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Verification of Statements of Account) Docket No. 2012-5
Submitted by Cable Operators and )
Satellite Carriers )

COMMENTS OF THE
NATIONAL CABLE & TELECOMMUNICATIONS ASSOCIATION

Of Counsel: Rick Chessen
Seth A. Davidson Diane B. Burstein
Edwards Wildman National Cable & Telecommunications
1255 23rd Street, N.W. Association
8th Floor 25 Massachusetts Avenue, N.W. – Suite 100
Washington, D.C. 20037 Washington, D.C. 20001-1431
(202) 222-2445

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Stephanie B. Power
Legal Research Specialist
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The National Cable & Telecommunications Association ("NCTA")\(^1\) submits these comments in the Copyright Office’s Notice of Proposed Rulemaking ("Notice") in the above-captioned proceeding.\(^2\) The Office proposes to adopt rules to implement Section 104(c)(5) of the Satellite Television Extension and Localism Act of 2010 ("STELA"), which amends Section 111 of the Copyright Act to authorize audits of statements of account ("SOAs") filed pursuant to the cable statutory license.\(^3\)

In STELA, Congress directed the Register of Copyrights to “issue regulations to provide for the confidential verification [of cable statements of account] by copyright owners whose works were embodied in the secondary transmissions of primary transmissions … of the information reported on the semiannual statements of account … for accounting periods beginning on or after January 1, 2010, in order that the auditor designated … is able to confirm

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\(^1\) NCTA is the principal trade association for the U.S. cable industry, representing cable operators serving more than 90 percent of the nation’s cable television households and more than 200 cable program networks. The cable industry is the nation’s largest provider of broadband service after investing over $185 billion since 1996 to build two-way interactive networks with fiber optic technology. Cable companies also provide state-of-the-art competitive voice service to more than 23 million customers.


the correctness of the calculations and royalty payments reported therein. STELA specified that those regulations must:

(1) establish procedures for the designation of a “qualified independent auditor”;

(2) establish procedures to safeguard all nonpublic information received by the auditor;

(3) require the auditor to review its conclusions with the relevant cable operator;

(4) establish a mechanism for the cable operator to (a) remedy any errors identified in the auditor’s report; (b) “cure” any identified underpayments, and (c) remedy any disputed facts or conclusions;

(5) limit the frequency of requests for audits of a particular cable system;

(6) limit the number of audits that any multiple system operator (“MSO”) can be required to undergo in a single year; and

(7) allow requests for verification of a SOA to be made only within 3 years after the last day of the year in which the SOA is filed.

These new rules will supplement the existing reviews of cable SOAs conducted by the Office’s Licensing Division and by individual copyright owners. The Licensing Division reviews those semi-annual statements for accuracy and makes them available for public review.

The cable industry as a whole files a total of nearly 3800 SOAs every six months, many of which cover multiple (and sometimes dozens of) “subscriber groups” with distinct signal carriage complements. Multiple system operators (“MSOs”) may file hundreds of such SOAs semi-annually. Under these circumstances, granting unfettered auditing rights to the multitude

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5 Id., §§ 111(d)(6)(A) – (E).
6 See 37 C.F.R. § 201.17(c)(2) (“the Office will examine the Statement [of Account] and fee for obvious errors or omissions appearing on the face of the documents, and will require that any such obvious errors or omissions be corrected before final processing of the documents is completed.”).
8 Source: Cable Data Corporation, data for Accounting Period 2011-1.
of copyright owners whose works were aired on any of the broadcast stations retransmitted by a cable system would severely disrupt cable operations.

Congress accordingly directed the Office to adopt rules that “minimize[] the burden and costs imposed by the audit process.” 9 Recognizing the unique nature of the cable licensing regime, Congress required that the Office appropriately tailor its rules to the “specific needs and circumstances of the reporting and payment of royalty fees under Section 111.”10 The Office therefore must strike a fair balance between copyright owners’ interest in gaining access to certain records that form the basis of cable operators’ royalty calculations and cable operators’ interest in having protections against the burdens, disruptions and expenses that even the most efficient audits could impose.

The Notice proposes several rules that fail to achieve that needed balance. In particular, as detailed below, the Office should establish a more even-handed process for selecting auditors; tighten the limits on the frequency of audits; and protect cable operators against any unfair assessment of audit costs.

DISCUSSION

A. The Office Must Establish Fair and Efficient Procedures for Selecting the Auditor and Conducting the Audit.

1. Cable Operators Should Have a Larger Role in Designation of the Auditor.

Section 111(d)(6)(A) directs the Office to “establish procedures for the designation of a qualified independent auditor.”11 The Notice makes copyright owners responsible for designating an auditor and for resolving any disputes among themselves concerning the

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10 Id.
allocation of costs. To be “qualified” for these purposes, the auditor selected by the copyright owners must be a certified public account. To satisfy the “independence” requirement, the auditor may not be an officer, employee or agent of a copyright owner for any purpose other than the audit, and must satisfy the Code of Professional Conduct of the American Institute of Certified Public Accountants (“AICPA”).

The Notice contemplates a very limited role for the cable operator who is the subject of the audit. An operator would have no opportunity to participate in the selection of the auditor. It could only raise concerns with the copyright owner(s) who selected the auditor regarding that auditor’s qualification or independence before the audit begins. If the parties cannot resolve the dispute over these baseline eligibility issues, the operator’s only recourse would be to the AICPA’s Professional Ethics Division or the State Board of Accountancy. Meanwhile, the audit could proceed while the auditor’s qualifications are being reviewed.

This type of regime for selecting the auditor contains inherent biases in favor of copyright owners. Wholly apart from whether the auditor meets the proposed eligibility standards, an auditor selected by the copyright owners may well have business reasons to satisfy its clients that could make for a less even-handed audit than otherwise would be the case. To protect against such a natural pro-copyright owner bias, the Office should adopt a procedure for choosing an auditor that provides both copyright owners and cable operators input into the auditor’s selection.

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12 Notice at 35646. The Office proposes to follow the same process as is used to initiate audits and verification procedures for other statutory licenses. A copyright owner would be required to notify the Office of its intent to audit and to serve notice on the subject of the audit. Once the Office receives a notice of intent to audit a particular SOA, it would not accept another notice of intent to audit that same SOA. The Office would provide Federal Register notice of receiving the notice of intent to audit and other copyright owners interested in joining the audit would be required to contact the initiating copyright owner.

13 Id.

14 Id.

15 Id.
A certified public accountant designated by the cable operator being audited and a certified
public accountant designated by the copyright owner(s) requesting the audit should jointly
choose a neutral auditor. This collaborative approach will help ensure a measure of fairness in
the audit from the outset, and will hopefully minimize the number of disputes that might arise
during that process.

2. The Office Should Adopt Meaningful Limits to the Number of
Systems and Statements of Account That Can Be Audited Annually.

Congress was cognizant of and concerned about the burden on cable operators that the
newly-approved audit right would impose; therefore, it mandated that the Office’s implementing
rules “limit the frequency of requests for verification for a particular cable system and the
number of audits that a multiple system operator can be required to undergo in a single
year.”16 While the Notice acknowledges the need to provide these important protections, the
approach that it has proposed (based in part on a proposal received from the copyright owners)
falls far short of the mark.

In the case of an MSO, the Notice proposes to allow three audits per year, with each audit
potentially covering previously unaudited SOAs for up to 50 percent of the MSO’s systems.17
The proposed rule also provides that if the auditor finds an underpayment of five percent or more
in any SOA filed by an MSO, that particular audit may be “expanded” to include all of the
MSO’s systems and all of its previously unaudited SOAs.18

17 Notice at 35647. On its face, the proposal appears to permit 150 percent of an MSO’s systems to be audited
every year.
18 Id. at 35648.
This approach – which the Office itself acknowledges is meant to be merely a “starting point” for discussion of the audit frequency issue\(^\text{19}\) – fails to provide the protections for MSOs envisioned in the Act and must be revised. As drafted, it would allow audits of every previously unaudited SOA of every system owned by an MSO every year. Given that nearly 3800 SOAs are filed semi-annually, more than a third by the top 10 MSOs, the proposed rule poses a significant risk of creating burdensome intrusions into cable operators’ business operations. The rules should be revised to establish meaningful limits on the audit process as applied to MSOs.

First, there is no reason to allow annual audits covering every system operated by an MSO and every SOA filed by those systems. To provide operators with the protections against disruptive audits that STELA intended, the Office should adopt rules that permit an audit of only a reasonable sampling of an MSO’s systems and SOAs. Copyright owners should be allowed to conduct a single audit per year covering up to 10 percent of an MSO’s systems, and that audit should cover no more than one SOA for any one system. Sample sizes of 10 percent or less are consistent with audit practices,\(^\text{20}\) and there is no reason to expand the sample size here. Audits of a representative sample of commonly-owned cable systems should be more than sufficient to determine whether an MSO’s SOAs suffer from any systemic problems.

Second, because an annual sampling of 10 percent of an MSO’s systems provides the copyright owners with the opportunity to detect systemic problems in the MSO’s royalty calculations, there is no need for the Office to adopt a “trigger” for expanding the number of

\(^{19}\) Id. at 35647.

\(^{20}\) See, e.g., Audit Sampling Considerations of Circular A-133 Compliance Audits, AICPA (2009) at 8 (“For populations between 52 and 250 items, a rule of thumb some auditors follow is to test a sample size of approximately 10 percent of the population ….”) Copyright owners are familiar with the use of sampling from various distribution proceedings. For example, Program Suppliers relied on statistical sampling of approximately 90 cable systems from the entire universe of 1200-1600 Form 3 SOAs filed during this period to support their case during the 2004-2005 royalty distribution proceeding. See Testimony of Martin R. Frankel, Ph.D, Distribution of 2004-2005 Cable Royalties (Sept. 28, 2009).
systems that can be audited in a year. Under the rules as proposed, an underpayment of 5 percent or more in just one SOA would open the door to an annual audit of 100 percent of an MSO’s systems and SOAs. But an isolated underpayment by one system in one accounting period is not a reasonable basis for suspecting that there is an MSO-wide issue and thus provides no justification for expanding the number of systems or SOAs subject to audit. It also provides entirely too many opportunities for gaming the system in order to circumvent the protections against burdensome audits. Therefore, the rules should not incorporate a “trigger” for expanded audit rights.

The proposed rules governing how often audits may be conducted of individually-owned cable systems also are flawed. Under the proposed rule, each SOA filed by the owner of a single cable system can be audited only once and the Office will not accept a second notice to audit the same SOA. While it appears that the Office’s intent was to limit the number of times that the owner of a single system can be audited to once per year, the proposed rule, by focusing on individual SOAs, does not accomplish that end. Rather, on its face, it places no limit on the number of times that the owner of a single cable system can be audited so long as each audit covers a different, previously unaudited SOA. Thus, for example, if none of the previous year’s SOAs filed by the owner of a single system had been audited, a request to audit the SOA for the first accounting period would not preclude a second request, during the same year, to audit the system’s SOA for the second accounting period. The rule should be amended to make clear that the owner of a single cable system may not have its system audited more than once in a year and that the audit may only cover one SOA identified in the audit request. Furthermore, the rules governing audits of both individually-owned systems and MSOs should include a period of

21 *Notice* at 35651.
22 Proposed rule § 201.16(k)(1).
repose. Once a particular system has been audited, it should not be subject to any additional audits for two years after the year in which the audit is concluded.

Finally, audits should be conducted at a records retention location designated by the cable operator at reasonable times during normal business hours. This would further help minimize potential disruptions to business operations and expedite the audit process.

3. The Proposed Regulations Must Provide MSOs with Sufficient Opportunities to Correct or Challenge the Audit Findings.

STELA requires that the Office’s implementing regulations include certain specific provisions designed to protect cable operators once the auditor completes its preliminary audit. The regulations must allow:

- “a consultation period for the independent auditor to review its conclusions” with the cable operator;
- “a mechanism for the cable system to remedy any errors identified in the auditor’s report and to cure any underpayment identified”; and
- “an opportunity [for the cable operator] to remedy any disputed facts or conclusions.”

a) Consultation

With respect to consultation, the Notice proposes to require the auditor to deliver a copy of its preliminary report to the cable operator prior to delivering a final report to any copyright owner. The proposed rules set out a strict timetable, both for consultation and for presentation of a final report. Within 30 days after delivery of the preliminary report, the auditor must review

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23 See, e.g., 37 C.F.R. § 262.6(b).
26 § 111(d)(6)(C)(iii).
27 Notice at 35651.
it with the operator’s designee at a mutually convenient time and place.\textsuperscript{28} If the operator disagrees with the facts or conclusions in the auditor’s report and wants to bring these disagreements to the auditor’s attention, it must submit its views in writing within two weeks following its “initial consultation” with the auditor.\textsuperscript{29} The auditor will have 60 days from the date it delivers the report to the cable operator to distribute a final report to the cable operator and the copyright owner(s).\textsuperscript{30}

Cable operators share an interest in ensuring that audits are conducted efficiently and expeditiously. However, depending on the number of audits conducted and the press of other business, the deadlines proposed in the \textit{Notice} may fail to provide sufficient time either for operators to fully consider and thoroughly respond to the audits or for the auditor to address that response. In particular, the proposed two-week deadline for the operator to follow-up its consultation with the auditor with a written response and the proposed 60-day deadline for the auditor to complete its final report are unreasonably short. Moreover, they represent departures from the Office’s other audit provisions, which do not establish a fixed deadline for the distribution of a final report and require simply that the statutory licensee “reasonably cooperate[] with the auditor to remedy promptly any factual errors or clarify any issues raised in the audit.”\textsuperscript{31} While there are good reasons to impose time limits on the audit process, the proposed rule is too inflexible. It should be modified to ensure that the cable operator and auditor can continue to discuss issues raised by the audit without cutting into the time given the auditor to prepare and distribute its final report.

\textsuperscript{28} Id.
\textsuperscript{29} Id. (proposed § 201.16(g) (consultation)).
\textsuperscript{30} Id.
\textsuperscript{31} 37 C.F.R. § 261.7(f); \textit{id.}, § 262.6(f) (same).
b) Curing Underpayments

In addition to this period of consulting with the auditor, STELA also provides licensees an opportunity to “cure” any identified underpayments. The legislative history makes clear that even before the preliminary report is made final and presented to copyright owners, the cable operator should be allowed to “cure” any deficiencies by “amend[ing] its statement of account and supplement[ing] its royalty payments (subject to the filing fee and interest requirements generally applicable to late, corrected, or supplemental statements of account and royalty fees) to conform with the auditor’s findings.”\textsuperscript{32}

The rules should provide an opportunity after the consultation period but prior to the completion and distribution of the auditor’s final report for a cable operator to amend its SOAs and to make any supplemental payments necessary to conform to the auditor’s findings. In addition, the rules should establish that an operator is relieved from any threat of copyright infringement liability based on deficiencies identified in an audit where the operator takes measures to “cure” those deficiencies.\textsuperscript{33} And where an auditor finds no material deficiency in the system’s SOAs, or where the system fully resolves any such deficiency by timely filing an amended SOA and making supplemental payments, the auditor’s final report to the copyright owners should expressly state that the system is in compliance with its filing and payment obligations.

c) Remedying Disputes

The rules also should provide a meaningful opportunity for cable operators to “remedy any disputed facts or conclusions” in the preliminary report. The Notice suggests that an

\textsuperscript{32} House Report at 10.

\textsuperscript{33} The legislative history explains that, absent a showing of bad faith, operators that make such filings “will not be subject to copyright infringement liability under Section 111(c)(2)(B) based on the deficiencies found by the auditor.” \textit{Id.}
appropriate remedy would simply be to require the auditor to “include [the operator’s written response to the report] as an attachment to his or her final report to the copyright owners.”\textsuperscript{34} However, the regulations should go further to make clear that absent any showing of bad faith, cable operators that dispute the preliminary audit findings will not face potential copyright liability while that dispute is being resolved.

4. Additional Protections for Confidential Material Are Needed.

STELA directs the Office to “provide for the confidential verification” of SOAs and to “establish procedures for safeguarding all non-public financial and business information provided under this paragraph….”\textsuperscript{35} The \textit{Notice} proposes to include in its rules certain protections for the handling of confidential information by the auditor and its employees.\textsuperscript{36}

Additional protections are needed to ensure that confidential information is not inadvertently – or intentionally – provided to copyright owners. Thousands of copyright owners may have had works retransmitted by any one cable system, and this sensitive financial data must be protected against disclosure to entities that may desire it for purposes unrelated to determining compliance with the cable compulsory license royalty fee calculations. As the \textit{Notice} points out, under most of the Office’s audit provisions, “access to confidential information has been limited to the auditor and his or her employees and agents.”\textsuperscript{37} A similar approach is warranted here. Accordingly, the Office should ensure that auditors do not provide copyright owners with access to any confidential information provided to them by a cable operator. The rules should require that evidentiary support for the auditor’s findings must be

\textsuperscript{34} \textit{Notice} at 35649.

\textsuperscript{35} 17 U.S.C. § 111(d)(6)(B).

\textsuperscript{36} For example, access to confidential information would be limited to the auditor and certain agents of the auditor. \textit{See} proposed rule § 201.16(m).

\textsuperscript{37} \textit{Notice} at 35650.
presented in a separate appendix that is redacted to protect any confidential information contained therein.  

B. Operators Should Not Be Unfairly Assessed Costs of the Audits

Citing other audit provisions and STELA’s legislative history, the Notice proposes that, “as a general rule, the copyright owner(s) who selected the auditor would be expected to pay for the auditor’s work in connection with the audit.” However, “if the auditor concludes that there was an underpayment of five percent or more reported in any Statement of Account that was included in the audit...the auditor’s fee [must be] paid by the statutory licensee that filed that Statement.” Those costs would shift back to the copyright owner “if a court, in a final judgment (i.e., after all appeals have been exhausted) rejects” the auditor’s determination regarding the extent of the underpayment. This cost-shifting approach is unwarranted.

The Office’s proposed cost-shifting rule, as drafted, is unclear as to whether the cost-shifting occurs on an SOA-by-SOA basis (i.e., the only costs that shift are those allocable to the particular SOAs that are found to have underreported royalties by five percent or more), or whether the finding that a single SOA contains an underpayment of five percent or more would shift the cost of the entire audit (including the audit of systems that were found to have no deficiencies or even may have overpaid). In either case, cost shifting to cable operators would be unfair. Unlike the operator being audited, copyright owners not only are the beneficiaries of the audit, but they also have control over whether to have an audit in the first place and can put together a large group over which to spread the audit’s costs. Meanwhile, operators inevitably

38 See, e.g., 37 C.F.R. § 201.30(g).
39 Id. at 35649.
40 Id.
41 Id.
will be forced to incur costs in complying with audit demands – even if an audit provides a clean bill of health – that they will have no opportunity to recover from the copyright owners initiating audits. For these reasons, we do not believe it is equitable for cable operators to be forced to bear any of the auditor’s costs.

If the Office nonetheless were to decide to adopt a cost-shifting mechanism, it must not put MSOs that file hundreds of SOAs and pay millions of dollars in royalty fees every six months at risk of bearing the entire cost of an audit based on the underreporting on a single SOA. As just one (albeit extreme) example, a cable system with over $527,600 in semi-annual gross receipts must file (and calculate its royalties using) a Form 3. The minimum fee that such a system can owe is around $5600. Under one reading of the Office’s cost-shifting proposal, an underpayment of as little as $280 (5% of $5600) on one such Form could result in an MSO with dozens of Form 3 filings having to bear the total cost of auditing its systems – even if not a single additional error were detected in any of the other SOAs audited. This outcome would be manifestly unfair.

If the Office adopts a cost shifting approach, basic fairness requires any calculation (i) to consider not only underpayments but also overpayments to determine whether the threshold has been met and (ii) to take into account the total amount of royalties paid by an MSO. More specifically, audit costs should only shift (if at all) where the total amount of underpayments, net of any overpayments, is equal to or greater than 10 percent of the royalty payments made for all SOAs reviewed by the audit. A 10 percent threshold for shifting costs is consistent with the cost-shifting trigger that the Office has adopted in the majority of its audit rules.\footnote{See 37 C.F.R. §262.6 (sound recordings); \textit{id.}, §380.25(g) (webcasters); \textit{id.}, §384.6(g) (ephemeral recordings).}
Furthermore, Copyright Office procedures in other audit contexts provide for fee shifting only after “a judicial determination or the filer’s agreement that royalty payments were understated…”\[^{43}\] or after “it is finally determined that there was an underpayment….\[^{44}\] The proposed rule turns this approach on its head by requiring the operator to pay first and then seek reimbursement from the copyright owners upon a final judgment rejecting the auditor’s determinations. The *Notice* offers no reason why, if costs are to shift to the operator, a different approach should be applied here than in other situations. To avoid the potential for unfair results and to conform these rules to rules for audits under other statutory licenses, the Office should provide that an operator’s payment of the cost of auditing an SOA is only triggered after a *final* determination is made as to whether the operator is required to bear that cost.

The regulations also should incorporate certain additional protections for the operator in the event the cost shifting provision is triggered. In particular, the regulations must provide some protection with regard to audit costs that an operator cannot control. At a minimum, as is the case with respect to other cost-shifting provisions adopted by the Office, reimbursement of cable audit fees should be limited to the “reasonable costs”\[^{45}\] incurred by the auditor and in no event should a cable operator be required to pay auditors’ costs in excess of the amount of any underpayment.\[^{46}\]

Finally, the Office’s rules should be even-handed and should cover not only supplemental additional payments resulting from the audit but also refunds. If audits are not solely to be paid by copyright owners but rather potentially by cable operators as well, cable operators should

\[^{43}\] 37 C.F.R. § 201.30(i).
\[^{44}\] § 261.7(g); § 262.6(g) (same).
\[^{45}\] *Id.*
\[^{46}\] *See generally id.*, § 261.7(g).
obtain the benefit of any overpayments they may have made that an audit uncovers. Thus, operators should be permitted to file for refunds of overpayments discovered during the audit process.

CONCLUSION

For all these reasons, the Office should adopt reasonable procedures that provide meaningful protection for cable operators against unduly burdensome and costly audits.

Respectfully submitted,

/s/ Rick Chessen

Of Counsel:
Seth A. Davidson
Edwards Wildman
1255 23rd Street, N.W.
8th Floor
Washington, D.C. 20037

Rick Chessen
Diane B. Burstein
National Cable & Telecommunications Association
25 Massachusetts Avenue, N.W. – Suite 100
Washington, D.C. 20001-1431
(202) 222-2445

Stephanie B. Power
Legal Research Specialist

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