companies and digital music services make to music publishers for the right to distribute recordings of songs to the public. In this proceeding, the Copyright Royalty Judges (the "Judges") have to balance the different roles played by songwriters and music publishers on the one hand and artists, record companies and digital music services on the other in creating, promoting and distributing recorded music products. The mechanical royalty rate should provide songwriters a fair reward for their work, but it also needs to recognize the many contributions that others must make to take a raw song and turn it into a product or service that will generate income for everyone in the music value chain. Because the commercial life of a song depends on its being recorded, promoted and distributed, a rate structure should be adopted, and rates should be set at a level, that will maximize those activities and thereby expand the music industry to the benefit of everyone in it.

The compulsory license provided by Section 115 is a complicated subject with a long history, and the music industry that has grown up around that compulsory license is even more complicated. Yet understanding the structure of the music industry and the nature and scope of the compulsory license is essential to determining royalty rates and terms under the compulsory license.

In my testimony I will first describe the structure of the music industry and the role of the various industry participants. I will then describe the history, scope and operation of Section 115.

DISCUSSION

I. An Overview of the Music Industry

As the Judges probably know, every recorded music product embodies two separate works of authorship with two separate copyrights.[1] One is a musical work, which is the notes and lyrics of a song.[2] The other is a sound recording, which is a particular recorded performance of the song by a performing artist.[3] The music industry is structured around these two different types of works and the different rights therein afforded by copyright law. I will begin by describing the musical work side of the industry and then turn to the recording side of the industry.

A. Musical Works

Exhibit A-102-DP is the sheet music for the song "The First Cut is the Deepest." That song, one of my personal favorites, was written by Cat Stevens in 1967. The song is a "musical work," and Cat Stevens (now known as Yusuf Islam) is the "songwriter." There are many thousands of songwriters in America. Many of them, like Cat Stevens, are also recording artists. He enjoyed tremendous commercial success in the 1960s and 1970s and has sold over 40 million records.[4] Artists who write their own music are sometimes called "singer-songwriters." Record

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[1] A copy of the relevant statutory provisions cited in Section I are attached as RIAA Ex. A-101-DP.

[2] *See* 17 U.S.C. § 102(2) (attached as RIAA Ex. A-101-DP).

[3] *See* 17 U.S.C. § 102(7) (attached as RIAA Ex. A-101-DP).

[4] *See* http://www.thebiographychannel.co.uk/biography_story/302:144/1/Cat_Stevens.htm (last visited November 19, 2006) (attached as RIAA Ex. A-103-DP).

producers are also often songwriters. Other songwriters, like three-time Grammy winner Diane Warren, write songs as their profession.[5] Still others work primarily outside the music industry.

Increasingly, songs have multiple writers. It is common, for example, for several members of a band and the producer of a track to share writing credit for a song. The co-writers each own a share of the copyright in the musical work - a phenomenon known as "split copyrights."

As the writer of "The First Cut Is The Deepest," Cat Stevens initially owned the copyright in that song (musical work). Under Section 106 of the Copyright Act, the copyright owner of a musical work enjoys various exclusive rights. Most relevant to this proceeding are the exclusive rights to reproduce and distribute the work in "copies" and "phonorecords":[6]

- Copies are reproductions of a musical work in sheet music, videos and other forms - but not sound recordings. The sheet music in RIAA Exhibit A-102-DP is a copy of "The First Cut Is The Deepest."
- Phonorecords are material objects, such as CDs, cassettes, vinyl records or computer hard drives, in which sounds are fixed.[7] RIAA Exhibit A-105-DP, a CD by artist Sheryl Crow containing her recent recording of "The First Cut is the Deepest," is an example of a phonorecord. However, in ordinary discourse it is common to refer to phonorecords as "copies."

The copyright owner also has the exclusive right to perform the work publicly, as well as certain other rights.[8]

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[5] http://realsongs.com/ (last visited November 19, 2006) (attached as RIAA Ex. A-104-DP).

[6] *See* 17 U.S.C. §§ 106(1), 106(3) (attached as RIAA Ex. A-101-DP).

[7] *See* 17 U.S.C. § 101 (attached as RIAA Ex. A-101-DP).

[8] 17 U.S.C. § 106(4) (attached as RIAA Ex. A-101-DP).

Songwriters often assign an interest in their copyrights to a business partner known as a "music publisher." According to Songfile, an online database of musical works provided by The Harry Fox Agency, the music publisher that controls "The First Cut is the Deepest" is Universal-MCA Music Publishing, part of the Universal Music Publishing Group.[9] The music publisher is responsible for administering the song by issuing licenses, collecting and distributing royalties, and performing audits and other administrative tasks such as registering the copyright with the Copyright Office. To acquire works, the music publisher generally pays the songwriter an advance and a share of the royalties from licensing the work.

The music publishing industry consists of a handful of major companies and tens of thousands of smaller, "independent" publishers. The latter are a diverse group, including small to medium-sized stand-alone music publishing businesses, independent record labels that also own publishing catalogs, and songwriters who "self-publish" their own works.

The basic business model of a music publisher is first to acquire songs, whether by buying catalogs of existing songs or by signing active writers (and typically paying them an advance), and then to commercialize them by licensing through various channels and for numerous purposes to generate as many streams of income as possible. Of these, a leading treatise on music publishing identifies the following as the forms of licensing giving rise to the primary streams of income enjoyed by publishers and writers:[10]

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[9] *See* RIAA Ex. A-106-DP, Songfile page for "The First Cut is the Deepest" available at http://www.harryfox.com/songfile/public/publicsearch.jsp (last visited November 25, 2006).

[10] *See* Al Kohn & Bob Kohn, Kohn on Music Licensing 87-90, 445-448 (3d ed. 2002) (attached as RIAA Ex. A-107-DP).

- Mechanical licenses – The subject of this proceeding, these are licenses for the reproduction and distribution of musical works as used in sound recordings (e.g., on CDs, as full-song downloads, as ringtones and through subscription services)
- Performance licenses – Licenses to perform musical works publicly, both in live venues and by means of transmission (e.g., television, radio, Internet webcasting)
- Synchronization licenses – Licenses for reproductions of musical works as part of audiovisual works, such as motion pictures, television programs and advertising
- Videogram licenses – Licenses for reproductions of motion pictures and other audiovisual works distributed to the public (e.g., on DVD or videocassette)

The same treatise identifies the following as other forms of licensing giving rise to secondary or emerging streams of income for writers and publishers:

- Print licenses – Licenses for printing sheet music and music books, and printed lyrics
- Electrical transcription licenses – This old-fashioned term refers to licenses for reproductions used in radio broadcasting and other specialized transmissions (e.g., use of a song in theme music for a radio program, or music on hold).
- Musical product licenses – Licenses for reproductions embedded in products such as music boxes, singing dolls and musical greeting cards
- Multimedia licenses – Licenses for distribution of multimedia products of all kinds, including computer software, video games, and karaoke discs
- Digital transmission and reproduction licenses – Licenses for other electronic distribution
- Dramatic performance and grand performance licenses – Licenses to use a song to carry forward the plot of a play, or to stage an opera or musical play

- Dramatic adaptation licenses – Licenses to dramatize a musical work

Most of these different types of licenses are granted and administered directly by music publishers, but there are a couple of important exceptions. Most relevant to this proceeding, over 30,000 music publishers outsource all or part of the responsibility of administering mechanical licenses to The Harry Fox Agency ("HFA"), a subsidiary of the National Music Publishers' Association ("NMPA").[11] HFA simplifies the compulsory licensing process for record companies and publishers alike by acting as a clearinghouse for licensing and offering a modified compulsory license with a quarterly accounting and payment schedule, rather than the monthly schedule that Section 115 requires. HFA issues mechanical licenses at the statutory rate, unless it has permission from the music publisher to issue a license at less than the statutory rate. RIAA Exhibit A-106-DP is a page from Songfile indicating that "The First Cut is the Deepest" is licensable through HFA.

Less relevant to this proceeding, writers and publishers generally affiliate with a performing rights organization ("PRO"), such as the American Society of Composers, Authors and Publishers ("ASCAP"), Broadcast Music, Inc. ("BMI"), or SESAC (originally the Society of European Stage Authors and Composers). PROs license public performances of musical works on a collective basis, and, in the United States, ASCAP, BMI, and SESAC administer the vast majority of such licenses. Television and radio broadcasters and digital music services, as well as concert venues, bars and restaurants, obtain performance licenses from PROs, and in exchange pay the PROs either a percentage of their gross revenues or a flat fee (depending on the PRO and licensing program). The PROs in turn distribute those payments to their members.

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[11] RIAA Ex. A-108-DP, Press Release, Harry Fox Agency, Music Publishers: Are You Getting Your Share of the Audio Home Recording Act Royalties? (Oct. 30, 2006), http://www.harryfox.com/docs/AHRA.pdf (last visited November 24, 2006).

B. Sound Recordings

The other work of authorship embodied in a recorded music product is the sound recording. A sound recording is a recorded version of a song by a "recording artist." Record companies typically enter into "recording contracts" with artists for the production of one or more albums. In addition to the work in the studio that is necessary to create an album, artists make special appearances to promote their albums and tour extensively, often with financial support of their record companies, both to generate touring income and to promote sales of their albums. Artists are also often songwriters. Between creation and promotion of an album and touring associated with the album, each album release typically represents a commitment of a couple years of effort by the artist, and the artist's career rises or falls with each album release.

Numerous artists have recorded the song "The First Cut is the Deepest." The songwriter, Cat Stevens, first recorded it in 1967 on his album "New Masters." It was later released on a compilation of Cat Stevens's greatest hits, titled "The Very Best of Cat Stevens." Exhibit A-109-DP is a CD of that compilation. Later, both Rod Stewart and, more recently, Sheryl Crow have recorded versions of "The First Cut is the Deepest." Rod Stewart's version of "The First Cut is the Deepest" was originally released in 1976, and was included in his recent compilation CD, The Story So Far: The Very Best of Rod Stewart, Vol. 2. One of my favorite versions of the song is on Sheryl Crow's popular album "The Very Best of Sheryl Crow," which was released in 2003. In fact, I only recently learned that Sheryl Crow did not write the song. Exhibit A-105-DP is a CD of this album. These later recordings of songs that have previously been released are known as "covers."

The copyrights in sound recordings are typically owned by the record companies that produced them. Often that is one of the four "major" record companies (or a subsidiary thereof):

Universal Music Group, Sony BMG, Warner Music Group and EMI Music. There are also numerous "independent" record companies not affiliated with the four "majors."

Record companies generally advance all the costs of creating, promoting and distributing a sound recording. In addition, record companies often make large advances to the recording artist before a song or album is even recorded. I understand that these advances are generally larger than advances provided to songwriters by publishers. The record company has to recover its investment, as well as pay the artist and producer, primarily through product sales, because limitations on the scope of its copyrights give it much less access to other streams of income than in the case of musical works.

The sound recording reproduction right extends only to duplication of the actual sounds of the sound recording by electronic, mechanical or similar means.[12] Artists can go into a studio and create a so-called "sound-alike" recording that imitates the original, and if they do, they will need to pay the music publisher and writer, but not the artist and record company that created the original recording. That may happen for uses such as motion pictures and television, where the producer needs a synchronization license from the music publisher but may create a sound-alike to avoid paying the artist and record company. Moreover, the sound recording performance right is much narrower than the musical work performance right, because it applies only to digital audio transmissions and is subject to numerous exemptions. Of course, it is also subject to the statutory license that is being addressed in other proceedings before the Judges.

Thus, for example, anyone could create a new cover version of "The First Cut is the Deepest." But to distribute it, the person creating the cover version would need to pay Cat Stevens and his music publisher - as did the record companies that produced Cat Stevens', Rod

[12] 17 U.S.C. § 114(b) (attached as RIAA Ex. A-101-DP).

Stewart's and Sheryl Crow's versions of "The First Cut is the Deepest." Even if someone imitated Sheryl Crow's rendition and created a sound recording that sounded identical to her original recording, that person would not need to pay Sheryl Crow or her record company. Similarly, Cat Stevens and his music publisher are paid by their PRO when any rendition of "The First Cut is the Deepest" is performed at a concert or other live venue or played on television, radio, satellite radio or an Internet webcasting service. The artist and record company are paid for performances only by such digital services as satellite radio and webcasters, not for live performances, not for television, and not for radio. Thus, as Sheryl Crow has been performing "The First Cut is the Deepest" on her tour this fall, Cat Stevens and his music publisher are entitled to be paid performance royalties for those live performances, but her record company is not.

II. Section 115

As I noted above, a "mechanical" license is a license for the reproduction and distribution of musical works to the public as used in sound recordings (e.g., on CDs, as downloads of full songs and ringtones, and through subscription services). Section 115 of the Copyright Act provides the basis for most mechanical licensing.[13]

A. Scope and Operation of Section 115

Section 115 makes a compulsory license available whenever phonorecords of a musical work have first been distributed to the public under the authority of the copyright owner. That condition is called the requirement of "first use." After first use, any person may obtain a

[13] Section 115 of the Copyright Act is attached at RIAA Ex. A-110-DP. Regulations relating to the statutory license of Section 115 are attached as RIAA Ex. A-111-DP.

compulsory license if his or her primary purpose in making phonorecords is to distribute them to the public for private use.[14]

To obtain a compulsory license, one must provide notice in accordance with statutory and regulatory requirements.[15] Unlike every other compulsory license provided by the Copyright Act, these requirements are quite complicated and procedurally difficult to meet. Most importantly, unlike every other compulsory license in the Copyright Act, works must be licensed individually. Thus for example, while a digital music service that wishes to rely on the Section 114 license can file a single notice of intention in the Copyright Office to obtain a license to every sound recording, and then can send a single check to SoundExchange, a service or record company relying on Section 115 has to track down and pay individual musical work copyright owners.

Payment requirements are also quite involved.[16] Detailed statements must be provided to the copyright owner each month, on a 20-day payment cycle. Cumulative annual statements also have to be provided. Both monthly and annual statements need to be manually signed by an officer of the corporation, and the annual statements need to be certified by a CPA. As Andrea Finkelstein will testify, a major record company requests tens of thousands of individual mechanical licenses each year in the United States, and in each accounting period makes payments to thousands of music publishers. If they actually followed the compulsory process, they would need a staff of vice presidents to sign statements of account.

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[14] 17 U.S.C. § 115(a)(1) (attached as RIAA Ex. A-110-DP).

[15] 17 U.S.C. § 115(b) (attached as RIAA Ex. A-110-DP); 37 C.F.R. § 201.18 (attached as RIAA Ex. A-111-DP).

[16] 17 U.S.C. § 115(c) (attached as RIAA Ex. A-110-DP); 37 C.F.R. § 201.19 (attached as RIAA Ex. A-111-DP).

Fortunately, over the last 100 years, the marketplace has evolved more workable licensing processes built upon Section 115. Apart from a flood of compulsory licensing notices by tape pirates in the 1960s, and some compulsory licensing notices by major record companies in recent years when they were desperate to launch new kinds of product and service offerings and unable to obtain licenses any other way (a topic to which I return below), use of the compulsory process has been almost nonexistent for decades.[17] To this day, all but a relative handful of uses of musical works are pursuant to licenses that are technically voluntary but predicated on Section 115 and the rates that will be set in this proceeding.

B. Early History

The compulsory license currently provided by Section 115 has its roots in an effort by the Aeolian Company during the early 1900s to obtain exclusive rights to reproduce musical works in the piano rolls it manufactured. Aeolian and a large number of music publishers entered into exclusive license arrangements that would have allowed Aeolian to monopolize the piano roll business. However, the Supreme Court in *White-Smith Music Publishing Co. v. Apollo Co.*, 209 U.S. 1 (1908) held that piano rolls were not infringing under the copyright law of the time, and no license was needed to reproduce songs on piano rolls.[18]

Shortly thereafter, Congress sought to revise the copyright law for the twin purposes of ensuring access to musical works for the creation and distribution of new sound recording products while ensuring that writers receive an appropriate royalty. Congress achieved these goals by adding to the Copyright Act of 1909 a compulsory license that allowed anyone to make

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[17] *See* Statement of Marybeth Peters before the Subcommittee on Courts, the Internet and Intellectual Property of the House Committee on the Judiciary, Section 115 Compulsory License (Mar. 11, 2004) (attached as RIAA Ex. A-112-DP).

[18] The decision in *White-Smith* is attached as RIAA Ex. A-113-DP.

a mechanical reproduction of a song at a specified royalty rate of two cents once the song's copyright owner had permitted a mechanical reproduction of the song.

Over the following decades, the modern music industry was built upon the foundation of the compulsory mechanical license. Piano rolls and wax cylinders gave way to other formats, and in 1927 The Harry Fox Agency was formed to facilitate mechanical licensing without the need to invoke the statutory licensing process. Once an expensive luxury item, records became an inexpensive and ubiquitous form of home entertainment. As sales grew and the long-playing album displaced single formats, the mechanical income of writers and publishers grew handsomely. Throughout it all, the compulsory license was available, if seldom formally invoked, to ensure that songs always would be available for the creation of new recordings.

Some of my first work for RIAA involved the industry negotiations leading to the general revision of the Copyright Act in 1976. Early in that process there may have been discussions of eliminating the compulsory license, but by the time I became involved, everyone recognized that the compulsory license had served the whole music industry well, and the debate had shifted from whether to maintain the compulsory license to what the statutory rate should be.[19] Ultimately, the compulsory license was retained and embodied in Section 115 of the Copyright Act. The 1976 Act increased the statutory rate to 2.75 cents per track and created the Copyright Royalty Tribunal, which was authorized to adjust the statutory rate at scheduled intervals, beginning in 1980, then again in 1987, and then every ten years thereafter.

C. <u>Royalty Rate Standard</u>

Under the 1976 Act, the Copyright Royalty Tribunal was directed to adjust Section 115 royalties in a manner calculated to achieve the following objectives:

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[19] *See* H. Rep. 90-83 at 66 (attached as RIAA Ex. A-114-DP).

> (A) To maximize the availability of creative works to the public;
>
> (B) To afford the copyright owner a fair return for his creative work and the copyright user a fair income under existing economic conditions;
>
> (C) To reflect the relative roles of the copyright owner and the copyright user in the product made available to the public with respect to relative creative contribution, technological contribution, capital investment, cost, risk, and contribution to the opening of new markets for creative expression and media for their communication;
>
> (D) To minimize any disruptive impact on the structure of the industries involved and on generally prevailing industry practices.[20]

Although the process for adjusting rates has changed over the years, with the Judges now having jurisdiction over such determinations, these objectives remain the standard for determining royalty rates and terms in this proceeding.

D. The 1980-1981 Copyright Royalty Tribunal Proceeding

In accordance with the 1976 Act, the first rate-setting proceeding under Section 115 (and the only litigated proceeding under Section 115 until this one) was held before the Copyright Royalty Tribunal in 1980-1981. I represented RIAA in that proceeding. In that proceeding, the publishers sought a mechanical royalty rate of 6% of the suggested list price of each record, which would be allocated among the songs on the record in accordance with a specified formula.[21] RIAA proposed retaining the existing cents rate, with adjustments in 1982 and 1985 based on the percentage change in the average price of leading albums.[22]

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[20] 17 U.S.C. § 801(b)(1) (attached as RIAA Ex. A-115-DP).

[21] *See* National Music Publishers' Association, Inc. Proposed Adjustment of Royalty and Administrative Provisions at ¶ A(1) (attached as RIAA Ex. A-116-DP).

[22] *See* Recording Industry Association of America Proposal for Adjustment of the Mechanical Royalty Rate at ¶ 1-2 (attached as RIAA Ex. A-117-DP).

Ultimately, the Tribunal set a rate of 4 cents per track.[23] That rate was approximately five percent of the average suggested retail list album price.[24] The Tribunal initially provided for annual adjustments of the rate based on increases in the average suggested retail list price of records.[25] However, on appeal, the D.C. Circuit found that the Tribunal had no jurisdiction to make those adjustments.[26] On remand, the Tribunal ultimately adopted a series of fixed rate adjustments intended to reflect an estimate of expected increases in album prices.

Thereafter, rates continued to increase steadily under non-precedential settlements in 1987 and 1997 that provided for biennial adjustments. I understand that Michael Pollack will testify concerning the business decision making behind these settlements. By operation of those settlements, the statutory rate today is the greater of 9.1 cents per track or 1.75 cents per minute of a track's playing time (or fraction thereof).

E. Coverage of Electronic Transmissions

By the early 1990s, it was clear to the recording industry that transmission of music over digital networks represented the future of our industry. To ensure that artists and record companies would be paid if the transmission of performances displaced product sales, we sought legislation that became the Digital Performance Right in Sound Recordings Act of 1995 ("DPRA"). The DPRA created the digital performance right in sound recordings and the Section 114 statutory license.

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[23] *See* Adjustment of Royalty Payable Under Compulsory License for Making and Distributing Phonorecords; Rates and Adjustment of Rates, 46 Fed. Reg. 10,466, 10,485 (Feb. 3, 1981) (previously codified at 37 C.F.R. § 307) (attached as RIAA Ex. A-118-DP).

[24] *Id. at* 10,481 ("We determined that an increase in the mechanical royalty rate to four cents would produce a 40 cent royalty on a record listed at $7.98.").

[25] *Id.* at 10,486.

[26] *See Recording Ass'n of Am. v. Copyright Royalty Tribunal*, 662 F.2d 1, 14-18 (D.C. Cir. 1981) (attached as RIAA Ex. A-119-DP).

At the same time, music publishers were concerned about their own future in the digital age. Anxious to ensure a steady stream of mechanical royalties, one of their most important royalty sources, publishers insisted that the DPRA confirm that the Section 115 compulsory license extends to distribution by means of electronic transmission. The DPRA added to Section 115 the concept of a "digital phonorecord delivery" or "DPD." A DPD is defined as

> each individual delivery of a phonorecord by digital transmission of a sound recording which results in a specifically identifiable reproduction by or for any transmission recipient of a phonorecord of that sound recording, regardless of whether the sound recording is also a public performance of the sound recording or any nondramatic musical work embodied therein.[27]

Thus, DPDs include a variety of different kinds of delivery of music by means of electronic transmission, whether over the Internet, a mobile network or otherwise.

When the DPRA was enacted in 1995, and at the time of the 1997 rate adjustment, the marketplace for DPDs was nonexistent or nearly so, and as a result it was premature to make any kind of informed judgment about royalty rates. Accordingly, rates for DPDs in general were pegged to the physical rate, with express requirements in statute and regulations that DPD rates be set in this proceeding without reference to that decision.[28] Section 115 also contemplates something called an "incidental DPD," which is a DPD where the reproduction or distribution of a phonorecord is incidental to the transmission which constitutes the DPD.[29] However, a rate was not set for them in 1997.[30]

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[27] 17 U.S.C. § 115(d) (attached as RIAA Ex. A-110-DP).

[28] 17 U.S.C. § 115(c)(3)(D) (attached as RIAA Ex. A-110-DP); 37 C.F.R. § 255.5 (attached as RIAA Ex. A-111-DP).

[29] 17 U.S.C. § 115(c)(3)(D) (attached as RIAA Ex. A-110-DP).

[30] 37 C.F.R. § 255.6 (attached as RIAA Ex. A-111-DP).

One other aspect of the DPD licensing provisions of Section 115 is worthy of note. You will hear about a contractual provision known as a "controlled composition clause." Such clauses are simply provisions in contracts between artists or producers and record companies in which an artist or producer who is also a songwriter grants a mechanical license, or agrees to obtain a mechanical license, with respect to the songs written by the artist or producer and recorded for the record company. A controlled composition clause typically also grants certain related rights, such as to produce videos of those songs. These licenses typically reflect a discount off the statutory mechanical royalty rate as part of the overall economic bargain between the record company and artist/writer or producer/writer. They also typically include a cap on the number of tracks that the artist can include on an album without having his or her mechanical or artist royalties reduced. The cap functions much like a percentage royalty rate structure would - giving the record company assurance that it can release an album with the tracks the artist wants without having a ruinous mechanical royalty cost. Under the DPRA, the statutory mechanical royalty rate for DPDs supersedes the discounted rates under controlled composition clauses entered into after June 22, 1995.[31] As DPDs represent an ever-larger piece of the recorded music market, and recordings made under pre-1995 contracts an ever-smaller piece of the market, the economic impact of controlled rates inevitably will diminish.

F. Application of Section 115 to New Types of Offerings

In recent years, technological advances have made it possible, and market forces have made it imperative, for record companies to deliver as many of their recordings as possible in the form of new types of product and service offerings. However, as we have moved from a market with basically one type of product - physical carriers (usually discs) with audio tracks - to a

[31] 17 U.S.C. §115(c)(3)(E) (attached as RIAA Ex. A-110-DP).

marketplace with numerous types of products and services with different types of content bundled and delivered in different ways with different payment models, record companies have time and again struggled to apply the antiquated provisions of Section 115, and particularly its inflexible cents rate structure. As we have done so, I have increasingly come to believe that the only rate structure that makes sense is a percentage rate that can be applied readily to all the products in the marketplace and all the new types of product and service offerings and business models that will be introduced in the coming years. I will highlight some of the difficulties that have led me to that conclusion.

1. Subscription Services

After the launch of the original, illegal Napster peer-to-peer service in 1999, record companies felt a desperate need to compete with services that gave their music away for free through legitimate subscription music services that would "feel like free" while still generating income for creators. Subscription services are online services that allow subscribers access to music for a recurring subscription fee (typically a monthly fee). The core offerings of subscription services are limited downloads (*i.e.*, downloads that can be played only for as long as the subscriber maintains his or her membership) and on-demand streams (*i.e.*, on-demand, real-time digital transmissions to allow a user to listen to a particular sound recording chosen by the user at a time chosen by the user). However, we were stymied by a mechanical compulsory licensing system and rate structure that just did not work. It was expected that such services would transmit music in various forms, including so-called "limited" or "tethered" downloads (that is, downloads available only for the duration of a subscription) and "on-demand streams" (that is, real time transmissions made on demand). However, it was not clear to us how the compulsory license applied to such activities, and if covered, what royalty rate applied.

We tried to negotiate with the music publishers as an industry, but those negotiations stalled. Record companies tried to serve notices of intention to rely on the compulsory license, but publishers sent back letters claiming that the compulsory license could not be relied upon for subscription services. We tried to get the Copyright Office to clarify the situation in a rulemaking proceeding, but that went nowhere.

It was not until October 2001 that we were able to resolve our differences with the publishers through a "subscription services agreement" between RIAA, NMPA and HFA that provided a framework for licensing such services through HFA. A copy of the agreement is attached as RIAA Exhibit A-120-DP. As part of that deal, the parties agreed that RIAA would pay HFA a million dollar advance, and that the rate would be determined by negotiation, or if necessary an adjudication, at a later date.

Section 8.1 of the agreement confirmed the parties' mutual understanding of certain principles of current copyright law that provide the underpinnings for the licensing process contemplated by the agreement. Among other things, it was agreed that (1) the process of making on-demand streams and of making limited downloads through subscription services (from the making of server copies to the transmission and local storage of the stream or download), viewed in its entirety, involves the making and distribution of a DPD; (2) such process in its entirety (*i.e.*, including any server copies and any temporary or cached reproductions through to the transmission recipient) is subject to compulsory licensing under Section 115; and (3) the process of making streams that would qualify for a statutory license under Section 114(d)(2) of the Copyright Act does not involve the making or distribution of a DPD, and thus does not require a mechanical license.

Record companies used this agreement to obtain mechanical licenses that were relied upon by the first subscription services, although I understand that today most subscription services obtain licenses of mechanical rights with respect to most record companies' recordings directly from publishers or their licensing agents (not through the record company).

We are pleased that we were able to reach this agreement, which enabled the launch of the first subscription services. However, this dispute delayed the launch of subscription music services, and infringing services took advantage of this delay to establish their presence on the Internet. As the dispute over subscription services dragged on, the infringing music services became more and more entrenched.

In setting royalty rates for on-demand streams, it is important to note that streams are primarily performances. Services that transmit on-demand streams pay performance royalties, which I understand may range up to about 6.5% of their applicable revenues.[32] The question is whether those royalties adequately compensate writers and publishers for the use of their music in on-demand streams through subscription services.

I believe that there is some value when a reproduction rights license is granted to enable multiple server copies to be made to give a service a competitive advantage through improved diversity of offerings and quality of service and reduced bandwidth costs. The only circumstance of which I am aware in which there has been an analogous attempt to quantify that value has been in the context of the statutory licenses provided by Sections 112(e) and 114 of the Copyright Act. Section 112(e) permits transmitting entities to make certain reproductions of sound recordings to facilitate performances licensed under Section 114. There, the payment for

[32] ASCAP Experimental License Agreement for Interactive Sites & Services –Release 2.0, Schedules A-C, available at http://www.ascap.com/weblicense/release2.0.pdf (attached as RIAA Ex. A-121-DP).

the reproductions under Section 112(e) is effectively 9.6% of the performance royalty payable under Section 114 for the same activity.[33] However, the analogy to Sections 112(e) and 114 is not perfect. Sections 112 and 114 provide a different statutory structure than applies to performance and mechanical licensing of musical works, and RIAA does not presently have access to detailed information concerning performance royalties paid, and use of server copies, by subscription digital music services. The mechanical royalty rate for on-demand streams through subscription services should not be any greater relative to the performance royalty than in the case of Sections 112(e) and 114, and additional information may show that it should be less.

2. Multisession Discs

The difficulties record companies have had obtaining mechanical licenses for new kinds of offerings have not been limited to electronic distribution. The inflexible cents rate structure and arguments concerning its application have troubled even physical product introductions. With physical product sales dropping sharply, the industry has long felt the need to give the consumer more value to lure them back into record stores - or at least breathe new life into physical sales for as long as possible. One possibility is to put more tracks on albums - and the average number of tracks per album has generally increased over time. However, the cents rate mechanical royalty makes that very expensive unless a controlled composition clause can be relied upon to cap the mechanicals cost for the album.

In 2003-2004, record companies were gearing up for a major push into new physical formats that would be more secure and have more capacity to offer high fidelity sound and bonus

[33] *See* 37 C.F.R. § 262.3(c) ("ephemeral" royalty under Section 112 is 8.8% of the total royalty under Sections 112 and 114, so the performance royalty under Section 114 is 91.2% of the total royalty; 8.8% is 9.6% of 91.2%) (attached as RIAA Ex. A-122-DP).

audiovisual material. These formats included DVD-Audio, SACD, DualDisc (an optical disc with a CD on one side and a DVD on the other), and the copy-protected CD. However, for technical reasons, if a disc is to play on different types of players, or on a computer in a protected format, or have both stereo and surround sound, the same recordings need to be encoded on the disc multiple times. The different places on the disc where these different instances of the recording are stored are sometimes called "sessions," so we refer to these types of discs as "multisession" discs.

As record companies were preparing to market test different multisession formats, publishers insisted that they had the right to be paid the full statutory rate (8.5 cents in 2004) for each session. The Harry Fox Agency sent a notice to its members to that effect on December 3, 2003.[34] We do not believe that is a correct interpretation of the current rate regulations, and RIAA wrote to HFA to say so.[35] More important, since nobody thought a DualDisc with CD, DVD-Audio and surround sound sessions would sell for materially more than a standard CD (let alone two or three times that much), paying a multiple of the statutory mechanical rate obviously would have been impossible. Starting in late 2004, record companies engaged in one-on-one negotiations with major publishers, who eventually agreed to license multisession discs at the standard CD rates as part of a package that included high mastertone rates. However, there is now considerable skepticism about the future of these formats, perhaps in part because of the year's delay caused by this dispute.

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[34] Important Notice Concerning Licensing of Multisession Products, dated December 3, 2003 (attached as RIAA Ex. A-123-DP).

[35] *See* Letter from Steven Marks to Jacqueline Charlesworth, dated January 22, 2004 (attached as RIAA Ex. A-124-DP).

3. Mastertones

Our experience with mastertones is related and has been similar. By 2003-2004, cell phone technology had advanced to the point that carriers and record companies were gearing up to distribute mastertones - typically excerpts of commercially released sound recordings. We always believed that they should be licensable under Section 115, but publishers insisted to the contrary, and insisted upon royalty rates well in excess of the statutory rate both in cents and as a percentage of the wholesale price of the mastertone.

For a while, record companies relied upon their controlled composition clauses to get some mastertones into the marketplace. Eventually record companies decided that they needed to get more mastertone products into the marketplace even if their mechanical royalty cost was high and, in order to get multisession discs licensed at the normal rate and receive other benefits, reluctantly agreed to pay higher mastertone rates as part of packages of rights and rates negotiated between individual record companies and publishers. However, because of this dispute, only a trickle of mastertones was available until well into 2005. A year's delay in moving into the format in a significant way is probably one reason that the U.S. mastertone market lags other countries.

As the Judges know, this dispute persisted until this proceeding, when the Judges referred to the Register of Copyrights the question of whether ringtones are licensable under Section 115. The Register of Copyrights then ruled that ringtones are licensable under Section 115, as we had said all along.[36]

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[36] *See In the Matter of Mechanical and Digital Phonorecord Delivery Rate Adjustment Proceeding*, Docket No. RF 2006-1 (October 16, 2006) (attached as RIAA Ex. A-125-DP).

G. The Need for a Rate Structure that Will Support New Types of Offerings

The examples I have just provided all involve a new product or service that was delayed in getting to market by disputes with publishers over the appropriate application of the compulsory license, and in the case of the first two, calculation of the applicable royalty. The lesson I have learned from these experiences is that we need a percentage rate structure that can be applied readily to all the products and services in the marketplace and all the new types of product and service offerings and business models that will be introduced in the coming years, with minimal chance of dispute. These kinds of dispute hurt everyone in the music value chain by delaying the introduction of new products and services that we all need.

A percentage royalty rate structure is the only structure flexible enough to encompass the range of offerings in my examples while minimizing the prospects for future disputes. A percentage royalty rate structure with a minimum number of rate categories, such as has been proposed by RIAA, easily could be applied to new products and services. For example, in the case of multisession discs, instead of fighting over whether multiple mechanical royalty payments are due for the various formats encoded onto a multisession disk, publishers would simply get a percentage of the wholesale price. If a product commanded a higher price than other established formats, writers and publishers would share proportionately in that success. But if not, we would not find ourselves either priced out of the market by a cents rate computation that makes no sense or arguing with publishers about how to perform a cents rate computation. The percentage rate aligns the record companies' and publishers' interests most closely, giving all parties an incentive to bring products quickly to market and establish revenue streams that will benefit all of us.

CONCLUSION

The changes in the music industry since the Copyright Act of 1976 was enacted have been extraordinary and exciting, and lately worrisome. We are in the midst of a sea change that will continue to play out over the next five years, as we try to maintain physical product sales, pioneer online and mobile markets for music, and contain piracy. This is not like 1981, or even 1987 or 1997, and the rates and rate structure we thought would work then will not work now. As the industry undergoes radical transformation, we need Section 115 to enable record companies and digital music services to innovate and get products to market so that we can expand the music industry economic pie rather than merely fighting over a shrinking pie.

I declare, under penalty of perjury, that the foregoing testimony is true and correct to the best of my knowledge.

Cary H. Sherman

Date: Nov 28, 2006

Exhibits Sponsored by Cary Sherman (Public)

Exhibit Number	Description
A-101-DP	Sections of the Copyright Act cited in Section I: 17 U.S.C. §§ 101, 102, 106, and 114
A-102-DP	Sheet music for the song "The First Cut is the Deepest," by Cat Stevens
A-103-DP	Biography of Cat Stevens (found at http://www.thebiographychannel.co.uk/biography_story/302:144/1/Cat_Stevens.htm) (last visited November 19, 2006).
A-104-DP	Website of songwriter Diane Warren (http://realsongs.com/) (last visited November 19, 2006)
A-105-DP	CD of the album "The Very Best of Sheryl Crow," by Sheryl Crow
A-106-DP	Songfile page for the song "The First Cut is the Deepest" (available at http://www.harryfox.com/songfile/public/publicsearch.jsp) (last visited November 25, 2006)
A-107-DP	Al Kohn & Bob Kohn, Kohn on Music Licensing 87-90, 445-448 (3d ed. 2002)
A-108-DP	Press Release, Harry Fox Agency, Music Publishers: Are You Getting Your Share of the Audio Home Recording Act Royalties? (Oct. 30, 2006), http://www.harryfox.com/docs/AHRA.pdf (last visited November 24, 2006).
A-109-DP	CD of the album "The Very Best of Cat Stevens," by Cat Stevens
A-110-DP	Section 115 of the Copyright Act, 17 U.S.C. § 115
A-111-DP	Regulations related to the statutory license of 17 U.S.C. § 115: 37 C.F.R. §§ 201.18, 201.19, 255.5, 255.6
A-112-DP	Statement of Marybeth Peters before the Subcommittee on Courts, the Internet

Exhibit Number	Description
	and Intellectual Property of the House Committee on the Judiciary, Section 115 Compulsory License (Mar. 11, 2004)
A-113-DP	*White-Smith Music Publishing Co. v. Apollo Co.*, 209 U.S. 1 (1908)
A-114-DP	H. Rep. 90-83 at 66
A-115-DP	17 U.S.C. § 801
A-116-DP	National Music Publishers' Association, Inc. Proposed Adjustment of Royalty and Administrative Provisions
A-117-DP	Recording Industry Association of America Proposal for Adjustment of the Mechanical Royalty Rate
A-118-DP	Adjustment of Royalty Payable Under Compulsory License for Making and Distributing Phonorecords; Rates and Adjustment of Rates, 46 Fed. Reg. 10,466, 10,485 (Feb. 3, 1981) (previously codified at 37 C.F.R. § 307)
A-119-DP	*Recording Ass'n of Am. v. Copyright Royalty Tribunal*, 662 F.2d 1, 14-18 (D.C. Cir. 1981)
A-120-DP	Joint Statement of the Recording Industry Association of America, Inc., National Music Publishers' Association, Inc. and The Harry Fox Agency, Inc., dated December 6, 2001, and attached Agreement
A-121-DP	ASCAP Experimental License Agreement for Interactive Sites & Services – Release 2.0, Schedules A-C, available at http://www.ascap.com/weblicense/release2.0.pdf (last visited November 25, 2006)
A-122-DP	37 C.F.R. § 262.3
A-123-DP	Important Notice Concerning Licensing of Multisession Products, dated December 3, 2003

Exhibit Number	Description
A-124-DP	Letter from Steven Marks to Jacqueline Charlesworth, dated January 22, 2004
A-125-DP	*In the Matter of Mechanical and Digital Phonorecord Delivery Rate Adjustment Proceeding*, Docket No. RF 2006-1 (October 16, 2006)