

SOUNDEXCHANGE DRAFT ANNUAL REPORT FOR 2010 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.

As of December 31, 2010, SoundExchange employed 55 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(c) and is not intended to be a presentation in accordance with generally accepted accounting principles. The information provided in this presentation is based upon pre-audited financials statements and is therefore subject to revision upon the completion of the 2010 audit.

Royalty Collection

Statutory

Services paying royalties to SoundExchange are generally doing so under rates and terms established by the Copyright Royalty Board or published in the Federal Register pursuant to the Webcaster Settlement Acts.

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 via federal statute. This license permits such services to reproduce and 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.

During 2010, SoundExchange was the sole entity designated by the Copyright Royalty Board 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 370, 380, 382, 383 and 384. 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 (i.e., subscription webcasters; “CABSAT” 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”)

In late 2008, Congress passed the Webcaster Settlement Act of 2008 which gave SoundExchange the authority to enter into agreements with webcasting services at rates and terms different from those established by the Copyright Royalty Board. Under the legislation, these agreements can then be presented to the Copyright Office for publication in the Federal Register where they will be available industry-wide as alternatives to those rates set by the Copyright Royalty Board.

In February 2009, SoundExchange concluded agreements under the Webcaster Settlement Act with the following entities: (i) Corporation for Public Broadcasting, on behalf of certain noncommercial webcasters; (ii) the National Association of Broadcasters; and (iii) a group of eighteen small commercial webcasters. The Corporation for Public Broadcasting Agreement covers the period January 1, 2005 through December 31, 2010. The National Association of Broadcasters and small commercial webcaster agreements cover the period January 1, 2006 through December 31, 2015. These agreements were published in the Federal Register on March 3, 2009 and became available to qualifying webcasters as alternative rates and terms on that date. See 74 Fed. Reg. 9293 (March 3, 2009).

On June 30, 2009, Congress passed the Webcaster Settlement Act of 2009 which similarly extended SoundExchange’s authority to enter into agreements with webcasting services to July 30, 2009. Pursuant to the Webcaster Settlement Act of 2009, SoundExchange reached additional agreements with the following entities:

- Certain “Pureplay” webcasters – setting rates and terms for certain commercial webcasters for the period January 1, 2006 through December 31, 2015. *See* 74 Fed. Reg. 34796 (July 17, 2009);
- Sirius XM Radio Inc. – setting rates and terms for certain commercial webcasters for the period January 1, 2009 through December 31, 2015. *See* 74 Fed. Reg. 40614 (August 12, 2009);
- College Broadcasters, Inc. – setting rates and terms for certain educational noncommercial webcasters for the period January 1, 2009 through December 31, 2015. *See* 74 Fed. Reg. 40614 (August 12, 2009);
- Northwestern College – setting rates and terms for certain noncommercial webcasters for the period January 1, 2006 through December 31, 2015. *See* 74 Fed. Reg. 40614 (August 12, 2009); and

- Corporation for Public Broadcasting – setting rates and terms for certain public radio noncommercial webcasters for the period January 1, 2011 through December 31, 2015. *See* 74 Fed. Reg. 40614 (August 12, 2009).

During 2010, the Copyright Royalty Board completed the Webcasting III proceeding, setting the default rates and terms for webcasters that have not elected one of the alternative rates and terms made available under the Webcaster Settlement Act. The “initial determination” was issued on December 14th, 2010, and the final determination was published in the Federal Register on March 9th, 2011. *See* 76 Fed. Reg. 13026 (March 9, 2011).

The Copyright Royalty Board also concluded proceedings for certain “new subscription services” that perform “sound recordings on digital audio channels programmed by the” service “for transmission by a cable or satellite television distribution service to its residential customers.” *See* 75 Fed. Reg. 3666 (January 22, 2010). (SoundExchange refers to these as the “CABSAT” rates.) These rates and terms were adopted pursuant to a settlement between SoundExchange and Sirius XM Radio Inc.

Lastly, the Copyright Royalty Board published the final rates and terms for the Satellite Digital Audio Radio Services (“SDARS”) for the period 2006-2010. These rates and terms were the subject of an appeal to the United States Court of Appeals for the D.C. Circuit. On remand to the Copyright Royalty Board, the only remaining issue related to the royalty rate for ephemeral copies of sound recordings, and that issue was resolved pursuant to a settlement between SoundExchange and Sirius XM Radio Inc.

SoundExchange collects royalties on a periodic basis. During 2010, services were required to pay royalties based upon either their revenues or their usage. “Revenues” and “Gross Revenues” are defined in the applicable regulations or Webcaster Settlement Act agreements. *See e.g.*, 37 C.F.R. §§ 382.2(e)(1), 382.11, 383.2(g), 74 Fed. Reg. 9293 (March 3, 2009), 34796 (July 17, 2009). In 2010, usage is generally expressed as the number of Performances streamed to recipients. “Performance” is a term defined in Copyright Royalty Board regulations. *See* 37 C.F.R. §§ 380.2(i). A service’s liability is calculated in accordance with the applicable rates and terms and reported on a Statement of Account, a form created by SoundExchange and made available on its web site. *See* www.soundexchange.com

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, 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 reviews Initial Notices filed with the Copyright Office and may demand payment from services that have failed to pay royalties. Importantly, however, a service is obligated to pay any royalties owed under the statutory license whether or not SoundExchange contacts the service. SoundExchange also has the right to demand late

fees from services that have failed to pay royalties when required, as is permitted under federal regulations. Federal regulations set forth the requirements for reporting and payment, as well as some of the penalties for failure to meet these requirements.

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 is eligible for statutory licensing. Similarly, SoundExchange does not continuously verify that such services are in full compliance with all applicable requirements. To minimize any confusion, SoundExchange has posted on its web site the following notification:

IMPORTANT NOTICE: NO WAIVER OF RIGHTS

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 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 or has been eligible to make use of the statutory licenses or in compliance with the requirements of the statutory licenses. By accepting payment, SoundExchange is not waiving any claims, including but not limited to claims that the service is ineligible for or non-compliant with the statutory license, that payment is partial or incomplete, or that payment is based on a miscalculation of royalties owed. The failure to submit compliant payments or statements of account on time may subject a service to late fees. Moreover, the failure to comply with the terms of the statutory license may expose a service to significant risk of liability for copyright infringement.

Non-Statutory

In addition, SoundExchange collects royalties from foreign performance rights organizations located around the world. These societies collect royalties in their own territories for the use of sound recordings associated with artists and sound recording copyright owners who have signed membership agreements with SoundExchange authorizing the organization to collect on their behalf.

Royalty Distribution

In accordance with the applicable regulations, SoundExchange generally allocates a service's royalties on a pro rata basis in accordance with the information provided in the service's reports of use. For example, 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 with identical usage reported for each track, then each distinct sound recording would be valued at one cent (\$0.01) ($\$100 \div 10,000$).

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, if the report of use is received but has faulty data, or if the Copyright Royalty Board 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. SoundExchange allocates all royalties received for domestic performances equally among **all** featured artists and copyright owners, regardless of whether or not they have executed appropriate membership documents with SoundExchange. Naturally, any potential payees must provide appropriate registration documents to SoundExchange prior to receiving any royalties owed to them. There is no fee for registering with SoundExchange.

The performance 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).¹ 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 [the Copyright Act] 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, for example, that where the featured artist is a band with four members, each member shall be entitled to 25% of the featured artist’s share absent their full agreement on different ratios. 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.

¹ In accordance with the statute, SoundExchange distributes 100% of the royalties collected pursuant to 17 U.S.C. § 112(e) for the ephemeral copy of the phonorecord to the copyright owner.

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 [costs] 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 and copyright owners pursuant to reciprocal payment agreements with foreign collecting societies when those artists and copyright owners 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 and copyright owners who have designated the Dutch organization to collect U.S. statutory royalties on their behalf. As part of that exchange, SoundExchange may also collect from the Dutch organization all the royalties due to featured artists and copyright owners that have designated SoundExchange to collect foreign royalties on their behalf. SoundExchange may 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 third-party is: 1) considered creative personnel credited or recognized publicly for the commercially released sound recording on which the featured artist performs, or 2) is 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, 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 the applicable regulations, SoundExchange retains all such undistributed royalties for not less than three years from the date of the initial distribution of the royalties, and thereafter may release those funds for the benefit of all other copyright owners, featured artists and nonfeatured performers entitled to royalties. During 2010, there were no such releases.

SoundExchange distributes royalties on a periodic basis. In 2010, SoundExchange's gross distributions exceeded \$250 million. As a result of returned checks and other voids as of the cut-off date for issuing this annual report, the current net

distribution totals \$249,209,783. We expect that many if not most of the voids and returned checks will be re-processed and ultimately result in payments during 2011.

Royalties Collected

In 2010, SoundExchange collected statutory royalties from all statutory classes of services in the amount of \$263,593,310. Non-statutory royalties (primarily from foreign collection organizations) collected amounted to \$4,486,316. The statutory royalties collected in 2010 represent an increase of 30% percent over statutory royalties collected in 2009 (which totaled \$202,440,367).

SoundExchange maintains royalties in money market funds, discounted notes, corporate bonds and government bonds. SoundExchange net earned interest on its cash accounts totaling approximately \$259,494 during 2010.

Administrative Expenses

SoundExchange incurs expenses to operate as the sole entity designated by the Copyright Royalty Board to collect and distribute royalties. Its expenses are divided into the following broad categories: Personnel, Operations, Legal & Licensing, External Affairs, 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, accounting, 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 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 2010, SoundExchange incurred the following expenses:

Personnel	\$ 6,044,260
Operating Expenses	\$ 5,334,500
Legal & Licensing	\$ 5,567,935
External Affairs	\$ 532,993
Royalty Systems	\$ 833,514
Unrealized loss (gain) on investments	\$ 37,576
Total Expenses	\$ 18,350,778

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 net interest income and the denominator of which is total annual royalties received.

SoundExchange expresses its administrative rate for 2010 as 6.7 percent (6.7%).

Summary

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

Period	Y/E 12/31/10 Pre-Audit	Y/E 12/31/09	Y/E 12/31/08
Royalty Receipts ²	\$268,079,626	\$204,963,556	\$169,435,819
Interest Earned	\$259,494	\$1,082,641	\$4,022,365
Total Income	\$268,339,120	\$206,046,197	\$173,458,184
Expenses			
Personnel	\$6,044,260	\$4,501,657	\$3,639,592
Operating Expenses	\$5,334,500	\$4,765,948	\$2,431,326
Legal and Licensing	\$5,567,935	\$5,470,728	\$4,966,007
External Affairs	\$532,993	\$609,305	\$803,398
Royalty Systems	\$833,514	\$1,260,672	\$803,297
Unrealized loss (gain) on investment	\$37,576	\$169,355	\$(231,515)
Total Expenses	\$18,350,778	\$16,777,665	\$12,412,105
Blended Administrative Rate	6.7%	7.7%	5.0%

² 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 collected and allocated according to the period for which the service reported the liability.