

**Before the
COPYRIGHT OFFICE
LIBRARY OF CONGRESS
Washington, D.C.**

In the Matter of)	
)	
Mechanical and Digital Phonorecord)	Docket No. 2012-7
Delivery Compulsory License,)	
Statement of Accounts)	

The National Music Publishers’ Association (“NMPA”), including its wholly owned licensing subsidiary, The Harry Fox Agency, Inc. (“HFA”), the Songwriters Guild of America (“SGA”), and the Nashville Songwriters Association International (“NSAI”) respectfully submit these Reply Comments pursuant to the Copyright Office’s Notice of Proposed Rulemaking dated July 27, 2012, 77 Fed. Reg. 44179 (July 27, 2012), to amend regulations for reporting monthly and annual Statements of Account for the making and distribution of phonorecords under the Section 115 compulsory license.

NMPA and HFA have participated in this inquiry by filing joint Comments with the Digital Music Association (“DiMA”), Recording Industry Association of America, Inc. (“RIAA”), and Music Reports, Inc. (“MRI”) as well their own separate Comments on issues on which consensus could not be reached. NMPA and HFA have also filed joint reply Comments with the above participants. NMPA, HFA, SGA, and NSAI (collectively referred to herein as “the Parties”) now wish to offer additional reply comments on several points raised by other parties in the initial round of comments.

Introduction

The existing regulations should be amended to require compulsory licensees to identify each third party service operating under their authority and report the number of digital phonorecord deliveries (“DPDs”) made by such services along with the associated statutory royalties. Such information is necessarily available to and relied upon by the compulsory licensee and should not be hidden from copyright owners. As discussed in the Parties’ initial comments, the compulsory license provisions of Section 115 of the Copyright Act create an honor system for licensing in which compulsory licensees self-license, self-report and self-assess. As a result, the information reported on the Statements of Account is the only mechanism for copyright owners to adequately understand the usage and payment for their works, and to ultimately assess the adequacy and viability of each third party service’s business model incorporating their works.

The Parties also explained in their initial comments that reserve accounting, which sometimes results in a negative reserve balance, was included in the existing regulations to accommodate a unique record label practice of selling physical phonorecords subject to a right of return. RIAA did not provide any evidence demonstrating that record labels are carrying an excessive number of negative reserve balances, that those balances are unduly large or, most importantly, that those balances are not actually being liquidated at a reasonable rate. The mere spectre of unliquidated reserves cannot support an expansion of reserve accounting to DPDs. In addition, no support for applying negative reserve balances to DPDs exists in the current regulations or legislative history. Lastly, the application of this practice to DPDs would have a

harmful effect on the rights of copyright owners and could very well result in significant unintended consequences for all parties if applied under controlled composition clauses.¹

Incorporating these two RIAA proposals into the compulsory license regulations would allow record labels to redirect royalty payments made for DPDs distributed by third parties to reduce negative balances from physical sales without identifying the true source of the money. These record labels proposals confirm every music publishers' and songwriters' worst fears about the Section 115 compulsory license: that compulsory licensees seek a system so opaque that music publishers and songwriters will never be properly compensated for the use of their works and will not have a chance of finding out they are being shortchanged.

To counteract these fears, the Parties are proposing a CPA certification that requires CPAs to conduct an examination in accordance with the attestation standards established by the American Institute of Certified Public Accountants (the "Attestation Standards") of either the annual statements directly or the processes that generate annual statements. This proposal will allow small and large users of the compulsory license to obtain the necessary certification while providing copyright owners with the confidence that an appropriate level of independence and testing is exercised. The Attestation Standards also permit reliance by one CPA upon an examination of another CPA or third party service providers. They, therefore, allow compulsory licensees the flexibility to hire vendors to perform licensing or reporting under the compulsory license provisions without fear that they will not be able to obtain a certification of the required annual statements.

I.

¹ Gear Publishing Company (hereafter "Gear") and Christian Castle have also submitted comments to the Copyright Office on these issues. As discussed below, the Parties believe Gear's positions regarding these two issues are consistent with those of the Parties'. The Parties also agree with Christian Castle's general concern regarding the need for stronger certification regulations in the absence of an audit right for copyright owners. The Parties have addressed this issue by proposing certification regulations below.

**STATEMENTS OF ACCOUNT PROVIDED TO LICENSORS SHOULD PROVIDE
IDENTIFICATION INFORMATION FOR THIRD PARTY LICENSEES**

The existing regulations should be amended to require compulsory licensees to disclose each third party service (“Third Party Licensees”) they have authorized to distribute DPDs, the number of DPDs transmitted by each Third Party Licensee, and the statutory royalties associated with such transmissions. As discussed in more detail at pages 3 to 5 of the Parties’ initial comments, without this information, music publishers and songwriters are unable to determine whether Third Party Licensees are acting under the authority of a compulsory licensee or are infringers and are deprived of the ability to use this information in important decision making regarding their musical works.

RIAA contends that providing the identification of Third-Party Licensees to copyright owners would be overly burdensome for compulsory licensees and points to a rejected proposal to require mechanical royalty accounting by distributors in the Copyright Office’s Notice on Compulsory License for Making and Distributing Phonorecords (hereafter “1980 Notice”). *Notice on Compulsory License for Making and Distributing Phonorecords*, 45 Fed. Reg. 79038, 79039 (November 28, 1980).

In the 1980 Notice, the Copyright Office stated that it

...has a duty to provide a system that is a realistic alternative to voluntary licensing. Neither the record-keeping nor the CPA audit requirements should be so burdensome or expensive as to undermine the Congressional intention by putting compulsory licensing out of the reach of record companies. The task is to provide a system that will function, not one so loaded with paperwork that it becomes prohibitive.

Id.

With this task in mind, the Office concluded, in 1980, that requiring licensees to track particular physical phonorecord shipments would make compulsory licensing prohibitive for some companies. *Id.*

It is misleading and wrong, however, to equate tracking sales and distributions of physical product through brick and mortar record stores to tracking third party digital services that reproduce and transmit DPDs to consumers pursuant to pass through rights under compulsory licenses. Digital services are obligated to contractually record and track their distributions and report them to the record labels pursuant to the labels' licensing agreements.² As a result, the labels' argument that it is overly burdensome to repurpose that information for inclusion on statements of account issued to publishers is far-fetched. If the labels have the technology necessary to analyze and track royalties related to sound recordings³, they have the ability to report the identity of third party digital distributors to music publishers. However, direct evidence, if any, relating to this burden is controlled solely by the record labels.

RIAA also argues that more detailed reporting would not necessarily allow copyright owners to better assess the accuracy of statements. Comments of the Recording Industry Association of America, Inc. (hereafter "RIAA Comments") at 15. The Parties strongly disagree. Copyright owners currently have no right to examine the information necessary to ensure the accuracy of statements on their own. Copyright owners must rely on a certification on

² The iTunes "frequently asked questions" page explains that iTunes provides content providers with monthly financial reports for each territory in which music is sold. <http://www.apple.com/itunes/content-providers/faq.html>.

³ *Kohn on Music Licensing* indicates that all record labels are already keeping track of this data, whether internally or by using an outside service. *Kohn on Music Licensing*, Al Kohn and Bob Kohn 1460 (4th ed. 2010) ("With an increasing proportion of a label's revenue being derived from digital revenue sources, comprising hundreds of millions of small transactions, each often far less than 1 cent each, the record company's IT department has begun to take a greater role in the pre-processing of much of the digital revenue. Once pre-processed, the revenue files are ingested into the label's royalty processing software, which is programmed with the appropriate royalty splits. Because of the increased volume of transactions that must be handled, many legacy software systems can no longer handle the load. To reduce costs, many labels have outsourced the pre-processing of their digital revenue data to RoyaltyShare, which helps the label aggregate revenue from all digital sources, match each transaction properly to the metadata of albums and tracks in the label's catalog, and identify and match any exceptions that could not be matched automatically").

their statements. Certification of detailed reporting would provide more transparency and assurance to copyright owners in addition to providing them with valuable information about how their music is being used. In its Comments to the Office, Gear (Bob Seger's music publisher) offers valuable insight on this issue and its effect on copyright owners. Gear explains how important it is to provide copyright owners with third party licensing information in order to ensure accurate accounting and compliance with the statutory licensing scheme. Gear also explains why this information is necessary in order to allow copyright owners to assess which uses are licensed and which are not, and why such information is valuable to both owners and licensees, as licensees would be harmed by unlicensed competitors as well. Gear Comments at 14.

II.

NEGATIVE RESERVE BALANCES APPLY ONLY TO PHYSICAL PHONORECORDS AND SHOULD NOT BE APPLIED TO DIGITAL PHONORECORD DELIVERIES

i. The Expansion of Existing Regulations to Include the Application of Negative Reserve Balances to DPDs Would Be Arbitrary and Capricious

The Parties' initial comments explained that RIAA's proposal to include the application of negative reserve balances to royalties due for the transmission of DPDs should not be adopted because it would improperly expand to the digital market a regulation designed to accommodate a unique facet of the physical music market, namely, the record label practice of selling physical product with a right of return. The Parties' Initial Comments at 5 to 7. RIAA's Initial Comments failed to present any factual, legal or legislative support for its proposal. It, therefore, should be rejected.

The Copyright Office's rulemaking procedures are governed by the Administrative Procedures Act (hereafter "APA"). 17 U.S.C. § 701(e). Under the APA, a court may hold unlawful and set aside any agency action adopted through the notice and comment process found to be "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." 5 U.S.C. § 706(2)(A). The Supreme Court has explained that the "arbitrary and capricious" standard requires that "the agency must examine the relevant data and articulate a satisfactory explanation for its action including a 'rational connection between the facts found and the choice made.'" *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983), quoting *Burlington Truck Lines, Inc. v. United States*, 371 U.S. 156, 168 (1962). The Court further clarified that:

[n]ormally, an agency rule would be arbitrary and capricious if the agency has relied on factors which Congress has not intended it to consider, entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise.

Id.

RIAA has asked the Office to expand existing regulations but does not provide any evidence necessary to support a satisfactory explanation for such an expansion. RIAA expresses a fear that, as physical deliveries become less popular, it will be difficult for licensees to liquidate negative reserve balances because there will be fewer royalties due for physical deliveries. *Id.* at 7. However, RIAA does not provide any evidence regarding the extent of unused negative reserve balances the labels are holding, the rate of liquidation of those balances, the relationship of the size of the negative reserve balances to the size of the original shipments or a translation of such evidence, which under the current regulations are denominated in units, into dollar values. As a result, the existence as well as the scope of the "problem" identified by the labels is impossible to evaluate. In short, RIAA has not demonstrated a real risk of

overpayment to copyright owners, but rather assumes in Chicken Little like fashion, that such a risk exists. Presumably, proper management of physical product reserves, among other alternatives, would ameliorate any such purported risk.

RIAA fails to provide any specific data that would allow the Copyright Office to make a rational connection between facts and an expansion of the current regulations that would allow the application of negative reserve balances to royalties due for the distribution of DPDs. Therefore, the Office must refrain from making such an arbitrary and capricious an expansion that cannot be supported by the required relevant data.

ii. RIAA Fails to Offer Compelling Legal Justifications for the Expansion of Existing Regulations to Include the Application of Negative Reserve Balances to DPDs

Although the Parties believe expansion of existing regulations to include the application of negative reserve balances to DPDs would be arbitrary and capricious and could not withstand judicial review, the legal justification offered by RIAA for such an expansion also fails.

1. Overpayment

RIAA first claims that the Office has a legal obligation to prevent overpayment of mechanical royalties. RIAA Comments at 3. RIAA cites the House Report on the 1976 Copyright Act revision (hereafter “1976 House Report”), which recognizes that compulsory licensees must pay for each phonorecord made and distributed but also states that payments for units not actually distributed are “unjustified.” H.R. 94-1476, at 110 (1976). Reserve accounting was the way this concern was addressed and the sudden paranoia regarding the overpayment of royalties seems unfounded because record labels are always free to apply negative reserve balances to statutory royalties due in connection with the sale of the relevant

physical phonorecords. Having established an appropriate regulation targeted to the physical music market, the Copyright Office announced its intention to avoid interfering with the refund process for royalty overpayments. In its 1980 Notice, the Copyright Office notes that it

did not intend, implicitly or explicitly, to suggest that music copyright owners have any legal obligation to make refunds for royalty overpayments. When the Office mentioned “negotiation” between the parties in this context, it was thinking of cases involving litigation or other forms of legal process where the amount of overpayment might be a factor to consider in settling a dispute; the Office did not mean to imply that, in a strict compulsory license situation, either the licensee has any right or the copyright owner any obligation to negotiate concerning overpayments. Without prejudging the issue in anyway, however, the Copyright Office continues to believe that resolution of this issue in particular cases is best left to application of general legal principles in the appropriate forum.

Notice on Compulsory License for Making and Distributing Phonorecords, 45 Fed. Reg. 79038 (November 28, 1980).

In addition, the Copyright Act states that royalties must be paid “for every phonorecord made and distributed in accordance with the license.” 17 U.S.C. § 115(c)(2). The same 1976 House Report that RIAA cites in support of its argument that the Copyright Office must authorize the application of negative reserve balances to statutory royalties due for the transmission of DPDs to prevent “unjustified” overpayment also specifically explained that distribution occurs when a licensee voluntarily relinquishes possession of the phonorecord, “unless it is actually returned and the transaction cancelled.” H.R. 94-1476, at 110-11 (1976). Since digital phonorecord deliveries cannot be returned, it would be incongruous to apply the negative reserve balance accounting to DPDs, as each DPD constitutes a final voluntarily relinquishment of the phonorecord.

Finally, the 1976 House Report warned that “this practice [reserve accounting] may be consistent with the statutory requirements for monthly compulsory license, but [that there is] the possibility that, without proper safeguards, the maintenance of such reserves could be

manipulated to avoid making payments of the full amounts owing to copyright owners.” *Id.* at 110. Clearly, Congress recognized that this limited exception to the rule requiring payment of statutory royalties within a month of distribution must be limited in order to protect the rights of copyright owners. While reserve accounting may be customary in the physical distribution world, the 1976 House Report acknowledges that the Office should be wary of any revision or regulation that would broaden the scope of this practice.

Finally, more recently in 1999, the Copyright Office explicitly recognized that the reserve practice was inapplicable outside of physical phonorecord deliveries. *See Notice and Recordkeeping for Making and Distributing Phonorecords*, 64 Fed. Reg. 41286 (July 30, 1999) (the “1999 Rule”) (“[T]he Office has found no basis for adopting the concept of ‘reserves’ to DPDs.”). Indeed, RIAA admits that the Copyright Office refused to apply the practice of maintaining reserves to digital phonorecord deliveries, stating that “[t]o the extent that the terms *reserve*, *credit* and *return* appear in this section, such provisions shall not apply to digital phonorecord deliveries.” *Id.* at 41289. Although RIAA attempts to discredit the explicit declaration by the Copyright Office not to extend reserve accounting to DPDs as uninformed, it is clear that the existing regulations are in harmony with the Congressional intent illustrated in the 1976 House Report. On balance, the legislative and regulatory history indicates the Copyright Office should be most concerned with protecting copyright owners from the manipulation of reserve accounting practices by limiting those practices and ensuring that safeguards are firmly in place. Permitting the application of negative reserve balances to offset digital royalties contravenes this directive.

2. Right of Offset

The Parties have found no statutory or common law authority that would support the offset of statutory royalties due for the distribution of digital phonorecords with funds held in a negative reserve balance for physical phonorecords.

The Supreme Court, as noted by RIAA, has recognized a general “right of setoff (also called ‘offset’) [that] allows entities that owe each other money to apply their mutual debts against each other, thereby avoiding the ‘absurdity of making A pay B when B owes A.’” *Citizens Bank v. Strumpf*, 516 U.S. 16, 18 (1995) (quoting *Studley v. Boylston Nat. Bank*, 229 U.S. 523, 528 (1913)). RIAA Comments at 6. However, RIAA is misguided in construing a negative reserve balance as a debt. Music publishers and songwriters do not borrow or buy anything from the record labels. Instead, they are barred from the free market and forced to accept a statutory royalty under Section 115 as implemented by the attendant regulations. Negative reserve balances exist solely because of the record labels’ decision to sell physical phonorecords with a right of return and, with respect to any particular release, their decision regarding how much product to ship. Record labels, unlike music publishers and songwriters, are free to amend their terms of sales.

Even if the Office were to accept that a negative reserve balance were somehow akin to a debt, RIAA was unable to point to any case law supporting the direct application of a right of offset to the music industry, physical and digital mechanical royalty payments or Section 115. While RIAA cites to several federal statutes that explicitly recognize a right of offset,⁴ the Copyright Act is silent on this issue. Assuming the Copyright Office accepts the argument that a general right of setoff exists in common law, “[c]opyright is a creature of statute [and therefore, a

⁴ The RIAA cites only to statutes and federal regulations that explicitly create a right of offset in unrelated areas, such as 11 U.S.C. § 553 (a) (creating a statutory right of offset for bankruptcy), 31 U.S.C. § 3728(a) (creating a statutory right of offset for the government when it is a defendant in a civil action), 42 C.F.R. § 405.370 (creating a regulatory offset for Medicare payments when Medicare beneficiaries owe certain debts).

court] will not lightly insert common law principles that Congress has left out.” *Silvers v. Sony Pictures Entertainment, Inc.*, 402 F.3d 881, 885 (9th Cir. 2005). When the applicable statute is ambiguous or fails to mention a certain common law principle, courts will look to the legislative history. *United States v. Daas*, 198 F.3d 1167, 1174 (9th Cir. 1999).

RIAA argues that the legislative history related to Section 115 supports a right of offset. RIAA Comments at 7. In short, RIAA claims that Congress was aware of the custom in the music industry that granted retailers of physical recordings a privilege of return for credit, which may affect the ultimate number of physical phonorecord deliveries, making it difficult to determine the number of physical phonorecords actually distributed by a licensee. H.R. 94-1476, at 110-11 (1976). As a result, the music industry has typically allowed licensees to maintain reasonable reserves of royalties in anticipation of the return of some of these physical phonorecords.

However, as discussed above, Congress was careful to note the dangers of applying this custom overbroadly, stating that it recognized that the practice “may be consistent with the statutory requirements for monthly compulsory license accounting reports, but [it] recognizes the possibility that, without proper safeguards, the maintenance of such reserves could be manipulated to avoid making payments of full amounts owing to copyright owners.” H.R. 94-1476, at 110-11 (1976). While the Copyright Office may have accepted the already common industry custom of applying negative reserve balances to physical phonorecords, nothing in the legislative history supports applying the general common law principle of offset across all physical and digital forms of distribution in the music industry.

iii. The Application of Negative Reserve Balances Cannot Be on a Unit-for-Unit Basis

RIAA contends that negative reserve balances should be maintained and applied on a unit-for-unit basis, essentially allowing one physical phonorecord unit to cancel out one DPD unit. RIAA Comments at 9. While RIAA notes that the statutory royalty rate is the same for permanent digital downloads as for physical products, it fails to acknowledge that under controlled composition clauses record labels rarely pay the statutory royalty rate for physical products and instead typically receive a much lower royalty rate of 75% or less of the statutory rate for physical products.⁵ Licenses issued at this reduced rate pursuant to controlled composition clauses typically incorporate the regulations attendant to Section 115, including the reserve accounting rules.

Congress made this practice inapplicable to digital phonorecord deliveries, which must be paid for at the full statutory rate. The Digital Performance Right in Sound Recording Act of 1995 requires that a controlled composition clause shall not be enforceable for DPDs of recordings released pursuant to a contract entered into after 1995, subject to some exceptions, ensuring that copyright owners will receive the full statutory rate for this type of delivery. *See* 17 U.S.C. § 115 (c)(3)(E), Digital Performance Right in Sound Recordings Act of 1995, Pub. L. No-104-39 (1995) (hereafter “1995 Act”). As a result, distributions of physical phonorecords and permanent digital downloads, in practice, are not subject to the same royalty rate. Offsetting physical units that bear a mechanical royalty of 6.825 cents per song unit or less with digital units subject to 9.1 cent mechanical royalty would allow the compulsory licensees to underpay copyright owners by at least 25% or more for each permanent digital download distributed—thereby undermining both the letter and spirit of the 1995 Act. Contrary to RIAA claims, it is the

⁵ All You Need to Know About the Music Business, Donald S. Passman 224 (7th ed.2009). (“The ink was hardly dry on the 1976 Copyright Act, raising the statutory rate from 2¢ to 2.75¢, when the record companies hit on the idea that they should require their artists to license controlled compositions at 75% of the statutory rate, with further reductions (to 50%) for record club or budget records [. . .] To a large degree, the companies have been successful in getting these 75% and 50% rates with almost all new, and many midlevel, artists.”)

compulsory licensees, not the music publishers and songwriters, who would obtain a windfall if licensees were permitted to offset units payable at a full rate with those payable at the lower controlled composition rate.

iv. Negative Reserve Balances Must Not Be Applied at the Statement Level

RIAA also argues that negative reserve balances should be applied at the statement level, so that they will cover multiple works, but admits that the Office has specifically noted that a negative reserve balance should be applied to shipments of the same recording. *Compulsory License for Making and Distributing Phonorecords*, 45 Fed. Reg. 79038, 79043 (Nov. 28, 1980). As an initial matter, the Notice of Intention to Obtain a Compulsory License is issued for a specific recording of musical work to be fixed on phonorecords already made or expected to be made under the compulsory license and must identify the configurations the compulsory licensee intends to distribute. 37 CFR §201.18(c). Courts have construed variances of the compulsory license issued by The Harry Fox Agency, Inc. (“HFA”) to be limited by their terms. *See Entm't v. KIDdesigns, Inc.*, 2005 U.S. Dist. LEXIS 44386 (M.D. Tenn. Sept. 14, 2005) (“the court finds that the language of the subject license is narrowly limited, giving [. . .] only the authorization to manufacture and distribute phonorecords of the subject compositions on the record numbers specified in the license, and with the designated album titles.”). *See also Rodgers & Hammerstein Org. v. UMG Recordings Inc.*, 2001 U.S. Dist. LEXIS 16111 (S.D.N.Y. 2001). To the extent each compulsory license is similarly limited to a specific recording of a particular musical work, the case law applicable to HFA licenses is persuasive and suggests the Office should similarly limit the application of any offset to the same recording of a musical work.

Further, the Office should be aware that the application of negative reserve balances at the statement level would result in practical difficulties. Gear correctly points out that each

compulsory license represents a separate and distinct privilege applicable to a specific recording and that accounting for each license is then made to a publisher or administrator. Gear Comments at 5. Under this system, if a licensee was permitted to cross-collateralize royalties between two or more songs, administering royalties would become extremely complex and could result in the unfair application of a negative reserve balance against the wrong copyright owner or work. *Id.* at 6.

Gear is singularly aware, perhaps more than any other commenting party, of the complexities of cross-collateralization – whether in a recording contract, publishing agreement, or compulsory license provision. It knows, as most in the music industry know, how cross-collateralization, of any kind, is easily prone to abuse, mistake, complexity, and increased cost to both the licensor and licensee, that is generally unknown to the parties until cross-collateralization actually occurs.

III.

CERTIFIED PUBLIC ACCOUNTANTS MUST CONDUCT AN INDEPENDENT EXAMINATION IN ACCORDANCE WITH THE ATTESTATION STANDARDS ESTABLISHED BY THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS TO CERTIFY ANNUAL STATEMENTS

Attached as Exhibit A is the Parties’ proposed regulation for the certification of Annual Statements by a certified public accountant (“CPA”) (“the Parties’ Certification Proposal”).⁶ This proposal requires an independent CPA to certify that the CPA has conducted an “examination” (see below) in accordance with the attestation standards established by the American Institute of Certified Public Accountants (the “Attestation Standards”) of either the

⁶ The Parties’ proposed regulation for the certification of Monthly Statements is attached as Exhibit B. Although not expressly discussed below, its language is derived from the same principles underlying the Parties’ proposed regulation regarding the certification of Annual Statements.

annual statements directly, or the processes that generate annual statements, that resulted in an “opinion” (see below) that the Annual Statements comply with Section 115 and its attendant regulations. It will allow small and large users of the compulsory license to obtain the necessary certification while providing copyright owners with the confidence that an appropriate level of independence and testing is exercised in order to evaluate whether the compulsory licensee has reported its usage and statutory royalties fairly and in material compliance with Section 115 and the attendant regulations. The attestation standards also permit reliance by one CPA upon an examination of another CPA or third party service providers. They, therefore, allow compulsory licensees the flexibility to hire vendors to perform licensing or reporting under the compulsory license provisions without fear that they will not be able to obtain a certification of the required annual statements.

When Congress created the compulsory license in Section 115, it was aware of the potential harms to copyright owners and enacted certain provisions in order to protect copyright owners from these harms. Requiring licensees to provide CPA certification for their statements of account was one way Congress sought to avoid these harms. In the 1976 House Report, Congress explained that “[i]n order to increase the protection of copyright proprietors against economic harm from companies which might refuse or fail to pay their just obligations, compulsory licensees will also be required to make a detailed cumulative annual statement of account, certified by a Certified Public Accountant.” H.R. 94-1476, at 111 (1976). Section 115 and the 1976 House Report make it clear that the CPA certification is intended to assure copyright owners that the Annual Statement required by Section 115 presents the usage and royalties due the copyright owner fairly and accurately. Assurance services are generally referred to as “attest engagements” by CPAs. Attest engagements are those in which a CPA is

engaged to issue or does issue an examination or other report “on subject matter or an assertion about the subject matter that is the responsibility of another party.” Standards for Attest Engagements at § 101.01.⁷ An attest engagement intended to provide a high level of assurance is called an “examination” and the CPA’s conclusion regarding the subject matter of the engagement is called an “opinion.” Any lower level of review would not serve the purposes under the CPA certification requirement of Section 115.

Several requirements under the Attestation Standards provide confidence that an examination resulting in an unqualified opinion as described in the Parties’ proposal would provide a high level of assurance that compulsory licensees were complying the Section 115 and the attendant regulations. For example, the CPA must have appropriate training, adequate knowledge of the subject matter and be able to identify suitable standards and benchmarks to measure and test the subject matter of the examination. The American Institute of CPAs Statements on Standards for Attest Engagements (“Standards for Attest Engagements”) at §§ 101.19-34. The CPA conducting the examination is required to exercise professional care and observe each of the Attestation Standards. Standards for Attest Engagements at §§ 101.39-41. In addition, the Attestation Standards require the CPA to conduct comprehensive field work in connection with an examination. The field work includes adequate planning and supervision, Standards for Attest Engagements at §§ 101.42-50, collecting “sufficient evidence” to provide a reasonable basis for the conclusion that is expressed in the report, Standards for Attest Engagements at §§ 101.51-58, and where appropriate written representations from the responsible party. Standards for Attest Engagements at §§ 101.59-62. Lastly, the CPA

⁷ The American Institute of CPAs Statements on Standards for Attest Engagements, § 101 Attest Engagements, is available at <http://www.aicpa.org/Research/Standards/AuditAttest/DownloadableDocuments/AT-00101.pdf>. It sets forth the general framework for Attest Engagements. Standards for Attest Engagements at §101.02.

conducting the attest examination must be independent. Standards for Attest Engagements at §§ 101.35-38.

The Code of Professional Conduct of the American Institute of CPAs⁸ (hereinafter, “AICPA Code”) requires that, “[a] member in public practice should be independent in fact and appearance when providing auditing and other attestation services.” *Id.* at § 55. Section 55 then notes that CPAs employed by a company cannot maintain the appearance independence, even though they must apply generally accepted accounting principles and be candid in all their dealings independent CPAs. *Id.* at §§ 55.01-04. Although one can be licensed as a CPA and be employed by a company, it is inappropriate for that CPA to provide a report of an examination intended to assure music publishers and songwriters that Annual Statements provided under Section 115 by the CPA’s employer are accurate. *See generally*, AICPA Code at §§ 55 and 57 and at §§ 101.35-38.

Section 101 of the Standards for Attest Engagements provides a rigorous, but flexible framework for conducting attest examinations. However, more specific standards have been developed to provide additional requirements for certain types of engagements and the related reports. *Id.* at § 101.02. For example, the AICPA has established specific standards for examining the processes operated by third party service providers on behalf of their customers. The reports of these examinations may be used by the customer or the customer’s CPA. *See* SOC Reports Information for Service Organizations⁹. One such report and opinion, the SOC 1, Type 2, is rendered in accordance with the AICPA’s Statement on Standards for Attestation Engagements No. 16 and is familiar to many companies that outsource financial services. In instances where a compulsory licensee outsources services related to the processing of

⁸ Available online at <http://www.aicpa.org/Research/Standards/CodeofConduct/Pages/default.aspx>.

⁹ Available online at <http://www.aicpa.org/interestareas/frc/assuranceadvisoryservices/pages/serviceorganization'smanagement.aspx>.

compulsory licenses, monthly, or annual reports, therefore, the compulsory licensee and the CPA it engages to certify Annual Statements will have the ability to rely upon an appropriate examination report issued by the service provider's CPA.

As a result, the Parties propose an examination by an independent CPA performed in compliance with the Attestation Standards that results in one of the following opinions:

A. the accompanying Annual Statement presents fairly, in all material respects, the compulsory licensee's usage of musical works identified in the Annual Statement and the royalties applicable thereto in accordance with 17 USC § 115 and 37 CFR parts 210 and 385, as amended or superseded from time to time;

or

B. (I) the processes, including the calculation of statutory royalties, were designed and operated effectively to generate Annual Statements that present fairly, in all material respects, the Royalty and Usage Data covered by the Annual Statements in accordance with 17 USC § 115 and 37 CFR parts 210 and 385, as amended or superseded from time to time, and

(II) the internal controls of the compulsory licensee and/or a Service Provider(s) relevant to the process and calculations used to generate the compulsory licensee's Annual Statements were suitably designed and operated effectively during the period covered by the Annual Statements thereto in accordance with 17 USC § 115 and 37 CFR parts 210 and 385, as amended or superseded from time to time. *See Exhibit A.*

The conclusions required by these opinions is that the Annual Statements themselves or the processes that generated the Annuals Statements complied in all material respects with Section 115 and related regulations. In addition, the Parties' proposal includes the required

assertions and a description of the examination procedures that comply with the Attestation Standards. *See* Exhibit A. By requiring examinations as set forth in Exhibit A that result in the alternative opinions set forth above, the Parties' proposed regulations ensure the high level of review necessary to protect music publishers and songwriters. This rigor is accomplished without unduly limiting the flexibility of compulsory licensees to operate their business using internal or external resources and relies upon the exercise of professional judgment by CPAs engaged by the compulsory licensee. Lastly, it places the responsibility for compliance on the management of the compulsory licensee and the CPA engaged to review their Annual Statements or their assertions about the process used to generate their Annual Statements.

CONCLUSION

For the reasons set forth above, the Parties request that the Office refrain from extending the application of negative reserve balances to DPDs and that the Office require that compulsory licensees report Third-Party Licensee identification information to copyright owners. Finally, the Parties request that the Office adopt the certification language in Exhibit A and Exhibit B.

Dated: December 10, 2012

Respectfully submitted,



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Exhibit A

The Parties' Proposed Regulation for Certification of Annual Statements by a CPA

210.17(f)(2)

(2) Each Annual Statement of Account shall also be accompanied by the certification of one or more licensed Certified Public Accountants (“CPA”), as applicable. Each such CPA shall certify that they have conducted an examination and rendered an opinion in accordance with the requirements of section (i) or (ii) below (as applicable).

(i) (A) that the CPA has conducted an examination in accordance with the attestation standards established by the American Institute of Certified Public Accountants, as amended or superseded from time to time (the “Attestation Standards”) of the accompanying Annual Statement prepared by the compulsory licensee, and

(B) an opinion based on such examination that the accompanying Annual Statement presents fairly, in all material respects, the compulsory licensee’s usage of musical works identified in the Annual Statement and the royalties applicable thereto in accordance with 17 USC § 115 and 37 CFR parts 210 and 385, as amended or superseded from time to time;

or

(ii) (A) that the CPA has conducted an examination in accordance with the Attestation Standards:

(I) of an assertion by management of the compulsory licensee that the processes, including the calculation of statutory royalties, it operated generated Annual Statements relevant to such examination that present fairly, in all material respects, both the compulsory licensee’s usage of compulsory licensors’ musical works under compulsory license during the fiscal year covered by such Annual Statements, the statutory royalties applicable thereto, and such other

data as are relevant to the calculation of the statutory royalties applicable thereto in accordance with 17 USC § 115 and 37 CFR parts 210 and 385, as amended or superseded from time to time (collectively, the “Usage and Royalty Data”); and

(II) of an assertion by management of the compulsory licensee that the internal controls relevant to the processes used to generate the Annual Statements prepared by or on behalf of the compulsory licensee were suitably designed and operated effectively during the period covered by the Annual Statements,

(B) that such an examination included examining:

(I) either on a test basis or otherwise as the CPA considered necessary under the circumstances and in its professional judgment, the Usage and Royalty Data, and

(II) such other evidence and procedures the CPA considered necessary under the circumstances and in its professional judgment to evaluate management’s assertions regarding the processes and/or internal controls, including, in the event a third party or third parties acting on behalf of the compulsory licensee (“Service Provider(s)”) provided services with respect to the relevant Annual Statements, review of a report and opinion rendered in accordance with the AICPA’s Statement on Standards for Attestation Engagements No. 16 (SOC 1), Type II, as amended or superseded from time to time, or similar report under the Attestation Standards, that the process and/or internal controls of the Service Provider relevant to the process and calculations used to generate the compulsory licensee’s Annual Statements were suitably designed and operated effectively during the period of the examination, and

(C) an opinion based on such examination, that:

(I) the processes, including the calculation of statutory royalties, were designed and operated effectively to generate Annual Statements that present fairly, in all material

respects, the Royalty and Usage Data covered by the Annual Statements in accordance with 17 USC § 115 and 37 CFR parts 210 and 385, as amended or superseded from time to time, and

(II) that the internal controls of the compulsory licensee and/or a Service Provider(s) relevant to the process and calculations used to generate the compulsory licensee's Annual Statements were suitably designed and operated effectively during the period covered by the Annual Statements thereto in accordance with 17 USC § 115 and 37 CFR parts 210 and 385, as amended or superseded from time to time.

Exhibit B

The Parties' Proposed Regulation for Certification of Monthly Statements

Monthly Certification

(f) *Certification.* (1) Each Monthly Statement of Account shall be accompanied by:

(i) The printed or typewritten name of the person who is certifying the Monthly Statement of Account;

(ii) If the compulsory licensee is a partnership or a corporation, by the title or official position held in the partnership or corporation by the person certifying the Monthly Statement of Account;

(iii) The date of certification; and

(iv) One of the following statements:

I certify that (1) I am duly authorized to sign this Monthly Statement of Account on behalf of the compulsory licensee, (2) I have examined this Monthly Statement of Account, and (3) all statements of fact contained herein are true, complete, and correct to the best of my knowledge, information, and belief, and are made in good faith.

or

I certify that (1) I am duly authorized to sign this Monthly Statement of Account on behalf of the compulsory licensee, (2) I have prepared or supervised the preparation of the data used by the compulsory licensee and/or its agent to generate this Monthly Statement of Account, (3) such data is true, complete, and correct to the best of my knowledge, information, and belief, and was prepared in good faith, and (4) this Monthly Statement of Account was prepared by the compulsory licensee and/or its agent using a process and controls that were subject to an examination, during the past year, by a licensed Certified Public Accountant in accordance with

the attestation standards established by the American Institute of Certified Public Accountants, as amended or superseded from time to time, the opinion of whom was that the processes, including the calculation of statutory royalties, and the controls related thereto, operated to generate Annual Statements that present fairly, in all material respects, both the compulsory licensee's usage of compulsory licensors' musical works under compulsory license during the fiscal year covered by such Annual Statements, the statutory royalties applicable thereto, and such other data as are relevant to the calculation of the statutory royalties applicable thereto in accordance with 17 USC § 115 and 37 CFR parts 210 and 385, as amended or superseded from time to time.