

**SOUNDEXCHANGE ANNUAL REPORT FOR 2006  
PROVIDED PURSUANT TO 37 C.F.R. § 370.5(d)**

SoundExchange, Inc. ("SoundExchange") is a 501(c)(6) tax exempt organization incorporated in Delaware and headquartered in Washington, D.C. It is controlled by an eighteen member board of directors comprised of equal numbers of representatives of sound recording copyright owners and featured and non-featured recording artists. SoundExchange was incorporated on September 22, 2003.

During Calendar Year 2006, SoundExchange employed 24 Full-Time Equivalent employees.

The presentation of financial information in this annual report is intended to comply with SoundExchange's requirements under 37 C.F.R. § 370.5(d) and is not intended to be a presentation in accordance with generally accepted accounting principles.

**Royalty Collection**

During 2006, SoundExchange was the sole entity designated by the Librarian of Congress to collect royalties paid by services operating under the statutory licenses set forth in Sections 112 and 114 of the Copyright Act and the implementing regulations established thereunder. 17 U.S.C. §§ 112 & 114; 37 C.F.R. Parts 260, 261, 262, 263, and 380. SoundExchange also collected royalties from XM Satellite Radio and SIRIUS Satellite Radio during 2006 under a confidential, direct statutory license entered into in 2003. SoundExchange is currently engaged in a rate-setting proceeding before the Copyright Royalty Judges to set new rates and terms for these satellite services.

The services paying royalties to SoundExchange fall into the following statutorily defined categories:

- Preexisting Subscription Services
- Preexisting Satellite Digital Audio Radio Services
- Eligible Nonsubscription Transmission Services
- New Subscription Services
- Services exempt from liability for transmissions to business establishments under 17 U.S.C. § 114(d)(1)(C)(iv) but liable for ephemeral phonorecords made to facilitate such transmissions ("Business Establishment Services")

During 2005, the eligible nonsubscription transmission services were further divided into various categories, including:

- Commercial Internet-Only Webcasters
- Small Commercial Webcasters paying royalties under the Small Webcaster Settlement Act of 2002
- Broadcast Simulcasters
- Noncommercial entities paying royalties under the Small Webcaster Settlement Act of 2002

- Noncommercial entities paying royalties established by the Librarian of Congress

In October 2005 a rate adjustment proceeding commenced before the Copyright Royalty Board to establish royalty rates for eligible nonsubscription transmission services and certain new subscription services (“statutory webcasters”) for the period January 1, 2006 through December 31, 2010. However, these rates and terms were not established prior to December 31, 2006. Pursuant to the Copyright Royalty and Distribution Reform Act of 2004, the above statutorily defined categories of services making transmissions of copyrighted sound recordings after December 31, 2005 were required to continue paying royalties at the rates in effect for 2005 until the rates for the next period were established. See Pub. L. 108-419, 118 Stat. 2341, 2356 (Nov. 30, 2004).

On May 1, 2007 the Copyright Royalty Board published its final rule establishing rates and terms for these services for the above referenced period. In its ruling, the Copyright Royalty Board, increased the rates paid by statutory webcasters for the 2006 license period. The Copyright Royalty Board also found that there was no special rate needed for small commercial webcasters. This ruling is currently the subject of an appeal to the D.C. Circuit Court.

SoundExchange collects royalties on a periodic basis. During 2006, services most frequently paid royalties based upon either their revenues or their consumption of music, expressed as the number of Performances or Aggregate Tuning Hours streamed to recipients. Each of “Performance” and “Aggregate Tuning Hours” are terms defined in Copyright Office regulations. See 37 C.F.R. §§ 262.2(a) & (j). These definitions, as applied to statutory webcasters, were included in the Copyright Royalty Board’s May 1, 2007 ruling and will be codified within 37 C.F.R. Part 380. During 2006, SoundExchange also collected royalties based on “Gross Revenues” and “Subscription Service Revenues,” which are also defined terms. See 37 C.F.R. §§ 260.2(e)(1) & 262.2(m), respectively.

A service’s liability is calculated on a Statement of Account, a form created by SoundExchange and made available on its web site. See [www.soundexchange.com](http://www.soundexchange.com) under the download forms page for digital music services. As previously stated, statutory webcasters had a continuing obligation to submit monthly statements of account and pay royalties pursuant to the 2005 rates and terms until the 2006 rates were established. Pursuant to the Copyright Royalty Board’s May 1, 2007 ruling, the statements of account for these services have changed for 2006. As a result, statutory webcasters are required to submit revised statements of account retroactively to January 1, 2006.

Except for the two preexisting satellite digital audio radio services, all other services paying royalties to SoundExchange are doing so under rates and terms established by the Librarian of Congress or Copyright Royalty Judges. Services availing themselves of the statutory license are able to do so by operation of law and are not SoundExchange licensees even though they are frequently referred to as such. Congress created a statutory regime under which any service complying with the statutory and regulatory conditions may obtain a license to reproduce or transmit sound recordings

lawfully released to the public without having to negotiate directly with the copyright owner for the rights to those recordings.

In order for a service to avail itself of the statutory license, it must first file a Notice of Use of Sound Recordings (an "Initial Notice") with the U.S. Copyright Office. See <http://www.copyright.gov/forms/form112-114nou.pdf>. This Initial Notice must be filed before the service makes any ephemeral phonorecords or digital audio transmissions of sound recordings. Otherwise, the service may be subject to liability for copyright infringement. In addition, a service must also comply with the applicable conditions of the statutory license, pay royalties and provide reports of use as required in order to avoid liability for copyright infringement.

No Invoicing. SoundExchange does not invoice services for their monthly payments. Each service is separately responsible for calculating its own liability and remitting payment to SoundExchange along with a Statement of Account. Because services are obligated to self-report and pay royalties on an honor system, there may be many more services making digital audio transmission or ephemeral phonorecords of sound recordings than there are services paying appropriate royalties to SoundExchange.

SoundExchange monitors Initial Notices filed with the Copyright Office and reserves the right to demand payment from services that have failed to pay royalties. SoundExchange also reserves the right to demand late fees from services that have failed to pay royalties when required.

Although SoundExchange collects royalties from individual services pursuant to Copyright Office regulations, SoundExchange does not make determinations as to whether each of the many services that rely on the statutory licenses under Sections 112 and 114 of the Copyright Act are eligible for statutory licensing, nor does it continuously verify that such services are in full compliance with all applicable requirements. To avoid any confusion in the marketplace, SoundExchange has posted on its web site the following notification:

#### **IMPORTANT NOTICE: NO WAIVER OF RIGHTS**

It has come to SoundExchange's attention that some services that have filed with the Copyright Office a Notice of Use of Sound Recordings under Statutory License may be under the misimpression that by accepting payment from them, SoundExchange has acknowledged that they comply with the requirements of the statutory licenses under Sections 112 and 114 of the Copyright Act. It is the responsibility of each such service to ensure that it is in full compliance with the requirements of the statutory licenses under Sections 112 and 114 of the Copyright Act. SoundExchange is not in a position to, and does not, make determinations as to whether each of the many services that rely on the statutory licenses is eligible for statutory licensing, nor does it continuously verify that such services are in full compliance with all applicable requirements. Accordingly, SoundExchange's acceptance of a service's payment does not express or imply any acknowledgment that a service is in compliance with the requirements of the statutory licenses. SoundExchange, its members and other copyright owners

reserve all their rights to take enforcement action against a service that is not in compliance with those requirements.

### Royalty Allocation

When a service pays royalties to SoundExchange, those royalties are allocated on a *pro rata* basis among the sound recordings transmitted by that service. By this we mean that if the net royalties (after deducting costs) paid by Service A total \$100 for period X and Service A reported 10,000 discrete sound recordings during that period, then each distinct sound recording would be valued at one cent (\$0.01) ( $\$100 \div 10,000$ ).

Certain licensees, such as webcasters and simulcasters transmitting over the internet, are not required under the statutory regulations to provide census reporting. Rather, they are only required to submit the sound recordings used for a two weeks period each calendar quarter. When a service only reports a sample, artists and copyright owners may not be compensated for sound recording transmitted in the weeks missed by the sample. SoundExchange continues to advocate for full census reporting and works with licensees otherwise not obligated to report on a census basis, to provide full reporting.

When SoundExchange is not provided with reports of use from a service (e.g., where a service fails to provide a report of use or regulations exempt a service from providing a report of use), SoundExchange will seek to allocate royalties using a proxy. In 2004, the Copyright Office issued a ruling allowing SoundExchange to distribute royalties paid by eligible nonsubscription transmission services, new subscription services and Business Establishment services through March 31, 2004, using proxy data received from the three preexisting subscription services. On October 6, 2006 the Copyright Royalty Board established regulations requiring the aforementioned digital music services to deliver reports of use to SoundExchange for their transmissions. These regulations apply to transmissions retroactive to April 1, 2004.

Under the Small Webcaster Settlement Act of 2002, noncommercial entities were permitted to pay an additional fee of \$25 for 2005 in lieu of providing reports of use for that year and those royalties will have to be distributed using a proxy. This requirement has since been nullified by the regulations established by the Copyright Royalty Board on October 6, 2006. As such, all noncommercial entities are required to provide reports of use for transmissions occurring in 2005.

Royalties may remain undistributed when there is an ongoing legal proceeding, including appeals, which may alter a previously established rate. Royalties may also remain undistributed if SoundExchange has not received reports of use information and the Copyright Office has not approved a proxy in lieu of actual report of use data.

The royalties paid by a service are allocated on a nondiscriminatory basis. Each sound recording is valued equally, regardless of whether the sound recording copyright owner or featured performer on the sound recording has specifically authorized SoundExchange to collect and distribute royalties on their behalf. SoundExchange distributes all royalties received for domestic performances equally among all

performers, regardless of whether or not they have executed appropriate membership documents with SoundExchange.

The royalties collected by SoundExchange are allocated according to the percentages set forth in Sections 114(g)(2)(A)-(D) of the Copyright Act. 17 U.S.C. §§ 114(g)(2)(A)-(D). The statute requires that:

- (A) 50 percent of the receipts shall be paid to the copyright owner of the exclusive right under section 106(g) of [Section 114] to publicly perform a sound recording by means of a digital audio transmission.
- (B) 2½ percent of the receipts shall be deposited in an escrow account managed by an independent administrator jointly appointed by copyright owners of sound recordings and the American Federation of Musicians or any successor entity) to be distributed to nonfeatured musicians (whether or not members of the American Federation of Musicians) who have performed on sound recordings.
- (C) 2½ percent of the receipts shall be deposited in an escrow account managed by an independent administrator jointly appointed by copyright owners of sound recordings and the American Federation of Television and Radio Artists (or any successor entity) to be distributed to nonfeatured vocalists (whether or not members of the American Federation of Television and Radio Artists) who have performed on sound recordings.
- (D) 45 percent of the receipts shall be paid, on a per sound recording basis, to the recording artist or artists featured on such sound recordings (or the persons conveying rights in the artists' performance on sound recordings. 17 U.S.C. §§ 114(g)(2)(A)-(D).

Royalties among a featured artist are generally allocated on a pro rata basis unless all of the members of a featured artist instruct SoundExchange as to an alternative allocation. By this we mean that where the featured artist is a band with four members, each member shall be entitled to 25% of the featured artist's share. When the members of a featured artist disagree as to the appropriate allocation of royalties, the amount of royalties in dispute are held pending resolution of the dispute.

### **Royalty Distribution**

Pursuant to the provisions of Section 114(g)(3) of the Copyright Act, SoundExchange deducts from its receipts, prior to their distribution, the reasonable costs incurred in –

- (A) the administration of the collection, distribution, and calculation of the royalties;
- (B) the settlement of disputes relating to the collection and calculation of the royalties; and

- (C) the licensing and enforcement of rights with respect to the making of ephemeral recordings and performances subject to licensing under section 112 and [section 114], including those incurred in participating in negotiations or arbitration proceedings under section 112 and [section 114], except that all costs incurred relating to the section 112 ephemeral recordings right [are] only . . . deducted from the royalties received pursuant to section 112.17 U.S.C. § 114(g)(3).

SoundExchange distributes royalties directly to copyright owners and featured artists when provided with the information necessary to effectuate payment. SoundExchange may also distribute royalties to featured artists pursuant to reciprocal payment agreements with foreign collecting societies when those artists have appropriately authorized SoundExchange to undertake this activity. For example, SoundExchange may pay the Dutch collecting organization all of the royalties due the featured artists who have designated the Dutch organization to collect U.S. statutory royalties on their behalf. SoundExchange will also consider paying a featured artist's royalties to a third party under a letter of direction received from a featured artist as an accommodation to such featured artist; provided the featured artist has executed SoundExchange's Designation and Authorization form and the third-party is considered creative personnel credited or recognized publicly for the commercially released sound recording on which the featured artist performs or a usual and customary royalty participant in such sound recording.

When SoundExchange is unable to distribute allocated royalties to either a copyright owner or featured artist – for example, by lacking correct address information, inability to identify the correct recipient entitled to the royalties, etc. – those royalties are held for the copyright owner or featured artist pending further attempts to effectuate payment.

SoundExchange expends significant resources to reduce the amount of allocated but undistributed royalties. Under Copyright Office regulations, SoundExchange retains all such undistributed royalties for not less than three years from the date of payment, and thereafter may release those funds for the benefit of all other copyright owners, featured artists and nonfeatured performers entitled to royalties. However, during 2006 SoundExchange did not release any allocated but undistributed royalties.

SoundExchange distributes royalties on a periodic basis. In 2006, SoundExchange distributed \$32,813,717 in royalties.

### **Royalties Collected**

Although SoundExchange believes that it should be entitled to disclose the sources of all collected statutory royalties, it is obligated to maintain the confidentiality of such information under various Copyright Office regulations or the provisions of private license agreements. Therefore, SoundExchange does not generally report the royalties collected from individual licensees or the amount of royalties collected from multiple licensees if the royalties of any individual service or class of services could be deduced from such reporting. See 37 C.F.R. § 262.5(c). SoundExchange was granted permission to disclose its royalty receipts to copyright owners and performers on a more transparent

basis for eligible nonsubscription transmission services and new subscription services through amended regulatory regulations. See 37 C.F.R. § 380.5(d)(3). SoundExchange hopes that in the future it will be permitted to make these disclosures on a more transparent basis for all statutory licensees. SoundExchange firmly believes that copyright owners and performers are entitled to know which services are using their creative works and the amount of royalties paid for such works.

In 2006, SoundExchange collected statutory royalties from all statutory classes of services in the amount of \$63,008,184. Non-statutory royalties collected amounted to \$71,995. This does not include any retroactive adjustments established in the Copyright Royalty Board's May 1, 2007 rate ruling. This represents an increase in statutory royalty collections of 45% percent. In 2005, SoundExchange collected statutory royalties in the amount of \$43,466,177.

SoundExchange maintains royalties in money funds, discounted notes, corporate bonds and government bonds. SoundExchange earned interest on its cash accounts totaling \$3,497,537 during 2006.

### **Administrative Expenses**

SoundExchange incurs expenses to operate as the sole entity designated by the Librarian of Congress to collect and distribute royalties. Its expenses are divided into the following broad categories: Personnel, Operations, Outreach, Legal & Licensing, and Royalty Systems.

SoundExchange incurs current, capital, and amortized expenses. Current expenses include, by way of example and not limitation, salaries, benefits, payroll taxes, office administration, occupancy, travel, conferences, outreach, information systems and technology, and legal and licensing. Capital expenses include royalty systems' extensions and modifications, computers and equipment, furniture and fixtures, and organizational costs. Amortized expenses are non-capital expenses that are amortized over a period of years for which the expense applies. For example, if SoundExchange incurred \$1 million in legal expenses to establish royalty rates for a five-year term, those legal expenses would be amortized over the five-year term of the license for which the expense was incurred.

In 2006, SoundExchange incurred the following expenses:

Personnel	\$ 2,411,311
Operating Expenses	\$ 1,493,665
Member Services	\$ 324,959
Legal & Licensing	\$ 2,168,520
Royalty Systems	<u>\$ 913,047</u>
Total Expenses	\$ 7,311,502

### **Administrative Rate**

The administrative expenses of SoundExchange are paid first with interest income earned and then through an administrative charge applied to royalties available for distribution in the form of an Administrative Rate. SoundExchange expresses its Administrative Rate as a fraction, the numerator of which is the Total Annual Expenses

less Annual Interest Earned on Investments and the denominator of which is Total Annual Royalties Received. If SoundExchange's Administrative Rate is less than 20%, SoundExchange shall pay the difference between its Administrative Rate and 20% to repay the principal and interest outstanding on the Promissory Note entered into with the Recording Industry Association of America, Inc. for the repayment of costs incurred in the initial arbitrations to establish rates and terms for preexisting subscription services and eligible nonsubscription transmission services. This note was fully paid off in March 2007.

SoundExchange expresses its Administrative Rate for 2006 as 6.0 percent (6.0%).

### **Summary**

The following table summarizes SoundExchange's collections, allocations and distributions:

<b>Period</b>	<b>Y/E 12/31/06</b>	<b>Y/E 12/31/05</b>
Royalty Receipts <sup>1</sup>	\$63,080,179	\$44,220,062
Interest Earned	\$3,497,537	\$1,471,928
Total Income	\$66,577,716	\$45,691,990
<b>Expenses</b>		
Personnel	\$2,411,311	\$1,679,528
Operating Expenses	\$1,493,665	\$874,822
Member Services	\$324,959	\$491,567
Legal and Licensing	\$2,168,520	\$607,282
Royalty Systems	\$913,047	\$1,054,366
<b>Total Expenses</b>	<b>\$7,311,502</b>	<b>\$4,707,565</b>
<b>Blended Administrative Rate</b>	<b>6.0%</b>	<b>7.3%</b>

<sup>1</sup> Statutory royalties are typically paid 45 days following the end of the month for the month in which the liability accrued. "Royalty Receipts" means that royalties were allocated according to the period for which the service reported the liability.