
Hughes Hubbard & Reed

Copyright Royalty Board Establishes First Time Mechanical Rates for Ringtones and Ad-supported Streaming Music

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After months of hearings, testimony and deliberations, on October 2, 2008, the United States Copyright Royalty Board (CRB) announced newly established rates for royalties to be paid to writers and composers (as opposed to performers) whose musical compositions are made and distributed as sound recordings (i.e., phonorecords), including via (1) physical recordings (e.g., CDs, tapes, vinyl, etc.), (2) permanent digital downloads, (3) ringtones, (4) limited/tethered digital downloads and (5) interactive streaming.

These new rate determinations, which will remain in effect until December 31, 2012, break new ground. Following a drawn-out battle between the National Music Publishers' Association (NMPA) (representing song writers and composers) and the Recording Industry Association of America (RIAA) and the Digital Media Association (DiMA) (representing the record labels and digital music retailers, respectively), the CRB established, for the first time, a rate for the distribution of ringtones (24¢ per delivery), while surprisingly maintaining the same rates for the distribution of physical recordings and permanent downloads of digital recordings that had been in effect since January 1, 2006 (9.1¢ per delivery). The rates for the distribution of sound recordings as limited/tethered downloads (i.e., downloads that only play a fixed number of times or for a fixed period of time) and as interactive streams (i.e., online digital streams of recordings selected by an end user on an on-demand basis), both of which had been slated for resolution by the CRB among the other rates at the outset of the lengthy proceedings, were actually negotiated to a consensus by the parties during the hearings, and their settlement was adopted by CRB, subject to ratification following public comment.

The announcement of the rates for limited downloads and interactive streaming of recorded music are of the utmost importance to both the publishers and the record labels alike because, prior to the announcement of the proposed rates, any service seeking to offer limited downloads and/or interactive streaming of recorded music was required to negotiate a royalty rate with individual writers, publishers or mechanical royalty collections

agencies such as Harry Fox. In other words, copyright ownership in a sound recording alone (or obtaining a license from the owner, typically a record label) does not allow for the distribution of that recording without first obtaining a license from the song writer or publisher owning and/or controlling the copyright in the musical composition contained therein. Section 115 of the Copyright Act, also known as the “mechanical compulsory license”, however, provides a mechanism whereby a licensee (typically retailers or record labels) may be automatically granted a license to distribute sound recordings containing songs that they neither own nor control simply by adhering to the terms of the compulsory license and paying the rates set by the CRB. In other words, the express permission of song writers and publishers is not required to make and distribute sound recordings incorporating their musical compositions, provided that the licensee pays the applicable rates and complies with the terms of the statute.

As evidenced over the last two years, the trend among social networking websites (e.g., MySpace, etc.) and other digital entertainment websites (e.g., imeem, last.fm, etc.) has been the inclusion of digital music in forms other than traditional webcasting or internet radio (i.e., non-interactive streaming, where the end user does not select each individual sound recording) in favor of a more personalized user experience. Obtaining a license to provide interactive streaming, however, has thus far been both a lengthy and expensive process, but now website publishers will only be required to negotiate licenses with the sound recording owners or providers and pay the required mechanical license fees and the applicable public performance fees without the need to negotiate a separate licensing arrangement with the publishers.

The new mechanical royalty rates for limited downloads and interactive streaming are unlike the statutory rate structure for physical recordings, permanent digital downloads, and ringtones, all of which are all based on per unit calculations (i.e., “penny rates” or a fixed amount per distribution). Instead, these new rates are based on a percentage of revenue formula, with varying rates based on the business model of the service offering the musical recordings, including subscription-based and ad-supported models. In other words, the amount due to each publisher whose work is incorporated in a sound recording selected by an end user for streaming or downloading is a certain pro-rata percentage of revenue earned by the service or digital platform.

The calculations are relatively complex, requiring multiple steps that vary according to the type of service. For all service models described in the proposed rate settlement, however, the calculation begins with a determination of monthly “service revenue” for the applicable accounting period, or all revenue recognized by the service from end users from the provision of the licensed activity, including subscription fees, sponsorships, commissions and third party advertising in connection with the interactive streaming and limited downloads offered on the service. The service revenue is then multiplied by the applicable percentage, which is identical across the all service models (10.5%). This amount is then subject to increase based on the applicable minimum payment amounts if the percentage of service revenue fails to exceed the minimums according to the type of service (i.e., whether music subscription fees are charged or whether the service is free or ad-supported).

For example, in the case of music subscriptions services (4 of the 5 service models), the applicable minimum payment is the greater of (a) a fixed amount for each paying subscriber (\$.15-\$.80) or (b) a fixed percentage of the amount paid by the service to the owners of the sound recordings (i.e., licensing fees paid to the recording labels and content aggregators) for the rights to stream and offer downloads of the recordings (17-22%). In the case of free or ad-supported models, the only applicable minimum is the fixed percentage of the amount paid to the owners of the sound recordings (18%-22%). Ultimately, the total amount due to the publishers is the percentage of service revenue or the applicable minimum payment amount (whichever is greater), less all public performance fees paid by the service provider to the applicable performing rights organizations for the rights to stream the applicable recordings.

These first time mechanical rates for music on ad-supported and free services represent a significant shift in the digital music space. First, it effectively removes any fixed payment obligation on such services (i.e., no penny rates

based on the amount of subscribers, downloads, or streams) other than 10.5% of service revenue or the fixed percentage paid to the owners of the sound recordings. Second, the absence of fixed dollar minimums provides much-needed flexibility for new business models to emerge and should allow them to continue to exist, as many would cease to be profitable if required to remit fixed dollar amount minimums when all revenue generated is dependent on alternate sources, including the receipt of advertising dollars.

Once the proposed rates are ratified, expect to see increased streaming activity in the digital music space among purveyors of online content, especially social networking websites. In fact, within a few days of MySpace's recent launch of its streaming music functionality, MySpace Music, the service had already well surpassed one billion streams, providing further evidence that a per stream or subscriber/member minimum would be cost prohibitive.

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