PUBLIC COMMENTS OF NPREX
to the Antitrust Division of the U.S. Department of Justice

The National Performing Rights Exchange (NPREX) respectfully submits the following in response to the request from June 5, 2019 by the Antitrust Division of the U.S. Department of Justice (Department) for comments on questions related to the ASCAP and BMI consent decrees (Consent Decrees).

NPREX is an electronic transactional platform that operates independently of music owners, music users and performing rights organizations (PROs). The platform serves as a market mechanism for direct transactions in music performance licenses between rights holders and music users. Each transaction occurs at an actual willing buyer-willing seller price. The willing buyer-willing seller price on NPREX serves two functions. First, it properly resolves the forces of demand and supply for a music performance license. Second, it internalizes various externalities, including the hold-up problem, that arise in the music performance licensing industry.

The only exchange of its kind in the world, the NPREX platform automates direct performance licensing. The platform contains technical innovations that are unprecedented in the music industry. These innovations inform our views on both the Consent Decrees and the collective licensing paradigm as practiced today by the PROs, of which ASCAP and BMI are the most prominent. For this reason, we first provide the Department with a summary of NPREX along with possible implications on the future of music performance licensing. We then provide responses to the questions posed by the Department.

Whatever becomes of the Consent Decrees, we respectfully submit that no licensing mechanism promotes the maximization of economic welfare of music owners and music users better than a well-organized market mechanism that facilitates voluntary exchange at actual willing buyer-willing seller prices.

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A. Introduction to NPREX

1. The Motivation for NPREX

Setting the Stage

A music license is a type of financial contract, not unlike a financial derivative, that can be standardized and made the object of a transaction between a music user and a music owner on an organized exchange designed specifically to facilitate efficient, direct licensing. Mathematical economics provides the basis for a price discovery mechanism that automates the execution of licenses and the generation of market prices. A transactional platform that incorporates such a price discovery mechanism and that allows agents to transact on behalf of their principals is the future of music licensing.

Marketplace as a Solution to the Coordination Problem

Imagine a busy marketplace where many voluntary transactions between anonymous buyers and sellers take place at mutually agreed upon prices. The marketplace serves a fundamental purpose within a system of voluntary exchange. It resolves the coordination problem between the many buyers and many sellers. That is, it makes it simple and efficient for a buyer and seller who might not otherwise know one another to transact directly at an agreeable price. In other words, the marketplace plays matchmaker, which is not always simple. Indeed, this may require active participation by the marketplace itself. This is where the terminology "mechanism" comes in. Maskin (2008) defines a mechanism as "an institution, procedure or game for determining outcomes" and the market mechanism as the "best" mechanism where (i) there are large numbers of buyers and sellers, none of which wield significant market power and (ii) there are no significant externalities that affect the

choices of buyers or sellers.[1] Where these assumptions fail, mechanisms that improve upon this situation are generally possible.[2] An intelligent mechanism that implements a price mechanism that resolves these issues is one example of such a mechanism.

To what literature is Maskin referring? What reasoning is there that a market mechanism is the best mechanism, in general? That is, how do we know that a market mechanism yields better results than the system the industry has today whereby collectives, or coalitions, act on behalf of a individuals without the benefit of a well-designed price mechanism within a well-organized marketplace? This is a very good question, and it has a very good answer.

Walras (1954) describes a market as a collection of well-informed buyers and sellers transacting at a price given to them.[3] The equilibrium price in this market is the price where supply just equals demand – the "market clearing price". The equilibrium price and the quantity of the transaction constitute the Walrasian equilibrium. What property does the Walrasian equilibrium possess? The First Fundamental Theorem of Welfare Economics says that a Walrasian equilibrium is Pareto efficient.[4] A Pareto efficient allocation is an allocation of goods such that changing the allocation diminishes the welfare of at least one person. In other words, a perfectly competitive market yields an allocation of goods at the Walrasian equilibrium price such that no buyer or seller can gain anything further unless someone else loses. The Second Fundamental Theorem of Welfare Economics says that any Pareto efficient outcome can be generated by a Walrasian equilibrium with the necessary allocation of resources.[5] This is not a call to redistribute resources, just to be clear. Rather, it is a

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[1] Maskin, Eric. 2008. "Mechanism Design: How to Implement Social Goals" (2008) *American Economic Review*, vol. 98 (3), pp. 567-576. This is a revised version of the lecture Professor Maskin delivered when he received the 2007 Bank of Sweden Prize in Economic Sciences in Memory of Alfred Nobel.
[2] Id.
[3] Walras, L. 1954. *Elements of Pure Economics*. London: Allen and Unwin.
[4] Koopmans, T. 1957. *Three Essays on the State of Economic Science*. New Haven: Yale University Press. (providing a proof of the First Theorem).
[5] See Arrow, K. 1951. "An extension of the basic theorems of classical welfare economics". *Readings in Mathematical Economics*. Edited by P. Newman. Baltimore: Johns Hopkins Press. Also see Debreu, G. 1953. "Valuation equilibrium and Pareto optimum." *Readings in Welfare Economics*. Edited by K. Arrow & T. Scitovsky. Homewood, Ill: Irwin.

validation of a marketplace as "the mechanism" for allocating goods such that the gains from trade are maximized. Each theorem supports the desirable nature of a market mechanism.

Building on the pioneering work of Edgeworth (1881), who argued that there is a price at which two traders will reach an agreement that delivers maximum utility, economists and game-theorists in the 1960s and 1970s began to explore the notion of a "core".[6] The core is a set of bargaining results that no subset of buyers and sellers can improve upon by foregoing the market mechanism in favor of some other mechanism. For instance, imagine that a subset of buyers and sellers step away from the Walrasian market believing that they can improve upon their condition by letting a judge set the price at which a transaction occurs. Would this subset of agents, also called a coalition, be better off outside of the Walrasian market?

At the risk of over-simplifying monumental achievements by a generation of researchers, the answer is no – they would most likely not be better off. A remarkable finding by these researchers is that the allocation represented by the "core" amounts to the allocation implicit in a Walrasian equilibrium as the number of buyers and sellers grows large – or the economy "replicates".[7] The literature speaks in terms of the convergence between the Walrasian equilibrium and the core. The conditions for convergence involve certain strong but common assumptions related to the preferences of buyers.[8]

Let us be clear. This literature - a cornerstone of modern microeconomic theory - suggests that the welfare of buyers and sellers is maximized by a market mechanism that supports voluntary exchange at a market-clearing price. This line of research affirms the desirability of a market mechanism as opposed to some other means by which a buyer and seller transact.

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[6] Edgeworth, Francis Y. 1881. *Mathematical psychics*. London: Kegal Paul.
[7] Anderson, R. 1992. "The Core in Perfectly Competitive Economies." *Handbook of Game Theory*, Volume 1, Chapter 14. Edited by R.J. Aumann and S. Hart. Elsevier Science Publishers B.V.
[8] Manelli, A. 1989. "Monotonic preferences and core equivalence." *Econometrica*, 59: 123-138. Here, the author shows that core convergence for large finite economies depends on strong monotonicity and convexity assumptions.

The results are also robust to the case where ideal conditions fail to obtain. What if the assumptions that underlie the Walrasian equilibrium fail to hold? For instance, what if there are big sellers that can control, to some extent, the price at which a transaction occurs? Does this mean that core allocations can no longer be characterized by some type of price mechanism that approaches a Walrasian equilibrium? At the risk of over-simplifying the work of other brilliant men and women who explored this question with mathematical rigor, the answer again seems to be **no – a price mechanism still works** in the best interests of both buyers and sellers even if there is imperfect competition within an industry.

One of the most remarkable findings of economic theory is that core allocations can still be implemented by a price mechanism in an imperfectly competitive industry that, although it differs somewhat from the Walrasian price equilibrium, shares some of its interesting features.[9] For our purposes, the most relevant research here is Shitovitz (1973), who showed that the core - the set of results that cannot be improved upon by coalitions of sellers (i.e., music publishers) - amounts to the results of a restricted competitive allocation where the sellers are organized as oligopolists.[10] In other words, just because an industry includes sellers (i.e., publishers) that wield market power does not mean that the core differs significantly from the market-based outcome. Using slightly different methods, Drèze et al. (1972) came to the same conclusion as Shitovitz.[11]

This brings us back to the point made by Maskin. The market remains, in general, the best mechanism for enabling transactions between buyers and sellers. One of the lessons of this voluminous and intricate literature is that *well-designed price mechanisms work*, and when there are

[9] See Gabszewicz, J. & B. Shitovitz. 1992. "The Core in Imperfectly Competitive Economies." *Handbook of Game Theory*, Volume 1, Chapter 15. Edited by R.J. Aumann and S. Hart. Elsevier Science Publishers B.V.
[10] Shitovitz, B. 1973. "Oligopoly in markets with a continuum of traders". *Econometrica*, 41: 467:505. Here, Shitovitz extends the equivalence theorem of Aumann (1964) to oligopolistic markets.
[11] Drèze, J., J.J. Gabszewicz, D. Schmeidler, K. Vind (1972) "Cores and prices in an exchange economy with an atomless sector", *Econometrica*, 40: 1091-1108.

externalities that exists, one should not just dismiss the market mechanism. Most certainly, in the case of music performance rights, one should design a market mechanism to internalize the externality and to foster welfare benefits that flow from voluntary exchange within an organized marketplace.

A Hypothetical

Imagine Wall Street. Now, let us do something extraordinary. *Take away the NYSE*. Remove the exchange from the picture altogether such that there is no transactional platform for buyers and sellers. No walls. No computer screens. No tickers. No bells. Nothing. What would be left? The answer is buyers and sellers, left to their own devices to coordinate transactions with one another, meandering around unsure of who is a buyer, who is a seller, and what is the going-price for a given instrument. With so many would-be buyers and sellers without a transactional platform to facilitate transactions, any one of them might misconstrue the abundance of buyers and sellers – a good thing indeed – as chaos that makes direct transactions infeasible.

Not only would a party have to determine for itself who its counter-parties are but, without the NYSE, it would also have to establish the terms of trade, including the pricing structure, which might vary from one transaction to another. Some transactions would get done, but without a marketplace to enable buyers and sellers to coordinate with one another automatically, not nearly as many transactions would be consummated as the economy would want. And even when a deal gets done, the price might not incorporate information efficiently. Indeed, prices might become a vague reflection of comparable transactions.

The other thing one would observe here is the emergence of middlemen to exploit the inefficiencies that arise from the absence of a market mechanism that efficiently resolves the coordination problem between buyers and sellers. There are two additional points to make. First, the last thing a middleman would want is the emergence of an exchange to provide an efficient solution

to the coordination problem. Second, the more complex the transaction conducted by the middlemen, the more sophisticated the exchange must be to resolve the coordination problem between the buyers and sellers. Indeed, it is conceivable that the longer the buyers and sellers go without this exchange the more convinced the middlemen - and perhaps even some buyers, some sellers and other third parties - become that the middlemen are necessary to enable the buyers and sellers to transact. Does any of this sound familiar?

Toward a Music Licensing Exchange

Until very recently, the music performance licensing industry had no marketplace to resolve the coordination problem between the many music users and many music owners. The absence of a well-designed market mechanism reflects nothing more than a failure to implement innovations over the last 30 years in mechanism design and computer science. This absence does not mean that a marketplace for direct performance licensing is impossible or that collective licensing is the best way to do things for all time. It just means that the industry has yet to answer the most fundamental question that exists among buyers and sellers of music licenses. What is the mechanism for licensing music performances that maximizes the economic welfare of music owners and music users? It is long past time for the industry to answer this question, and in doing so, it is time for the industry to realize that this is primarily an economic issue, not a legal issue and certainly not a political issue. It is insufficient, if not altogether misguided, to address this question with yet another legal mechanism. The industry needs an actual marketplace, along the lines of a financial exchange, designed specifically to resolve the coordination problem between the music users and music owners.

The properties of a music licensing exchange are clear. The exchange must implement the direct licensing paradigm at less cost than the collective licensing paradigm. The exchange must enable

a music user to acquire a full suite of licenses at market prices - call it full insurance - with little or no effort. The market price generated by this exchange must be a willing buyer-willing seller price.

The willing buyer-willing seller price struck on the exchange must have the following properties. The price must be a nonlinear price that conveys to the buyer a volume discount, no matter that volume of music used by the buyer. The price must correctly incorporate music usage so that the music user pays for what it plays, no more and no less. The price must incorporate music ownership so that the buyer pays a price that reflects the extent of ownership of the seller in every song within the licensed catalogue. The price must internalize the externality caused by fractional licensing. The price must reflect the bargaining power of the underlying catalogue as agreed upon by the counter-parties to yield a profit-maximizing price under the circumstances; this ensures there is voluntary exchange, as opposed to compulsory licensing that forces the music owner to convey its license at a price to which it did not necessarily agree.

An exchange that implements all of this is no small thing. Some might argue that this is impossible and that the industry ought to fall back on collective licensing or statutory licensing or some combination of the two. Respectfully, we submit that statutory licensing and collective licensing are artifacts of the unenlightened past. The future is not the past. The future - actually, the present – includes a marketplace that implements these things, including a price mechanism that satisfies all these conditions. This marketplace already exists. It is NPREX, and those of us behind NPREX look forward to helping the Department any way we can to help this industry that we care about very much.

2. A Brief Summary of NPREX

NPREX is a primary marketplace for direct transactions in music licenses that takes the form of an electronic transactional platform. While the NPREX platform works for mechanical, performance and synchronization licenses, our comments focus on performance licensing. The

NPREX platform allows a rights holder to sell performance licenses directly to music users at actual willing buyer-willing seller prices with minimal transaction costs. A rights holder can be a publisher or a record label. A music user can be a radio station, TV network, digital streaming service, a satellite radio network or a general licensing establishment such as a bar, restaurant or other establishment that performs music for the entertainment of its clientele.

NPREX makes possible what Justice White suggested in 1979 was a "virtual impossibility".[12] NPREX makes it easy for a copyright holder to sell licenses directly to many music users. Doing one transaction on NPREX is as simple as doing many. Like any good marketplace, NPREX does two key things. First, it matches like-minded buyers and sellers so that they can transact. Second, it generates a rational market price around which the buyer and seller coordinate. NPREX calls on advanced math, economic theory, and computer science to do this. Together, these processes - the NPREX Matching Process and the NPREX Price Mechanism - automate the execution and settlement of direct performance licenses. We discuss each process in turn.

3. The NPREX Matching Process

Buyers and sellers on NPREX submit offers to execute a direct license. An offer has standardized terms. If the offers submitted by counter-parties have matching terms, NPREX executes a license between the like-minded counter-parties. This happens automatically, and the only thing either party needs to do to avail itself of this process is to communicate the terms of an offer to NPREX. Plus, the music user pays nothing up-front for a music performance license.

[12] *Broadcast Music Inc. v. CBS*, 441 U.S. 1, 20 (1979) (noting that "[a] middleman with a blanket license was an obvious necessity if the thousands of individual negotiations, a *virtual impossibility*, were to be avoided. Also, individual fees for the use of individual compositions would presuppose an intricate schedule of fees and uses, as well as a difficult and expensive reporting problem for the user and policing task for the copyright owner.") (emphasis added).

The NPREX Matching Process enables a music user, through a few key-strokes, to execute individual licenses with all rights holders on the exchange and vice-versa. This means a music user can acquire "full insurance" with little work and no up-front cost. In other words, the NPREX platform enables a music user to obtain every license available on the exchange in a simple and transparent way. Since the music user pays only for what it plays, the music user has no reason not to acquire every license whose terms are acceptable. This eliminates the claim by devotees of collective licensing that there is no more efficient means to conduct bulk performance licensing than collective licensing. The meaningfulness of the NPREX Matching Process lies in the ability of NPREX to map the agreed upon terms of trade within a license to a rational price for the license. This is the job of the NPREX Price Mechanism.

4. The NPREX Price Mechanism

The NPREX Price Mechanism is a mathematical framework derived from advanced economic theory that generates an *actual* willing buyer-willing seller price for a license, based on certain fundamental inputs, including the terms agreed upon by the parties in their music license, such that the forces of demand and supply are properly resolved.[13] The result is a price that has the following properties. First, the price is a bulk, or nonlinear, price giving the music user a volume discount. Incidentally, bulk can mean two works, three works or something much, much larger – like two or three million works. Second, the price properly accounts for the existence of other music owners who

[13] The NPREX Price Mechanism follows in the mechanism design tradition. The question posed by mechanism design is the following: what (price) mechanism maximizes the economic welfare of a seller – perhaps an oligopolistic seller - when selling to a buyer that has given set of preferences over goods and services, including savings? Depending on the preferences of the buyer, the optimal price mechanism could be a uniform price per unit, a pure nonlinear price, or some combination thereof. The point is that this approach looks at the buyer, the seller and the surrounding circumstances to fashion the price mechanism that maximizes the welfare of the seller while enabling the buyer to reach an optimal level of consumption.

are also selling licenses to the music user. Third, the price properly accounts for the ownership of each song within the catalogue licensed by the music owner. Fourth, the price properly accounts for the bargaining power of the underlying catalogue as agreed upon by the music user and music owner within their license. Finally, the price properly internalizes the problems that give rise to externalities in the performance licensing market.

Literature has emerged over the past 10 years that calls on regulatory economics and cooperative game theory to try to address the issue of how to price a statutory license or a collective license. This literature is very narrowly tailored to address the pricing problem from the perspective of the collective – whether a rate tribunal or a society. That is, each approach assumes the existence of a collective or a rate tribunal charged with posting a price for a statutory or collective license. We discuss each effort in turn.

Judge David Strickler of the Copyright Royalty Board lamented in 2015 the absence of a principled-approach to the determination of statutory license fees, suggesting, among other things, that the Efficient Component Pricing Rule (ECPR), based on the theory of contestable markets, might have an application in pricing music licenses.[14] The ECPR has been used to set rates in regulated industries where the subject of a transaction is "access". Gans (2018) argues that, while the formulae of ECPR cannot readily be applied to the pricing of music licenses, there are certain fundamental principles behind ECPR that can be applied in the determination of prices for music licenses.[15] The basic principles are that copyright holders should earn fees that compensate them for the opportunity cost of making their work available for use by various music users and should have a structure that is neutral across business models. We agree.

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[14] Strickler, David. 2015. "Royalty Rate Settings for Sound Recordings by the U.S. Copyright Royalty Board: The Judicial Need for Independent Scholarly Economic Analysis." *Review of Economic Research on Copyright Issues*. 2015. vol. 12(1/2), pp. 1-15.

[15] Gans, Joshua S. 2018. "Getting Pricing Right on Digital Music Copyright." *Review of Economic Research on Copyright Issues*, vol. 15(2), pp 1-22.

Watt (2010) proposes a method based on cooperative game theory to price a performance license sold by a collective.[16] The author applies an allocation rule called Shapley's value. This application seeks an allocation rule that "divides the pie" of revenue in the radio industry among radio stations and copyright holders. In doing so, Watt assumes that every seller charges the same price for a direct performance license to a given radio station. While this is an acceptable assumption for the collective licensing paradigm, it is not an acceptable assumption for the direct licensing paradigm because it assumes away the pricing problem faced by an individual buyer or seller in an actual marketplace. The question remains how does a copyright holder set its price for a direct performance license under the circumstances such that the five properties we addressed at the outset of this section are satisfied.

The NPREX Price Mechanism addresses this question head-on and makes no assumptions about the outcomes of relative prices of individual copyright holders in direct licensing transactions. Instead, the NPREX Price Mechanism is a mathematical framework that constitutes the solution to the mechanism design problem faced by the music performance licensing industry: what price mechanism maximizes the welfare of buyers and sellers of *direct* performance licenses?

As we will discuss later, the NPREX Price Mechanism can be calibrated in any number of ways to generate a host of outcomes in terms of prices and allocations of licenses. One such outcome is the collective licensing outcome itself where all sellers post the same price per unit to a given buyer. That is, the NPREX Price Mechanism is sufficiently general in both design and effect to replicate the collective licensing outcome assumed by Watt. In a subsequent section of this document, we will review the properties of the collective licensing outcome and ask whether this outcome comports with first principles.

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[16] Watt, Richard. 2010. "Fair Copyright Remuneration: The Case of Music Radio." *Review of Economic Research on Copyright Issues*, vol. 7(2), pp 21-37.

5. Additional Thoughts

The implications of the NPREX marketplace on the future of music performance licensing and the Consent Decrees are significant, if not profound. For the first time in the 100-year history of performance rights licensing, an efficient and intelligent marketplace, that costs a fraction of the cost of a collective to operate, now exists for a music publisher and music user to conduct transactions easily and directly, from any computer in the world, at a price agreed upon by both parties. In short, the industry now has a marketplace for direct performance licensing.

The existence of NPREX presents a legal question never-before reached in our industry. Does a market mechanism like NPREX that serves as an alternative to collective licensing give rise to the application of the rule from *NCAA v. Board of Regents of the University of Oklahoma*, 468 US 85 (1984)? *NCAA* stands for the proposition that a horizontal restraint fails the rule of reason when there is an alternative mechanism that benefits the industry. We discuss this question and others in the following section.

B. The Implications of NPREX on Music Performance Licensing

The first implication is that collective licensing is no longer the only way for performance licensing transactions to be done. The second implication is that the collective licensing paradigm is a special case of the direct licensing paradigm, and through this lens, the flaws of the collective licensing paradigm can be very clearly seen. The third implication of NPREX is that the PRO can become a broker of direct licensing transactions on the NPREX platform. The fourth implication of NPREX is that the existence of NPREX raises serious questions about the legality of collective licensing.

Before we proceed, let us make a distinction between collective licensing and the agents that implement it – the "societies" or rights organizations. The Consent Decrees rightly exist because of

the practice of collective licensing, not because of the PROs in and of themselves. In other words, for as long as collective licensing remains the business model implemented by ASCAP and BMI, the Consent Decrees should persist for the sake of both music owners and music users. However, if the PROs were to evolve into agents that facilitate direct licensing transactions, then, in theory, the Consent Decrees, at least as currently drafted, would not be necessary.

1. First Implication - Collective Licensing is Not the Only Solution

With NPREX collective licensing is no longer the only way for performance licensing to occur. Indeed, NPREX is a non-trivial solution to the coordination problem. The coordination problem refers to the inability of music users and music owners to conduct broad-based direct performance licensing transactions.[17]

There are three primary factors that contribute to the coordination problem: the infeasibility problem, the imperfect foresight problem, and the pricing problem. We discuss each in turn. The collective licensing paradigm is a trivial solution to the infeasibility and the imperfect foresight problems.

First, in the absence of a well-designed market mechanism that actively matches buyers and sellers of music performance licenses in direct transactions, it is infeasible for a music owner or music user to transact with its many potential counter-parties. There are too many music owners, too many music users, and only so many hours in the day. This is the "infeasibility problem".

Second, the future cannot be foreseen with certainty. Where a music owner cannot foresee who will perform its music, it is difficult for the music owner to know to whom to sell a direct performance license. Likewise, where a music user cannot foresee what music it will perform, it is

[17] Some will rightly point to data problems as the big problem in the music industry. While bad meta-data or opaque ownership data are problems, neither contributes significantly to the coordination problem. Even with perfect ownership data, the coordination problem remains.

difficult for the music user to know from whom to purchase a direct performance license. This is the "imperfect foresight problem". This problem is distinct from the infeasibility problem, but each serves to worsen the effects of the other.[18]

Finally, because the industry has never had a market mechanism that resolves either of these problems, the industry has never developed a formal understanding of how to price a music performance license. Consequently, there has been no rational price mechanism around which a music user and music owner can coordinate to conduct direct performance licensing. This is the "pricing problem".

Collective licensing collapses the many sellers into one or a few sellers. This trivializes both the infeasibility problem and the imperfect foresight problem. The industry has had no choice but to resort to a trivial solution, and for over 100 years collective licensing has been the industry's trivial -solution-of-choice.

The proverbial double-edged sword, the collective licensing paradigm creates as many problems as it solves, if not more. The trivial solution to the infeasibility and imperfect foresight problems gives rise to nontrivial problems in economics and antitrust law in depriving both the music owners and the music users of the benefits of voluntary exchange at willing buyer-willing seller prices.

2. Second Implication of NPREX – Clarity as to the Collective Licensing Outcome

The collective licensing paradigm is a special case of the direct licensing paradigm. The collective makes decisions about pricing to achieve the collective licensing outcome. The collective licensing outcome amounts to a restriction on the possible outcomes that would flow from direct

[18] The coordination problem is not cured by a public database that holds music ownership information. The infeasibility and imperfect foresight problem persist even in the presence of publicly available and reliable music ownership data.

licensing. Against this back-drop the properties of the collective licensing outcome can be clearly seen.

The mathematical sophistication of NPREX allows us to understand the properties of the collective licensing outcome. Let us start with a simple characteristic of direct licensing. By definition, the total price paid by the music user for all direct performance licenses across all rights holders is the sum of the individual direct license fees. Of course, under collective licensing, the collective license fee amounts to almost the same thing: the fee paid by the music user for the collective license is just the sum of individual direct license fees, with one caveat. In the collective licensing paradigm, the collective, or PRO, chooses the bargaining power of each catalogue in pricing each direct license such that the sum of the individual license fees equals a certain share of the revenue of the music owner.

Let us make clear what the collective licensing outcome entails. First, the collective license fee equals the sum of direct license fees where each direct license fee is calibrated at the bargaining power wielded by the collective on behalf of the rights holder of the catalogue in question. Second, at the calibration of bargaining power that replicates the collective licensing outcome, the price of any direct performance license – and thus the price of the collective license fee – is invariant to changes in the number of songs used by the music user, whether actual or planned. Third, the collective license fee per performance is the same for each song in the playlist of the music user. In other words, at the collective licensing calibration, the fee per performance for the most popular song performed by the music user equals the fee per performance for the least popular song.[19] Fourth, at the collective licensing outcome, the bargaining power of the most performed catalogue is *less than* the bargaining power of the least performed catalogue. That is, assuming popularity and frequency of usage are very

[19] We refer here to the license fee paid by the music user relative to the music usage by the music user, not to the royalty paid to the publishers and writers by the collective according to its royalty distribution methodology, which is not a matter of public record.

highly correlated, the most popular catalogue wields the least amount of bargaining power, and vice-versa.

The Problems with Collective Licensing

In the previous section, we outlined the properties of the collective licensing outcome. Before we point out what is problematic about the outcome, let us summarize what is not problematic. All the ancillary functions of the PRO aside, it is the simplicity of the conveyance of a bundle of performance rights through one license that constitutes the sole benefit of collective licensing. Having said that, the conveyance of the same rights through a sufficiently intelligent and efficient market mechanism is now possible and more efficient.

A lot has happened over the past forty years following the decision by the US Supreme Court that blanket licensing is not a per se violation of the Sherman Act. Indeed, a lot has happened over the last five years. Innovations made by NPREX allow us to see the blanket license as simply a collection of direct licenses whose individual prices are calibrated by the collective to achieve the collective licensing outcome. Through this technology, one can readily see that collective licensing comes at a very high price to both music users and music owners. Not only does collective licensing give rise to distortions and regulations, but it also serves to slow the adoption of mutually beneficial voluntary exchange between music users and music owners.

The Invariance of the Collective License Fee to Changes in Music Usage

Collective licensing entails rigidities that direct licensing through a well-designed mechanism does not. One of the primary rigidities of the collective licensing mechanism is that the blanket license fee does not vary with changes in the amount of songs performed by the licensee.

While some may view this property as a virtue of the blanket license, the fact is the invariance of the blanket license fee to changes in music usage is a peculiarity that defies first principles. Here is an example. In the absence of a mathematical mapping between the count of songs included in a catalogue and the license fee itself, it is impossible to arrive at a license fee that accounts for the extent of the share of ownership or collection rights of the licensor in any fundamentally sound way. In simple terms, the price of a license to perform a bunch of songs in a catalogue should probably be an increasing function of, among other things, the number of songs in the catalogue. And, surely, somewhere along the way, the extent of the seller's ownership of those songs must matter too.

It is disappointing that the machinery of the large music performance licensing industry, after 100 years, cannot posit a mathematical framework that gives rise to blanket license fees derived from first principles. Having said that, we respectfully submit that it is not simple to solve this problem, nor is it simple to embed the solution into an operable exchange for direct performance licensing transactions.

Uniform Fee Per Performance

Take the collective license fee and divide it by the number of performances made by the licensee in the relevant period. This is the fee per performance received by every song, no matter the song. It is the same for every song, no matter how popular or unknown it is. Would a free market yield this result?

Think of the biggest songs from the past 50 years. And then think of the songs from the past 50 years that might have been performed a handful of times in public. In what market would the most popular product sell for the same price as the least popular? It would be a rare scenario indeed where the forces of demand and supply would yield this outcome. Yet for music, through collective licensing,

the price per performance of the most popular song equals the price per performance of the least popular song in every licensing transaction.[20]

Obviously, the owner of the most popular song would have good reason to question this, but consider this from the perspective of the owner of the least popular song. This owner should have enjoyed the flexibility to lower its fee per performance to incentivize music users to perform its song more. Yet, this is impossible under collective licensing. The individual rights holder must do what everyone else does, not what is in its best interests under the circumstances.

There is no question but that the collective licensing mechanism restricts the ability of the individual to do what is best for itself under the circumstances. Collective licensing restricts the options of the would-be willing buyers and willing sellers. The uniform fee per performance is thus a reflection of the restrictive nature of collective licensing.

Collective Licensing and the Relationship between Bargaining Power and Popularity

The collective licensing outcome creates an inverse relationship between the bargaining power of a catalogue and the popularity of a catalogue. In other words, the bargaining power of the least popular catalogue exceeds that of the most popular catalogue in the collective licensing outcome. The probability that a free market would generate this outcome is close to zero. In a free market, the bargaining power, or market power, of a catalogue is directly related to its popularity.

Like the uniform fee per performance, the inverse relationship between bargaining power and the popularity of a catalogue in the collective licensing outcome is an obvious reflection of the nature of collective action. Members of the collective with relatively more bargaining power who join the

[20] See Footnote 16. Watt (2010) assumes that music publishers charge the same price (per unit) in hypothetical direct licensing transactions. This assumption is unwarranted in a direct licensing paradigm.

collective effectively transfer some of their bargaining power to the members with relatively less bargaining power.

Devotees of collective licensing will trumpet this result, espousing that everyone is better off in a collective, especially the member with less bargaining power than the collective itself. Is this true? Is it welfare-maximizing for anyone? The answer is no. There are two reasons for this.

First, while unregulated collusion between sellers can momentarily lead to greater profit, unregulated collusion is not feasible because it gives rise to antitrust regulation, which defeats the purpose. The Consent Decrees themselves are evidence of this. Unregulated collusion among sellers of substitutable products in product market competition within an economy that prohibits collective action is akin to the concept of arbitrage in financial transactions; it is fleeting – something that does not prevail in a well-designed marketplace. Insofar as it is fleeting, it is not a stable solution.

Second, the maximization of bargaining power is not the point, anyway. We realize the Department understands this, but there are those on the supply side of the music performance licensing industry who do not. Bargaining power does not pay the bills. Revenue does. Rights holders need to generate revenue. To put a finer point on it, rights holders need to generate net revenue, or profit. By implication, the objective of the rights holder is to maximize its profit under the circumstances, not to maximize its bargaining power. This is not to say bargaining power is not valuable. Of course, it is. But bargaining power, like beauty, is in the eye of the beholder. One cannot have more bargaining power by proclamation.

3. Third Implication - PRO as Broker of a Direct Licensing Transaction

The PRO has served for over 100 years in the capacity of a collective bargaining agent for the music rights holders. With NPREX, that can change for the good of everyone, including the PRO. The PRO can choose to evolve into a broker of direct licensing transactions on the exchange.

A publisher and PRO can enter into a principal-agent relationship whereby the PRO serves as a broker of direct licensing transactions through the NPREX transactional platform. The NPREX platform includes firewalls to assist brokers in preventing one transaction from bleeding over into another. While the direct licensing paradigm does not depend on the participation of the PROs, each PRO can choose to participate.

4. Fourth Implication - Legal Implications of NPREX

As a nontrivial solution to the coordination problem, NPREX presents an important legal question. The question is whether collective licensing can survive if it is subjected to renewed legal scrutiny now that the performance licensing industry has an actual licensing marketplace where music publishers and music users can transact directly at arm's length and at minimal transactions costs. Case law states that horizontal restraints like collective licensing can fail the rule of reason test where an alternative to the horizontal restraint exists such that the industry benefits.[21]

Again, we reiterate the distinction between the collective licensing paradigm and the PROs that implement it. While a rigid assessment of our industry will not distinguish between the paradigm and the collective itself, we believe this view is not helpful. The industry will shift to direct licensing, and the PROs can choose to participate.

C. Questions

1. **Do the Consent Decrees continue to serve important competitive purposes today? Why or why not? Are there provisions that are no longer necessary to protect competition? Which ones and why? Are there provisions that are ineffective in protecting competition? Which ones and why?**

[21] See *NCAA v. Board of Regents of University of Oklahoma*, 468 U.S. 85 (1984)

The Consent Decrees continue to serve important competitive purposes. There are three distinct purposes that we believe are served. These purposes are not controversial. First, the Consent Decrees exist to mitigate the problems associated with the ongoing collective bargaining activities of ASCAP and BMI. That ASCAP and BMI continue to engage in collective bargaining on behalf of their rights holders is a sufficient reason for the continuance of the Consent Decrees. Second, the Consent Decrees exist to ensure that under no circumstance should a music user be made to pay a price that serves as an unreasonable restraint on trade. Finally, the Consent Decrees exist to promote the implementation of a competitive market-based outcome in the absence of an actual marketplace for music performance licenses.

We respectfully submit that the decrees are more important now, with the existence of NPREX, than they have ever been. While the Decrees very clearly serve the first and second purpose, it is in serving the third purpose - the promotion of market-based outcomes - where the Decrees will take on a new and very significant meaning. Now that direct licensing is both possible and relatively more efficient through NPREX than collective licensing, a music publisher can fulfill its potential as the seller of performance licenses to all music users, who today purchase collective licenses from ASCAP and BMI. Furthermore, competition between music publishers within the direct licensing paradigm allows the industry to achieve many welfare-enhancing outcomes that up until now have been impossible under collective licensing. The real question is how does the Department, whether through the Consent Decrees or otherwise, enable a transition from the collective licensing paradigm to the direct licensing paradigm. But we are getting ahead of ourselves.

In the absence of NPREX, our recommendation would be to let the Decrees remain as is. However, the existence of NPREX requires that we go further. We respectfully submit that the Department should consider whether the industry still needs the collective licensing paradigm implemented by the PROs through the blanket licenses. If the answer is either that the industry no

longer requires collective licensing or that the industry needs to transition away from collective licensing to the direct licensing paradigm, then the Department needs to consider two possible avenues, which are not mutually exclusive. First, at the very least, the Department should ensure the Consent Decrees do not impede the transition from the collective licensing paradigm to the direct licensing paradigm. Second, the Department should implement modifications to the Consent Decrees that are necessary to enable the industry to transition from collective licensing to direct licensing. Later, we propose modifications to the Consent Decrees that will serve this purpose.

Even if the Department believes that collective licensing paradigm must remain, there are certain considerations that should be made. First, the Consent Decrees should not be modified either to diminish federal oversight of ASCAP or BMI or to enhance the ability of either ASCAP or BMI to engage in collective licensing. An entrenchment of collective licensing or an expansion of the same into other areas of music licensing would give rise to more economic distortions. Given the innovations of NPREX, there is no reason to saddle the music owners and music users with more collective licensing.

2. What, if any, modifications to the Consent Decrees would enhance competition and efficiency?

We respectfully submit that the Consent Decrees should be modified immediately to facilitate the smooth adoption of the direct licensing paradigm, which, as explained in the introduction, is now possible due to innovations in direct licensing technology made by NPREX over the last the five years.

The list of modifications is relatively short. First, the definition of repertory in each decree should be revised to allow for partial withdrawals. Second, the Consent Decrees should prohibit the PRO from commingling license fees from dissimilarly situated licensees in its royalty distribution processes. For example, the PRO should not commingle radio license fees and general license fees in the payment of commercial radio royalties. This serves to distort the direct licensing marketplace for

both radio and general licensing. Instead, the PRO should distribute the same funds through two distinct distribution processes: a radio distribution and a general licensing distribution. In the general licensing distribution, the PRO could use the same radio data that the PRO would have used at its rightful discretion in its radio royalty distribution system. Today, the PRO ties the two markets in a way that is fundamentally unsound for everyone, including the PRO. The prohibition we recommend will prevent the PRO from distorting the direct licensing marketplace and inadvertently interfering with direct licensing transactions. Third, the BMI consent decree should mirror the ASCAP consent decree in its prohibitions against limiting, preventing or interfering with direct licensing. Fourth, the definition of the blanket license should incorporate the credit mechanism of the carve out blanket license to provide transparency and efficiency to the emerging direct licensing market. Finally, the Consent Decrees should prohibit the PROs from refusing to administer a direct license between a publisher and music user.

Let us say a few words about the final point. Both ASCAP and BMI have benefited in many ways from the Consent Decrees. One benefit is the acquisition and maintenance by the PRO of songwriter payment information under the auspices of the Consent Decrees. If a publisher were to do a direct license with respect to both the publisher and writer shares of a catalogue, the publisher or a third party would need songwriter payment data to ensure the writer receives its royalty payment.

A PRO that has acquired writer payment data while under the protection of the Consent Decrees should not be allowed to withhold writer-payment services from a music publisher. Moreover, the PRO should not be allowed to force the publisher to submit its portion of the direct license fee to the PRO's admin charge. This is not in keeping with the spirit of the Consent Decrees, which have enabled the PROs to acquire writer payment information. We respectfully submit that the Department should consider an addition to the Consent Decrees that either prohibits such a

refusal by the PRO or mandates the PRO pay those writers whose data were acquired by the PRO under the protection of the Decrees.

3. Would termination of the Consent Decrees serve the public interest? If so, should termination be immediate or should there instead be a sunset period? What, if any, modifications to the Consent Decrees would provide an efficient transitionary period before any decree termination?

Termination of the Consent Decrees will serve the public interest if and only if termination is accompanied by additional steps that facilitate the adoption of the direct licensing paradigm. The additional steps consist of two things: (1) the creation of a rational timeline for termination and (2) the implementation of modifications to the Consent Decrees discussed in our answer to question 2.

Having already discussed the modifications to the Consent Decrees that make the transition smooth, let us discuss elements of the plan and a timeline. The best policy is the one that best facilitates the smart and efficient implementation of the direct licensing paradigm. Insofar as the Consent Decrees perpetuate collective licensing, the Consent Decrees should be terminated in a reasonable fashion. However, we respectfully submit that it is not a sound policy for the Department to terminate the Consent Decrees and to enable the continuation of collective licensing. This would open the door to antitrust litigation, which is not what the industry needs. The industry needs simple and efficient direct licensing transactions.

Termination of the Consent Decrees should not be immediate. There should be a well-defined sunset period during which industry participants engage in direct transactions through NPREX or otherwise so that the transition is smooth.[22] There are several issues that should be addressed.

[22] If the PRO chooses to become an agent for direct transactions, it will need time to make this feasible, and NPREX is fully prepared to assist. We estimate that this will take no more than one year. The PROs have already built admin functions that handle direct licenses that their clients strike. With NPREX built and operational, there is little that the PRO needs to do to broker direct transactions.

First, should anything be done about advances, guarantees and other monetary obligations between songwriters and PROs that the PROs issued to retain market share to bolster fee negotiations? We believe the answer is no. The liability on the part of the writer remains, and the PROs can broker direct licensing transactions on behalf of the writer through NPREX. For reasons discussed in our answer to Question 6, there is a very strong argument to be made that the PROs should not be allowed to conduct collective licensing transactions. Nevertheless, this does not foreclose the PRO from brokering direct licensing transactions as we discussed in the introduction.

Second, is there anything to be done about licenses in effect? The answer is no. Any license in effect should remain so, and the proceeds should be paid to the PRO's affiliates or members. The music user will engage in direct licensing transactions and obtain refunds from the PROs through a carve out blanket license. The combination of licenses in effect and the carve out blanket licenses provides a very efficient means for the industry to adopt direct licensing. This implies that the Decrees should remain in effect for as long as there is an outstanding license in effect.

In closing, we recommend the establishment by the Department of a timeline for a transition plan. There are three guiding principles. First, collective licensing should end after a short period of time ("the sunset period"). Second, during the sunset period, any new licenses executed by the PRO should be short-term, extending no further than the end of the sunset period. Third, starting immediately, the PROs should no longer execute contracts with music owners or music users that have the effect of delaying adoption of direct licensing or that extend beyond the end of the sunset period.

4. Do differences between the two Consent Decrees adversely affect competition? How?

Differences between the two Consent Decrees do not adversely affect competition. With two minor exceptions, both ASCAP and BMI are subject to the same basic restrictions as far as direct licensing is concerned and to the same principles of antitrust law. Nevertheless, we make note of two differences between the Consent Decrees. The purpose of this is to remind the Department of the implications of NPREX on the collective licensing paradigm.

First, the BMI Decree does not include the same safeguards for direct licensing that the ASCAP decree does. There is no good reason why the Decrees should differ in this respect. Second, unlike the ASCAP Decree, the BMI Decree does not specifically allow for licenses in effect. The ability of the PRO to issue a license that remains "in effect" as to the breadth of its repertoire on the day the license is initialized is an important safeguard for music users. Combined with the carve out blanket license as implemented through NPREX, the license in effect provision will help to provide the industry a smooth transition to direct licensing. However, the Department should be aware that the PRO has an incentive to use the license in effect as a means of making the PRO sticky to both the music user and the music owner. If used in this way, the license in effect might serve to prevent or frustrate direct licensing transactions.

5. Are there differences between ASCAP/BMI and PROs that are not subject to the Consent Decrees that adversely affect competition?

There are differences between the regulated and unregulated PROs that adversely affect what would otherwise be competition between music publishers in a direct licensing paradigm. However, the most troublesome thing about the PROs has nothing to do with a difference between them. Rather, the most troublesome thing involves a similarity. We discuss each in turn.

A Key Difference between the Regulated and Unregulated PROs

Unlike ASCAP and BMI, neither SESAC nor GMR offer carve out blanket licenses to music users who purchase licenses directly from music publishers. We are not suggesting that SESAC or GMR should be subject to consent decrees. Nor are we suggesting that either SESAC or GMR has an obligation to offer carve out blanket licenses. Here, we mention this because today the carve out blanket license provides the only flexibility in the price mechanism used by the PROs. The rigid nature of the price mechanism used by the PROs is a big problem. Left unaddressed, the problems will only get worse. The solution, of course, is not more legislation. The solution is a price mechanism that generates for music licenses market prices *that vary with music usage*.

A Key Similarity between PROs that Adversely Affects Competition

Today, BMI charges a blanket license fee of x percent of a music user's revenue. ASCAP charges x percent too. SESAC charges y percent. GMR charges z percent. And neither x nor y nor z bears any direct and contemporaneous relationship to actual music usage by the licensee. With all due respect to the efforts of generations of well-meaning individuals on both sides of the industry who have spent countless hours refining and improving upon this system, this is not a well-designed price mechanism.

We understand very well the frustration of each stakeholder. The music owner rightly wants to receive a market price for the use of its works, and the music user rightly wants to pay a reasonable price. The industry is far from this, and the primary reason for this is the complete absence of a market with a well-designed price mechanism. As the Department knows, market prices flow from market mechanisms, and it is the design of the market mechanism itself that determines the quality of the prices that flow from it.

Consider the prices that flow from the current mechanism. Take the music user that today pays a total percentage of revenue equal to $2x + y + z$, rather than $2x + y$, when it uses the same amount of music today that it used before the advent of GMR. A flexible price mechanism in the face of migrations from ASCAP and BMI to GMR would have easily enabled the music user to pay $2x' + y' + z$, where x' < x and y' < y. No such mechanism exists. This is an economic problem that demands an economic solution that does not further ensconce the collective licensing paradigm.

We also understand the frustration of the PROs in trying to secure a reasonable fee from the music user for the benefit of the publishers and songwriters. The PROs need a better way to do this. The music users and music owners will be better off; indeed, everyone in the space will be better off with a price mechanism that accounts for both music ownership and music usage in the determination of a rational price for a performance license.

Not just any price mechanism will do. There is a big issue that must be resolved. Prices that emerge from competition among sellers of perfectly complementary products tend to be higher than prices that emerge from collusion among those same sellers. For instance, a buyer of a pair of shoes spends more when it buys the left shoe from one seller and the right shoe from a second seller than when it buys the pair of shoes from one seller. As we know, this effect is due not to transactions costs but to an externality that emerges from the strategic interaction between the two sellers, each of which seeks to maximize its own profit, given that the other seller is selling not a substitutable product but a complementary product.

A music user would be better off buying licenses directly from music publishers through a smart market mechanism than from multiple PROs in a collective bargaining framework. The fractional ownership of music by publishers gives rise to the externality associated with the sale of perfectly complementary products by multiple sellers. That the buyer must go from one seller to the next also gives rise to the hold-up problem. The best solution to this problem is not more regulations

around collective licensing but a sufficiently smart price mechanism within a direct licensing paradigm that extracts the effects of these externalities and renders a market price free of these effects. This solution would serve both sides of the industry very well. The NPREX Price Mechanism is such a solution.

There are indications that additional PROs will soon emerge and will try to engage in collective licensing that today saddles the industry with antitrust regulation. This will create more problems, not less. Indeed, the music user will soon find itself paying $2x + y + z + p + q + \ldots$ This is the logical extension of the collective licensing paradigm where no collective charges a price that has a direct and contemporaneous relationship with actual music usage. While not necessarily a reason to sound the alarm, this should give pause to both buyers and sellers of music performance licenses who understand the law of demand.

6. Are existing antitrust statutes and applicable case law sufficient to protect competition in the absence of the Consent Decrees?

Existing statutes and antitrust case law are sufficient to protect competition in the absence of the Consent Decrees because now there is an alternative to collective licensing that, we believe, gives rise to the rule in *NCAA v. Board of Regents of Univ. of Oklahoma*. The *NCAA* case stands for the proposition that horizontal restraints like collective licensing can fail the rule of reason test if there is an alternative to the horizontal restraint that benefits the industry. We believe that a marketplace for direct licensing adopted by buyers and sellers of performance licenses represents a viable alternative to the collective licensing mechanism such that the *NCAA* rule must be invoked. With this, the collective licensing paradigm might give way to the direct licensing paradigm where music publishers compete with one another in the sale of licenses directly to music users at willing buyer-willing seller prices that incorporate the rightful market power of each seller.

Having explained our position, let us echo what we are sure is a common refrain. In the absence of a direct licensing mechanism like NPREX that benefits the industry, existing statutes and antitrust law are insufficient to protect competition. That is, without NPREX, the rule in *NCAA* cannot be invoked. This means the question of the legality of collective licensing turns on an application of the rule of reason under the *BMI* decision. Other than the existence and innovations of NPREX, nothing significant in the performance licensing space has changed other than the arrival of additional PROs, so it is very likely that collective licensing would satisfy the rule of reason. To the extent this would strengthen the hold on the industry of the collective licensing paradigm, it would in turn weaken the hold of the direct licensing paradigm. This would serve to threaten competition, not to protect it.

One final note is that the removal of the Consent Decrees without additional steps to ensure that competition is protected could create problems, not the least of which is litigation around the question of whether collective licensing, in the absence of the Consent Decrees *that require non-exclusive relationships between the PRO and its members*, constitutes an illegal restraint of trade.

Respectfully submitted,

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