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MEMORANDUM TO CLIENTS

Re: Copyright Office Rejects NCTA's "Phantom Signals" Proposal, Clarifies Policy.

The Copyright Office yesterday published an order terminating its inquiry regarding the appropriate treatment of "phantom signals" under the cable compulsory copyright license. The Office ruled that it lacked the statutory authority to adopt a proposal made by NCTA to allow cable operators to calculate their royalties on a "subscriber group" basis. The Office further held, by way of clarification of its phantom signals policy, that while cable operators must report and pay for phantom signals, such payments can be calculated using the "base rate" formula, not the 3.75 percent rate.

Background. Phantom signals are distant broadcast signals that a cable operator carries in some, but not all communities served by a system. According to the Copyright Office (and the copyright owners), cable operators are required to attribute the carriage of these phantom signals to all subscribers served by a cable system, not just the subscribers in the communities where the signals are actually being retransmitted. Phantom signal situations frequently (but not exclusively) arise when cable operators purchase neighboring contiguous systems, which are then deemed by the Copyright Office to be a single system for purposes of calculating royalty rates. If the two systems carry different distant signals, application of the phantom signal policy could result in a very significant increase in compulsory license royalty liability, even though no subscriber is receiving (or can receive) any additional distant signals.

NCTA first raised concerns about the phantom signals policy nearly twenty-five years ago. The Office eventually did commence a proceeding to consider the issue, but terminated the proceeding without taking any action in 1997. The Office explained its decision to terminate the proceeding by noting that Congress had requested the Office to prepare a report on the compulsory license and that the Office would address the phantom signals therein. And, in fact, the Office's 1997 report to Congress did recommend that the phantom signal problem be addressed through the adoption of an amendment to the Copyright Act that expressly would allow cable operators with systems that serve multiple communities to calculate their royalty payments on a "subscriber group" basis. Congress, however, has not acted on the Office's recommendation and, as the cable industry has consolidated, the phantom signal problem has continued to fester. In August 2005, NCTA again petitioned the Office to exercise its rulemaking authority to ensure that compulsory license royalty payments are based on actual, not fictional, distant signal carriage. In December 2007, the Office finally put out a notice soliciting comment on NCTA's petition.

Rejection of NCTA's Proposals. NCTA's petition contained two separate proposals. First, NCTA proposed that the Copyright Office revise its rule defining what constitutes a cable system for purposes of the cable compulsory license. That rule currently provides that two or more separate facilities will be treated as a single system whenever the two facilities (1) are in contiguous communities and under common ownership and control or (2) are operating from a single headend (whether or not the areas served are contiguous). This definition was adopted in order to address concerns that cable operators might attempt to "artificially fragment" their systems into multiple facilities in order to reduce their copyright liability (since smaller cable systems pay lower royalties than larger systems). NCTA argued that the actual effect of the rule is to "artificially consolidate" contiguous systems that are technically and operationally distinct. NCTA's proposed solution called for the Office to revise the cable system definition so that multiple facilities would be deemed to constitute a single cable system only where the facilities are (1) contiguous; (2) commonly owned; and (3) served by a single headend.

NCTA's second, and more significant, proposal for addressing the phantom signal problem was a proposed amendment to the Copyright Office's rules that would expressly allow a cable operator with a system serving multiple communities to calculate the system's royalty payments on the basis of separate subscriber groups. Specifically, NCTA's proposed rule would require cable operators to determine which royalty formula applied to a system (i.e., Form 1/2 or Form 3) by combining the revenues from all the communities served by the system, but would allow operators to then apply that formula separately to groups of subscribers that receive the same complement of distant signals.

Arguing that it has a limited role in administering the compulsory license, the Office rejected both of NCTA's proposals. Specifically, the Office held that it lacked the statutory authority either to re-interpret the cable system definition (which is based on language in the Copyright Act) or to adopt a subscriber group calculation methodology.

Clarification of the Phantom Signals Policy. According to the Office, some cable operators have resisted paying royalties for phantom signals on the grounds that the Office had not resolved the issue. In order to put this argument to rest, the Office (while contending that its position has long been known to the cable industry), announced that with the release of the order rejecting NCTA's petition, "the cable industry can no longer cite to any inaction on our part for not paying royalties" for phantom signals. However, the Office did clarify one aspect of its phantom signal policy: the application of the 3.75 percent rate to phantom signals. Specifically, the Office found that because the 3.75 percent rate was only intended to apply to "newly added" distant signals, it could not apply to phantom signals that are not actually added to a subscriber's line-up. Thus, under the Office's clarification, cable operators are subject only to the "base rate" for phantom distant signals, even where actual carriage of those signals would trigger the 3.75 percent rate.

We would be pleased to respond to any questions regarding these matters.

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