

**ANNUAL REPORT**  
**FOR**  
**SOUNDEXCHANGE, INC.**  
**April 1, 2003 - March 31, 2004 (FY 2004)**  
**Pursuant to 37 C.F.R. § 270.4(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 recording artists. SoundExchange was incorporated on September 22, 2003.

During FY 2004, SoundExchange employed 17 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. § 270.4(d) and is not intended to be a presentation in accordance with generally accepted accounting principles.

**ROYALTY COLLECTION.**

SoundExchange is 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 pursuant to those licenses. 17 U.S.C. §§ 112 & 114; 37 C.F.R. Parts 260, 261, 262, 263 and 270. SoundExchange occasionally collects royalties under private agreements entered into between SoundExchange and services complying with the provisions of the aforementioned statutory licenses. In addition, SoundExchange may collect royalties pursuant to private agreements between SoundExchange and certain foreign collecting societies for the reproduction or public performance of certain sound recordings outside the United States. Foreign royalties are not subject to statutory regulations. 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")

SoundExchange collects royalties on a periodic basis. Services most frequently pay royalties based upon either their revenues or their consumption of music, expressed as the number of Performances or Aggregate Tuning Hours streamed to recipients. The terms "Performance" and "Aggregate Tuning Hours" are defined in Copyright Office regulations. See 37 C.F.R. § 262.2. "Gross revenues" or "Revenues," when available as a payment option, is also a defined term. See 37 C.F.R. §§ 260.2(e)(1), 262.2(m). A service's liability is calculated on a Statement of Account, a form created by SoundExchange and made available on its web site.

Except for the two preexisting satellite digital audio radio services and noncommercial entities covered by the license agreement entered into among SoundExchange, the Corporation for Public Broadcasting and National Public Radio, all other services paying royalties to SoundExchange are doing so under rates and terms established by the Librarian of Congress or pursuant to rates and terms published in the Federal Register under provisions of the Small

Webcaster Settlement Act of 2002. Services availing themselves of the Section 112 and 114 statutory licenses are granted the license by operation of law and are not SoundExchange licensees even though they are frequently referred to as such.

In order for a service to avail itself of a statutory license, it must first file a Notice of Use of Sound Recordings Under Statutory License (an "Initial Notice") with the U.S. Copyright Office. 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 and any implementing regulations, pay royalties and provide statements of account and reports of use in order to avoid liability for copyright infringement.

SoundExchange does not invoice services for their monthly payments. Each service is separately responsible for calculating its own liability and remitting payment to SoundExchange. Because services are obligated to self-report and pay royalties on an honor system, there may be many more services making digital audio transmissions or ephemeral phonorecords of sound recordings than there are services paying royalties to SoundExchange.

SoundExchange 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 generally 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. Accordingly, SoundExchange's acceptance of payment does not express or imply any acknowledgment that a service is in compliance with the requirements of a statutory license or in fact eligible for the rates and terms under which the service may have calculated its liability. SoundExchange, its members and other copyright owners reserve all their rights to take enforcement action against a service that is not in compliance with the requirements of a statutory license.

### **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 transmitted 10,000 distinct sound recordings during that period, then each distinct sound recording would be valued at one cent (\$0.01). In order to allocate royalties among the tens of thousands of copyright owners and performers entitled to such royalties, SoundExchange relies upon data contained in reports of use provided by the statutory licensees (e.g., data identifying artist name, album title, song title, marketing label, track-label P-line, ISRC code, etc.). Where such reports of use have not been provided by licensees, SoundExchange is unable to accurately and fairly allocate royalties. In a few situations, SoundExchange has been compelled under Copyright Office regulations to use a proxy to allocate royalties, but such proxies are an imperfect and non-preferred means of allocating royalties.

Royalties may remain unpaid when there is an ongoing legal proceeding, including appeals, which may alter a previously established rate or if SoundExchange lacks sufficient data to allocate royalties.

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.

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(6) 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 in the sound recordings).

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 alternate 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 subject to disagreement are held pending resolution of the disagreement.

### **ROYALTY DISTRIBUTION.**

Pursuant to the provisions of Section 114(g)(3) of the Copyright Act, 17 U.S.C. § 114(g)(3), SoundExchange deducts from its receipts, prior to their distribution, the reasonable costs incurred by SoundExchange after November 1, 1995, 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. 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 may also pay a portion of a featured artist's royalties to a third party under a letter of direction.

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 FY 2004, SoundExchange did not release any allocated but undistributed royalties, and all such royalties were available for distribution to the copyright owners and performers entitled thereto.

SoundExchange distributes royalties on a periodic basis. SoundExchange distributed royalties twice in FY 2004 – in June, 2003 and January, 2004.

### **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 licensing agreements. Therefore, SoundExchange does not 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. SoundExchange hopes that in the future it will be permitted to disclose its royalty receipts on a more transparent basis under amended regulations or contractual provisions. SoundExchange firmly believes that copyright owners and performers are entitled to know which services are using their sound recordings and the amount of royalties paid for such recordings.

From April 1, 2003 through March 31, 2004<sup>1</sup>, SoundExchange collected royalties in the amount of \$15,632,476. SoundExchange maintains royalties in money funds, discounted notes, corporate bonds and government bonds. SoundExchange earned interest on its royalty accounts totaling \$228,111 from April 1, 2003 through March 31, 2004.

### **ADMINISTRATIVE EXPENSES.**

SoundExchange incurs expenses to operate as the sole entity designated by the Librarian of Congress to collect and distribute royalties and to collect royalties under other agreements. 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.

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<sup>1</sup> SoundExchange switched from a fiscal year (April 1 to March 31) to a calendar year in 2004.

From April 1, 2003 through March 31, 2004, SoundExchange incurred the following expenses:

Personnel	\$1,416,148
Operating Expenses	\$481,724
Member Services	\$72,881
Licensing and Legal	\$469,766
Royalty Systems	\$496,031

**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. ("RIAA") for the repayment of costs incurred in the initial arbitrations to establish rates and terms for preexisting subscription services and eligible nonsubscription transmission services. For Fiscal Year 2004, SoundExchange repaid \$415,685 in principal and interest to the RIAA.

SoundExchange's Administrative Rate for the period April 1, 2003 through March 31, 2004 was seventeen and one-third percent (17.33%).