

**Before the
UNITED STATES COPYRIGHT OFFICE
Washington, D.C.**

In the Matter of:

Mechanical and Digital Phonorecord Delivery
Compulsory License

Docket No. 2012-7

SUPPLEMENTAL REPLY COMMENTS OF MUSIC REPORTS, INC.

Music Reports, Inc. (“Music Reports”) hereby submits these Supplemental Reply Comments in response to the Copyright Office’s Request for Additional Comments dated December 26, 2013 (78 FR 78309) (the “Request”) in the above-captioned proceeding.

The Request indicated that the Office seeks additional input on amendment of the regulations proposed by the parties in this proceeding on December 10, 2012 (the “Reply Comments”) due to “the passage of time since issuance of the NPRM [of July 27, 2012 (77 FR at 44184)], marketplace developments and changes in business models....”

Since filing its Reply Comments in this matter, Music Reports has continued to consider its proposal on the certification of Statements of Account (the “Music Reports Proposal”), in comparison to the proposal which was submitted by the National Music Publishers’ Association, its wholly owned licensing subsidiary, the Harry Fox Agency, Inc., and others (collectively, the “Publishers”), and we again respectfully request adoption of the Music Reports Proposal.

I. Discussion

A. The Narrow Problem of High-Volume Statements

In the introduction to its NPRM of July 27, 2012 (77 FR at 44181), the Office noted that “[T]he current regulations do not specifically accommodate the more complex methods for

calculating the royalty for limited downloads, interactive streaming... or the new services identified in the Copyright Royalty Judge's May 17, 2012 Notice of Proposed Rulemaking." While it is certainly true that the method for calculating the royalty for these new offerings and services is much more complex, it is also true that until recently the statutory mechanical license provided by Section 115 of the Copyright Act (the "Statutory License") was used only on rare occasions by record companies, as an alternative to voluntary licenses, in connection with the release of a limited number of phonorecords. Today, however, the Statutory License has become a critical tool for today's digital music service providers ("DSPs"), enabling the use by consumers of millions of phonorecords. Due to the difficulty and expense of administering the Statutory License in such volume, the vast majority of DSPs choose to outsource administration to a service provider like Music Reports.

The Statutory License was already in widespread use by DSPs prior to settlements of the Copyright Royalty Board proceedings to set rates and terms for the Statutory License (Docket Nos. 2006-3 CRB DPRA and 2011-3 CRB Phonorecords II). However, as a result of these settlements, DSP licensees (or service providers like Music Reports, on behalf of DSPs) began to send thousands of music publishers separate statements each month, for each offering on each of the DSPs' licensed services.

With so many statements being generated, it would clearly be commercially impossible for a CPA to certify that they "have examined the attached [statement]", as provided in the current regulations. (37 CFR 201.19(f)(6)) Therefore, relative to the question of "Certification", the Office sought comments on the following narrowly focused question:

"[T]he Office is aware that licensees have expressed interest in adopting alternative methods of certifying the Statement of Account to accommodate large volumes of statements and welcomes suggestions on modifications to

the process provided that any proposed alternative form of certification fits within the statutory requirements and complies with the original intentions of the CPA requirement. The CPA requirement should assure that copyright owners receive the royalties to which they are entitled, but the requirement should not burden the licensee to the point that it would prevent the compulsory licensee from being a practical option for record companies or services. Are there alternative certification methods that satisfy both goals and should be considered by the Office?”

- NPRM of July 27, 2012 (77 FR at 44184)

The Music Reports Proposal answers this question with a simple, bifurcated proposal: require one certification for the so-called ‘usage and royalty data’ from DSPs which goes into the statutory royalty calculation, and a separate certification for the *process* by which high-volume statements are generated *from* that usage and royalty data. The Music Reports Proposal is further described below.

B. The Publishers’ Overbroad Proposal to Address the Problem

In contrast to the Music Reports Proposal, the certification language proposed by the Publishers in their Reply Comments of December 10, 2012 (the “Publishers’ Proposal”) ratchets up the underlying auditing standard by which CPAs must certify statements and then imposes a new ‘process audit’ requirement on DSP licensees. Rather than simply addressing the narrow question of how to certify a high-volume set of statements prepared by a service provider, the Publishers’ Proposal goes farther, confining CPAs to a narrow set of available accounting standards on which to base their review, and restricting the pool of CPAs eligible to certify statements to those who are not employed by DSPs. In doing so, the Publishers’ Proposal adds complexity and expense to the use of the Statutory License, thereby upsetting the balance sought by the Office between the Publishers’ right to be assured they are receiving the royalties to which they are entitled, and the burden on licensees’ access to the Statutory License as a practical

option. At the same time, if the Publishers' Proposal is adopted, it will create a double standard and unfairly discriminate against DSPs, as it will hold record companies involved in phonorecord distribution to a lower standard than DSPs.

1. The Current Auditing Standard vs. the Proposed Standards

Section 115(c)(5) of the Copyright Act provides that “[t]he Register shall ... prescribe regulations under which detailed cumulative annual statements of account, certified by a certified public accountant, shall be filed for every statutory license under this section.” In accordance with Section 115(c)(5), the Office has previously adopted regulations which impose ‘generally accepted auditing standards’ on licensees: “Our examination was made in accordance with **generally accepted auditing standards** and accordingly, **included tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.**” 37 CFR 201.19(f)(6)(ii)(A) (first paragraph) (*emphasis added*). Thus, the current regulations allow a CPA to use professional judgment according to generally accepted auditing standards to determine how to examine the statement, with the goal of opining that the statement presents fairly the **number of phonorecords made and distributed by the licensee**, and the **“amount of royalties applicable thereto.”** 37 CFR 201.19(f)(6)(ii)(A) (second paragraph).

The Music Reports Proposal attempts to conserve this approach, except where circumstances require its modification. Thus, with respect to low-volume Annual Statements of Account, a CPA acting **according to the professional standards of the American Institute of Certified Public Accountants** (the “AICPA”) would certify to having examined each statement and rendered an opinion that it presents fairly the licensee’s **“usage of musical works”** and the **“statutory royalties applicable thereto.”** Music Reports’ Proposal, at proposed Sec. 210.7(f)(2)(i).

By contrast, the Publishers' Proposal would in all cases (including both low-volume and high-volume situations) narrow the range of auditing options available to the certifying CPA from those that a CPA might 'consider necessary in the circumstances' taking into consideration professional judgment under the AICPA standards, and instead require the CPA to audit pursuant to the AICPA's "*attestation engagement*" standards. See Publishers' Proposal, at proposed Sec. 210.17(f)(2)(i). The AICPA's attestation engagement standards comprise a small subset of methods by which CPAs may perform audits. See AICPA's Audit and Attest Standards, available at <http://www.aicpa.org/Research/Standards/AuditAttest/Pages/audit%20and%20attest%20standards.aspx>.

The Publishers argue that this particular set of standards will "provide[] 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...." See Publishers' Reply Comments of December 10, 2012 ("Publishers' Reply Comments") at p. 16. This argument is a rhetorical leap from the non-specific use of the term "assure" in the 1976 House Report (H.R. 94-1476, at 111 (1976)) to the modern AICPA concept of "assurance services" which the Publishers suggest without citation are "generally referred to as 'attest engagements'". Publishers' Reply at p. 16. The Publishers further suggest, again without citation, that "[a]ny lower level of review would not serve the purpose under the CPA certification requirement of Section 115," (Publishers' Reply at p. 17) despite the fact that since inception, the regulations have left the appropriate level of review to the professional judgment of CPAs applying Generally Accepted Auditing Standards. 37 CFR 201.19(f)(6)(ii)(A).

In conclusion, though the problem the Office sought a solution for was the narrow problem of high-volume certification, the Publishers' Proposal raises the baseline auditing

standard that has existed since 1978 for all Annual Statements of Account—even in low-volume contexts such as physical distribution.

2. The Process Audit Hurdle for DSPs

As noted above, the Music Reports Proposal is to bifurcate the examination of the *processes* used to generate high-volume statements, from the examination of the so-called “Usage and Royalty Data” (usage, revenues, label payments, performance rights payments, and, if applicable, subscriber counts) which are *always the same*, repeated across all statements for a given period. This bifurcation would leave the current regulations “as is” while solving the high-volume problem the Copyright Office directed the parties to address in the NPRM. Since the Usage and Royalty Data never changes from statement to statement, there is no defensible reason to alter the “presents fairly” opinion standard in the current regulations for these static values. On the other hand, all parties to this proceeding agree that as to the multitudinous statements generated *based on* the Usage and Royalty Data (each of which is different, depending on the usage of the copyright owners’ works and the allocation of royalties based on the volume of that usage), it is appropriate that the systems which generate those statements have suitable controls in place, and that those controls should operate effectively. Therefore, Music Reports and the Publishers agree that as to the statement generation process, a ‘process audit’ should be required, i.e., one that examines whether the internal controls of such process are “suitably designed”, and whether they are “operating effectively”. For this reason, both Music Reports and the Publishers agree that the appropriate standard for examination of the statement generation process is the SSAE 16 (SOC 1) Type II standard promulgated by the AICPA. See generally, Music Reports Proposal and Publishers’ Proposal.

Again, however, the Publishers’ Proposal goes further, requiring not only that the statement generation process be audited, *but that the processes used by the DSPs to generate*

the Usage and Royalty Data be audited. See Publishers' Proposal at proposed

210.17(f)(2)(ii)(I). While Music Reports has already undertaken to have its processes regularly audited, the DSPs have had no reason under current law and regulation to expect that they would be required to undergo such audits. In the first year of such an audit, a DSP could expect to incur hundreds of thousands of dollars in costs to design, implement, and test the internal controls required for even one process—and the Publishers' Proposal would apparently require this level of scrutiny as to each of the processes underlying the five separate Usage and Royalty Data elements. This will certainly add an enormous degree of complexity and expense for the DSPs, making access to the Statutory License much less practicable, especially for smaller DSPs.

Usage and Royalty Data is subjected to scrutiny in other contexts. Without doubt, the revenues of (and where applicable, the number of subscribers to) all DSPs are very carefully audited by their shareholders and potential investors, among others. Likewise, the payments DSPs make to the labels and performing rights societies are subject to audit by the labels and performance societies. And while the actual usage of tracks on a given DSP is not directly subject to audit, the DSPs have no interest in the *allocation* of the royalty pool—only the *size* of the royalty pool. They have no incentive to do anything other than report the usage on their services faithfully, as that information is typically used by their marketing departments to make their services more compelling to existing users, and to attract new users.

Moreover, because the Publishers' Proposal would require a process audit of the Usage and Royalty Data in high-volume contexts, but not require a process audit in low-volume contexts, it creates a double standard which discriminates against DSPs vis a vis record companies. It is not fair that DSPs should be required to undergo expensive and time consuming audits of their processes for determining the static data inputs to their statements, but that record companies should not be similarly required to undergo audits of the processes by which they

manufacture and distribute records, or calculate the number of records ‘voluntarily relinquished’ in a year, or the lapse of reserves.

C. The Complexity of Nested Opinions

Where a DSP employs a third party service provider to generate statements, the Music Reports Proposal would require that the CPA for the DSP certify each statement as to the Usage and Royalty Data (which is the same data across all statements) and that the CPA for the service provider certify each statement as to the process used to generate it (which likewise, is the same process across all statements). This proposal is straightforward, consistent with the goal of modifying the regulations only where necessary to accommodate high-volume statements, and provides publishers with a direct certification from each of the CPAs involved in the generation of their statements.

The Publishers’ Proposal, in contrast, provides that only a third party CPA not employed by the DSP¹ may certify annual statements of account. Under this approach, where a service provider is employed by the DSP to generate the annual statement, the CPA for the DSP must nevertheless certify a statement which the DSP did not produce. In doing so, it must rely on the ‘review of a report and opinion’ rendered by the CPA for the service provider. This approach therefore ‘nests’ the opinion of the service provider’s CPA within a secondary certification by the CPA for the DSP.

While the intention of this approach may be to impose a sense of accountability on the CPA and management for the DSP, it is unlikely to achieve that result without collateral damage

¹ The Publishers read the attestation standards to require the opinion of an external “independent” auditor, while Music Reports believes the attestation standards may be satisfied by an internal auditor, as long as the internal auditor is exercising “independent” judgment. Music Reports would appreciate the Copyright Office’s view of what “independent” means in the attestation standards in this context.

to the efficiency of the certification process. Under Music Reports' Proposal, the management and CPA of the DSP are already held accountable owing to their independent responsibility for the certification of the Usage and Royalty Data. Moreover, the Publishers' nested approach creates two unfortunate possibilities. On the one hand, the CPA for the DSP might choose to rely in blind faith on the opinion of a third party CPA, thereby depriving the publisher of a reasonable level of scrutiny. On the other hand, the CPA for the DSP might decide that it needs to completely review the work of the service provider's CPA in order to trust it, effectively subjecting the service provider to a secondary audit of the processes for which it has already received a favorable opinion. The second possibility is overwhelmingly likely, as is the complexity, delay, and expense that would come with it.

III. CONCLUSION

In light of the foregoing, Music Reports again respectfully requests that the Office adopt the proposed regulations submitted as Exhibit A to our Reply Comments of December 10, 2012.

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Respectfully submitted,



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