

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

In the Matter of:

Mechanical and Digital Phonorecord Delivery  
Compulsory License

Docket No. 2012-7

**COMMENTS OF THE RECORDING INDUSTRY ASSOCIATION OF AMERICA, INC.**

The Recording Industry Association of America, Inc. (“RIAA”) is pleased to have reached agreement with other key stakeholders concerning proposed resolutions of most of the issues raised by the Copyright Office’s Notice of Proposed Rulemaking (“NPRM”) in the above-captioned proceeding. RIAA provides these separate Comments to supplement the Joint Comments it is filing with other stakeholders, to address certain issues on which the stakeholder group could not agree.

RIAA is the trade organization that supports and promotes the creative and financial vitality of the major recorded music companies. RIAA’s members create, manufacture and/or distribute approximately 85% of all legitimate recorded music produced and sold in the United States. To distribute those products, its members obtain mechanical licenses both by the compulsory process presently provided in 37 C.F.R. § 210.18 and by voluntary agreement (frequently incorporating by reference the compulsory license terms). Accordingly, RIAA and its members have a significant interest in the outcome of this proceeding.

In these Comments, RIAA first addresses negative reserve balances (Section 1.B of the NPRM) and then turns to identification of third-party services (Section 3.B of the NPRM).

## **I. Negative Reserve Balances (Section 1.B of the NPRM)**

Whether mechanical royalties should be payable on all phonorecords made, or only those distributed, was a major issue in the general revision of the Copyright Act. In the end, Congress' resolution of that issue was unambiguous: "It is unjustified to require a compulsory licensee to pay license fees on records which merely go into inventory, which may later be destroyed, and from which the record producer gains no economic benefit." H.R. 94-1476, at 110 (1976).

The NPRM's discussion of negative reserve balances raises two separate questions of how the Office can most fairly reflect in the accounting regulations the statutory mandate that royalties be payable for phonorecords that are distributed, but not for phonorecords that are not distributed: (1) whether an overpayment due to returns should be recoupable from future DPD distributions, and (2) whether an overpayment due to returns should be recoupable at the musical work level or more generally, such as at the copyright owner level.

For over 30 years, the accounting regulations have used the negative reserve balance construct to allow record companies to recover overpayments of mechanical royalties occurring when units of physical product on which royalties were paid are returned. When all distribution was of physical products, the overpayment was of course applied to the next distributions of those products. Now that distribution is increasingly occurring by means of transmission, and digital phonorecord deliveries ("DPDs") constitute about half of industry shipments, music publishers would like to limit recovery of the overpayment to future distributions of physical products only. This is not surprising. Such a result would permit music publishers to keep the overpayment, or at least prolong the state of overpayment, which is in their economic interest.

However, since Congress has decided that royalties should only be paid for units actually distributed, there is no justification for maintaining a state of overpayment due to returns for

longer than necessary. Accordingly, RIAA proposes certain adjustments to the regulations proposed in the NPRM (the “Proposed Rule”) and to the regulations proposed in the Joint Comments to confirm that such an overpayment is recoverable from both physical phonorecords and DPDs.

The NPRM also inquires whether negative reserve balances should apply only on a per work basis or more broadly across payments to the relevant copyright owner. This is a separate question from that of whether a negative reserve balance should be recoverable from DPD distributions, because negative reserve balances potentially might be recoverable from physical or DPD distributions either on a per work basis or more broadly. However, the answer to this question is to be found in the same considerations discussed above. Congress has spoken. Payments for units not actually distributed are “unjustified.” Accordingly, when a copyright owner has been overpaid due to returns, a negative reserve balance should be recoverable from any other payments to that copyright owner, certainly where the same writer’s works are involved.

**A. Application of Negative Reserve Balances to DPDs**

**1. Background**

Under Section 115, royalties are payable “for every phonorecord made and distributed in accordance with the license.” 17 U.S.C. § 115(c)(2). For this purpose, “a phonorecord is considered ‘distributed’ if the person exercising the compulsory license has voluntarily and permanently parted with its possession.” *Id.*

When Congress enacted Section 115, it recognized that records are customarily provided to distributors with a privilege of return for credit, and that as a result, the actual number of phonorecords distributed is typically not known for some time. It contemplated that the

accounting regulations would address this situation. *See* H.R. 94-1476, at 110-11 (1976). The mechanism adopted by the Office for matching the royalties paid to the number of phonorecords actually distributed is the reserve accounting structure presently set forth in Section 201.19, and carried forward without material change in the Proposed Rule.

As the NPRM explains, a negative reserve balance exists when physical phonorecords are returned to a compulsory licensee after the corresponding reserves for returns, and all other eligible reserves, have been eliminated. 77 Fed. Reg. 44,181. A negative reserve balance is the accounting construct corresponding to a particular type of mechanical royalty overpayment – one occasioned by returns. The construct is presently defined in Section 201.19(a)(11). Rules for offsetting reserves with returns and for creating a negative reserve balance are presently provided in Section 201.19(c). In computing the total royalty on a monthly statement, an adjustment for a negative reserve balance is presently provided in Step 4(c) of Section 201.19(e)(4)(ii). These provisions correspond to Sections 210.12(l), 210.14 and 210.16(d)(2)(iv)(C) of the Proposed Rule.

When the concept of a DPD was added to Section 115 in the 1990s, but business models for distribution of DPDs had not yet emerged, the Copyright Office adopted modifications to Section 201.19 in anticipation of the DPD business. *See Notice and Recordkeeping for Making and Distributing Phonorecords*, 64 Fed. Reg. 41,286 (July 30, 1999) (the “1999 Rule”). In the Office’s consideration of the 1999 Rule, an area of controversy was whether there could be such a thing as a return of a DPD, and whether licensees might be permitted to maintain reserves against such returns. The Office answered those questions in the negative. *Id.* at 41,287-88. It implemented the resolution of those issues by adding a new paragraph to Section 201.19 providing 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 41,289. That provision subsequently was renumbered, and now is Section 201.19(a)(9). However, the 1999 Rule gives no indication that the Office specifically considered the question of whether negative reserve balances should be applicable to DPDs.

In 1999, everyone recognized that distribution by means of transmission was in its infancy. Accordingly, the 1999 Rule was promulgated as an interim rule. The rule was expressly intended to be “without prejudice to the parties who, at the appropriate time, may propose final regulations that may differ significantly from the interim rules based on the developing business trends in the industry.” 64 Fed. Reg. at 41,286. RIAA does not take exception to the Office’s resolution of the questions specifically decided in the 1999 Rule. However, RIAA believes that the Office should at this time specifically consider the question of application of negative reserve balances to DPDs that the Office did not consider in 1999. Upon doing so, RIAA believes that the Office should find negative reserve balances applicable to future DPDs, just as they have always applied to future physical product shipments.

## **2. Negative Reserve Balances Should be Applicable to DPDs**

In the NPRM’s discussion of negative reserve balances, the Office raises a threshold question of whether there is statutory authority for allowing application of a credit for negative reserve balances to DPDs. 77 Fed. Reg. at 44,182. To the extent the statute speaks to this question, the governing principle is clear: mechanical royalties are payable “for every phonorecord made and distributed in accordance with the license.” 17 U.S.C. § 115(c)(2). Conversely, payment for units not actually distributed is “unjustified.” H.R. 94-1476, at 110.

When a negative reserve balance exists, mechanical royalties have been paid for phonorecords that ultimately were not distributed. The statute provides no justification for

affording copyright owners the windfall of hanging on to royalties that were improvidently paid on units not distributed. The statutory mandate is that such a windfall should not exist. Consistency with this statutory principle requires that royalty payments should, as quickly as possible, be brought into balance with actual distributions.

Beyond this fundamental principle, the Office generally has significant discretion as to the accounting regulations. Section 115(c)(5) provides that payments are to comply with the accounting regulations, but does not specifically speak to negative reserve balances; they are solely a creature of the accounting regulations. If the Office can create and implement the concept of a negative reserve balance, plainly it can decide details of how that concept will be implemented.

The Office then asks whether there are reasons to limit application of negative reserve balances to physical phonorecords. RIAA believes the answer is a resounding “no.” When a negative reserve balance exists, it means that the copyright owner has been paid more than the statute contemplates. As discussed above, the statute provides no reason to let music publishers keep the windfall of an overpayment, or prolong the period over which such a windfall is retained. The Office likewise has recognized that the accounting regulations should be tailored to produce proper payments, not overpayments. 45 Fed. Reg. at 79,039 (“[t]he accounting system must insure full payment, but not overpayment”).

Likewise, the common law has long recognized a right to “offset.” *See generally Citizens Bank v. Strumpf*, 516 U.S. 16, 18 (1995) (“The right of setoff (also called ‘offset’) 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.’” (quoting *Studley v. Boylston Nat. Bank*, 229 U.S. 523, 528 (1913))). This common law principle has been explicitly incorporated into various

aspects of federal law. *See, e.g.*, 11 U.S.C. § 553(a) (statutory offset in bankruptcy); 31 U.S.C. § 3728(a) (statutory offset for the government); 42 C.F.R. § 405.370 (regulatory offset for Medicare payments).

While the general common law right of offset presumably applies to mechanical royalty payments like others, the negative reserve balance construct serves a useful function in the accounting regulations by prescribing a consistent, auditable means of exercising the right of offset. It is in that sense like other provisions of federal law prescribing specific means of exercising offset in specified circumstances. Just as the common law right of offset is broadly applicable, the negative reserve balance construct should be broadly applicable to achieve the just results long sought and recognized by the common law offset principle.

Due to marketplace developments, now is an appropriate time to recognize that negative reserve balances can be applied to DPDs. Not so many years ago, virtually all distribution was physical. DPDs now constitute about half of distributions in the U.S. And with declining retail shelf space devoted to physical products, DPDs are now a critical mode of distribution for aging releases. When a negative reserve balance exists, it is because retailers are sending the product back as the door closes on retail distribution of that release as a physical product. However, releases generally remain available indefinitely for distribution through online and mobile channels. Thus, if negative reserve balances were to be applied at the work level, application of a negative reserve balance to DPDs may well be the only practicable means of recouping the overpayment and bringing overall payments back into line with the statutory principle that royalties ultimately are owed only for units distributed.

The principal justification that publishers have offered for limiting application of negative reserve balances to physical products is an interpretation of the 1999 Rule. One can

debate whether the 1999 Rule actually bars application of negative reserve balances to DPDs,<sup>1</sup> but that is beside the point in this proceeding. It is clear that the Office did not consciously decide the negative reserve balance question in the 1999 Rule, and that the 1999 Rule was conceived as a placeholder until DPD markets emerged. Now that such markets have become important, and the issue has been joined in this proceeding, the Office should decide the question specifically without allowing the 1999 Rule to prejudice the outcome, just as the Office indicated would happen when it adopted the 1999 Rule. *See* 64 Fed. Reg. at 41,286.

Publishers also have raised the specter of “overshipping,” and argued that limiting the application of negative reserve balances to physical products is necessary to avoid that asserted evil. *See* NPRM, 77 Fed. Reg. at 44,182. However, this makes no sense:

- Record companies do not solely determine shipments. It takes a customer to make a sale.
- Consumer tastes in music are sufficiently difficult to predict that initial distribution will never be matched precisely to demand. However, in such an environment, “overshipping” is preferable to the alternative. Nobody’s interests are served when

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<sup>1</sup> The 1999 Rule added the sentence now in Section 201.19(a)(9) providing that “[t]o the extent that the terms *reserve*, *credit* and *return* appear in this part, such provisions shall not apply to digital phonorecord deliveries.” Among those terms, reserve and return plainly preclude creating reserves for DPDs and foreclose the possibility of returns of DPDs, but do not clearly speak to the negative reserve balance issue. The term *credit* is used in the accounting regulations primarily in the context of describing the return privilege (e.g., the “privilege of returning unsold phonorecords for credit or exchange” as described in Section 201.19(a)(8)(iii)). It seems likely that is the concept the Office wanted to make inapplicable to DPDs. However, future distributions can be “credited” against a negative reserve balance. 37 C.F.R. § 201.19(c)(4). The publishers’ argument concerning the interpretation of the 1999 Rule thus turns on whether the reference to “credit” in Section 201.19(a)(9) makes the term “credited” in Section 201.19(c)(4) inapplicable to DPDs.



consumer demand for a hit recording cannot be met because there are insufficient product units in the manufacturing/distribution pipeline.

- Record companies have plenty of incentives to try to match the manufacture and distribution of physical product units to expected consumer demand. Manufacturing and distributing physical products costs money – not just in mechanical royalties. When products are returned long after release and must be destroyed, those costs are wasted. Record companies do not need an unrecoverable overpayment of mechanical royalties as an incentive to make prudent judgments about estimated sales volumes.
- To the extent that overshipments happen and result in negative reserve balances, that is from a music publisher's perspective a good thing. It means that the music publisher has been paid more than ultimately owed. Conversely, reducing shipments would be a bad thing from a music publisher's perspective, because it would tend to lead to lower mechanical royalty payments.

Accordingly, publishers' opposition to application of negative reserve balances to DPDs must be understood as simply a desire to hang on to a windfall for as long as possible.

While it is clear that negative reserve balances should be applicable to DPDs, there is still a question of how to implement that in the Proposed Rule. Negative reserve balances have historically been measured in product units. Applying negative reserve balances to standalone sales of permanent digital downloads is trivial, because the statutory royalty rate is the same for downloads as for physical products. *See* 37 C.F.R. § 385.3(a). Thus, distributions of permanent digital downloads can offset a negative reserve balance on a unit-for-unit basis. And this straightforward offset takes care of the vast majority of relevant commerce, because the overwhelming proportion of DPDs accounted for by the record companies that potentially have

negative reserve balances are permanent digital downloads. However, the ringtone rate is higher than the physical product rate, *see* 37 C.F.R. § 385.3(b), and payments for the percentage rate offerings addressed in Part 385 Subpart B can vary. Thus, the Proposed Rule should address application of negative reserve balances when DPD rates are different than the physical rate.

RIAA proposes addressing application of negative reserve balances to DPDs as follows:

- Current Section 210.19(a)(9) should change or be supplemented to reflect the resolution of this issue. The Joint Comments suggest moving that sentence to Section 210.13(d), because it is not a definition. Wherever it ends up, RIAA suggests adding to the end the following:

Accordingly, for purposes of this part, the compulsory licensee shall not take digital phonorecord deliveries into account in establishing a phonorecord reserve and will not be considered to receive returns of digital phonorecord deliveries. However, where a negative reserve balance exists, digital phonorecord deliveries may be credited against such negative balance, and the negative reserve balance reduced accordingly. If the royalty rate applicable to such digital phonorecord deliveries under part 385 is different from the royalty rate for physical phonorecords under Part 385, the digital phonorecord delivery royalty shall be converted into physical phonorecord units by dividing the royalty rate applicable to such digital phonorecord deliveries under part 385 by the royalty rate for physical phonorecords under Part 385.

- With that provision so modified, RIAA believes that no change is required to the provision concerning the negative reserve balance adjustment for cents rate uses (currently Step 4(c) of Section 201.19(e)(4)(ii), and Section 210.16(d)(2)(iv)(C) of the Proposed Rule and the proposed regulations attached to the Joint Comments).
- In practice, a negative reserve balance may not often be applied to a percentage rate use, since licensees responsible for mechanical royalties on percentage rate uses tend not to be responsible for mechanical royalties for physical products. However, completeness suggests providing for that possibility. Accordingly, RIAA proposes

adding the following new paragraph (iii) to the end of 210.16(d)(3) of the proposed regulations attached to the Joint Comments:

If, in the month covered by the Monthly Statement, the aggregate reserve balance for all previous months is a negative amount, percentage rate royalties for that month may be applied to reduce the negative reserve balance as described in §210.13(d). In any such case, the reduction shall be shown on the Monthly Statement.

RIAA respectfully requests that the Office make these changes to the Proposed Rule.

## **B. Level at Which Negative Reserve Balances Are Applied**

### **1. Background**

The current accounting regulations do not clearly and directly say at what level a negative reserve balance should be applied. However, they seem to point to application of negative reserve balances at the statement level. Thus, Section 201.19(a)(11) defines a negative reserve balance as an “aggregate number of phonorecords.” Section 201.19(c)(4) elaborates that “[w]here a negative reserve balance exists, the aggregate total of phonorecords comprising it shall be accumulated into a single balance,” and “any phonorecords relinquished from possession by the compulsory licensee for purposes of sale or otherwise, shall be credited against such negative reserve balance . . . .” Section 201.19(e)(2)(vi) requires each Monthly Statement to specify the “total royalty payable for the month.” That total plainly can encompass multiple works, because Section 201.19(e)(2)(iv) contemplates including multiple titles on a statement. Section 201.19(e)(2)(vi) points to Section 201.19(e)(4) for computation of the total for the month, and it is there that the adjustment for negative reserve balances is to be taken. RIAA acknowledges, however, that when the Office adopted the present provision for adjusting payments based on negative reserve balances, it said that a negative reserve balance should be applicable to shipments of the same recording. *Compulsory License for Making and Distributing Phonorecords*, 45 Fed. Reg. 79,038, 79,043 (Nov. 28, 1980).

This is the first major overhaul of the accounting regulations in the three decades since the Office last considered application of negative reserve balances. Accordingly, it seems appropriate that the Office now consider from a policy perspective the level at which negative reserve balances should be applied and perhaps clarify the Proposed Rule accordingly.

## **2. Negative Reserve Balances Should be Broadly Applicable**

The NPRM suggests that negative reserve balances should at least be applicable at the musical work level. But there is no reason that negative reserve balances should not be applied more broadly against other payments to the copyright owner, certainly where the same writer's works are involved.

The governing statutory principle is the same as discussed in the preceding section. Mechanical royalties are payable "for every phonorecord made and distributed in accordance with the license." 17 U.S.C. § 115(c)(2). When a copyright owner has been overpaid relative to this principle, the statute provides no basis for letting the copyright owner keep the windfall. Instead, the accounting regulations should endeavor to achieve the proper level of payment as soon as practicable.

RIAA believes that negative reserve balances should be applied at the statement level, so that they could be recouped from any mechanical royalty payments to the relevant copyright owner. However, RIAA recognizes that there may be a question as to what happens when the copyright owner is a music publisher that must share royalties with a songwriter, and the publisher already has distributed the songwriter's share of an overpayment to the songwriter at the time a negative reserve balance is applied by a record company to recoup the overpayment. As an accounting matter, the answer is straightforward. If the record company applied a negative reserve balance to works by a writer other than the one who received the overpayment,

the music publisher would need to debit the account of the writer who received the overpayment and credit the account of the writer whose work had the negative reserve balance applied to it. Because music publishers typically pay songwriters across a portfolio of works and uses and for a period of a quarter or two, it seems likely that the music publisher generally could be made whole by recouping the overpayment to its writer on a current basis even if the negative reserve balance was applied by the record company to works by a different songwriter than was overpaid. However, if the record in this proceeding ultimately demonstrates that this approach would be impracticable, the negative reserve balance still should be applicable to other works by the same songwriter. There is no justification for allowing a music publisher and songwriter to hang on to the windfall represented by a negative reserve balance while the record company is required to continue making payments to the same publisher and songwriter for different songs.

RIAA does not at this time propose specific language for addressing this point. Because the better reading of the current regulations and the Proposed Rule seems to be that negative reserve balances can be applied at the statement level, RIAA is not convinced that any change is necessary beyond those discussed above to make negative reserve balances applicable to DPDs. However, if the Office determines that it would be appropriate to address the point more specifically, RIAA submits that the proper place to do that would be Section 210.14(d) of the Proposed Rule, the provision that addresses aggregation and application of negative reserve balances.

## **II. Identification of Third-Party Services (Section 3.B of the NPRM)**

The NPRM describes a disagreement between copyright owners and licensees as to whether sales data reported on statements should be broken down to identify third party services distributing DPDs. 77 Fed. Reg. 44,183.

As a threshold matter, we should be clear that this disagreement concerns cents rate uses only. The percentage rate calculation is specific to a particular service offering, so it is only natural that the offering would be identified in applicable statements. Moreover, this usage is typically accounted for by the services themselves, making identification of the distributor trivial. Accordingly, Section 210.16(c)(2)(ii)(H) of the proposed regulations attached to the Joint Comments implements identification of the distributor for percentage rate uses.

As to cents rate uses, permanent downloads and ringtones are available through a large number of services, and the royalty rate does not vary from service to service as it does in the case of percentage rate uses. That sales data is reported by a service up the distribution chain to its licensor (whether a record company or aggregator) does not mean that the service-by-service breakdown of this data is necessarily available to the compulsory licensee (e.g., if it distributes through an aggregator or other intermediate distributor), or that it should be separately processed through royalty accounting systems or separately reported on royalty statements. Separately calculating and reporting royalties for each of many distributors would lead to a multiplication in the volume of data processed by record companies and the size of the statements delivered to copyright owners. Moreover, some record companies have legacy royalty accounting systems that were not set up to account for distribution through different distributors separately. In at least one case, a large record company has sought to manage the relevant data volumes by preprocessing sales data feeds to consolidate reporting across distributors before processing the sales data through its royalty system. A requirement to report usage by distributor would require significant changes to business processes and systems, at a substantial cost.

In 1980, the Office rejected a proposal to do mechanical royalty accounting by distributor. 45 Fed. Reg. 79,039. Ever since, identifying distributors has not been required, and

RIAA is not aware of circumstances that would warrant a change now. The NPRM suggests that more granular reporting might permit copyright owners to better assess the accuracy of statements. 77 Fed. Reg. at 44,183. However, it is certainly not obvious why that might be the case. The Office should not impose this burdensome new reporting requirement.

### CONCLUSION

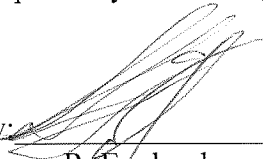
For the reasons set forth above, RIAA urges the Office to confirm that negative reserve balances are broadly applicable to DPDs and payments to the relevant copyright owner, and to refrain from imposing a new requirement of reporting distributors of cents rate DPDs.

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Respectfully submitted,

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