

Written evidence submitted by Hipgnosis Songs Fund Limited

DCMS Select Committee: Economics of Music Streaming Inquiry

Hipgnosis Songs Fund Limited (“Hipgnosis”) welcomes the opportunity to respond to the committee’s inquiry into the economics of music streaming.

Hipgnosis was founded to give the investment community access to extraordinarily successful hit songs by culturally important artists, and to establish songs as an uncorrelated asset class with attractive risk-adjusted returns. We believe we are disrupting the industry by delivering value for our investors and, crucially, our artists. We see ourselves as ‘Song Managers’ who act as custodians for the songs we own. Compared to the major music publishing houses, Hipgnosis are viewed as a real and safer alternative who can protect the meaning and legacy of songs as well as securing a song creator’s financial future.

Hipgnosis is an advocate and catalyst for improving the share of income received by artists and songwriters via streaming and other channels. We aim to leverage our assets to address the structural imbalance between payments on recorded music (i.e. music that can be played back or reproduced) and payments on songs (i.e. the underlying composition of a piece of music) in favour of the songwriter. This ‘ulterior motive’ has been shared with and endorsed by our investors right from the start of our relationship with them; we want people to invest in our vision as well as our fund.

The economic equation and the ‘70% divide’

Streaming has completely changed the economics of music. Previously, ‘going platinum’ – i.e. a million album sales to music enthusiasts – was the benchmark for success. Now, streaming services (Digital Service Platforms, or ‘DSPs’) have broadened access to music significantly, with some individual tracks being played hundreds of millions of times. This is a result of what used to be the passive consumer – who never paid for music previously – now spending c. £120 per year on a streaming subscription. Music has gone from being a discretionary or luxury purchase to a utility product.

To be clear, we believe streaming has saved the music business by making it more convenient for people to once again consume music legally rather than through illegal file sharing and copying. The concept of every single song being legally available in one place is now commonplace, but was a brave and innovative move by Daniel Ek, Spotify’s Founder and CEO, in 2006.

Hipgnosis believes the focus of this inquiry should be on how the 70% of revenue that is sent to “Rights Owners” and where the money goes once they are paid by the streaming services. Streaming services are not perfect – like any industry, there is room for improvement – but they have revolutionised the music industry, expanding the market for the benefit of consumers and all market participants. Streaming has given millions of records, artists and songwriters a second life. The relationship between the 3 major record labels holding the master recording (‘master’) and the control they have over the 3 major publishing companies holding song copyrights (‘copyright’) is, in our opinion, the issue.

The conflict of interest created by the three major record companies (Universal Music, Warner Music and Sony) owning the three largest publishers (UMPG, Warner Chappell and Sony ATV respectively) is critically important to understand. These three publishers are being prevented from advocating for songwriters’ interests as a result of being controlled by their parent companies who wish to push economic improvement towards recorded music where they make an 80% gross margin and a 40% net margin.

As a guide to how the revenue from music is split, the typical income earned by a master holder is c. 80%. The typical income earned by a publisher is c. 15%. Given the major record labels own the publishers, it is in the record labels' interest to push for the income received on the master / sale side to be greater than on the writers / publishing side.

Whilst there is a discussion to be had about the fact that c. 30% of revenue from music streaming goes to the DSPs, we do not believe this is the core issue. Much more significant is how the c. 70% paid to rights holders is divided between the record companies and song creators. Record companies do the deals with the DSPs, not the publishers. They take the lion's share of the royalties from the songs. They are even paid much faster than the publishing side as they control the supply chain; the record labels take payments through an automated process whilst the publishing side are paid in a more cumbersome, manual process.

It is this imbalance that should be the focal point of policymaker and industry scrutiny.

Hipgnosis' recommendations for how the relationships between artists, streaming platforms and record companies could be improved are as follows:

- 1. Songwriters and artists should have a direct seat at the table in remuneration discussions** and be represented by their peers, not by record labels or their publishers. There is much that all parties agree on, but equally there are important areas where songwriters and artists must express their own views.
- 2. A music stream should be treated as a license, not a sale:** A 'license' gives the artist 50% of the royalties for a song whereas a 'sale' gives artists between 18% and 30%. Since streaming became the main mechanism for consuming music, record companies have unilaterally decided that a stream is considered a sale because it maximises their profits. Artists and songwriters need up to date clauses in their contracts to reflect the true nature of how their songs are consumed, which is via a license.
- 3. Move to a broadcast rate of payment to musicians for passive listening:** The broadcast rate is appropriate for compensating artists and songwriters for music that has been streamed to consumers without them searching for it – not the (lower) sale rate. Also, streaming services should be more transparent with the data about when users have actively searched for a song versus when they have listened to it passively via an algorithm or a playlist.
- 4. Data inputs and sources need to be secured:** DSPs should tell major labels that they need both an ISWC and ISRC when signing contracts, which are required for preventing losses to artists due to unreliable data. This would mean the major labels would need to develop a faster, more reliable system for creating an ISWC code.
- 5. Regulation needs to be introduced to clarify the grey area around 'breakage' in record company and DSPs' contracts.** As streaming is not included in any detail in most agreements, breakage is not subject to a contractual method of distribution. Proper regulation and confirmation that all income gained in this way by the major labels is distributed fairly and appropriately is required. A kite mark would be helpful to certify to artists that all surplus revenues from advances were distributed across to the artists they relate to.
- 6. Remove non-disclosure agreements (NDAs) between record labels and streaming platforms.** At present, artists and songwriters are denied access to a real understanding of 98% of their streaming income by NDAs. In almost all cases in the music business, a full audit finds money

missing or incorrectly allocated. Artists and songwriters should not be blocked by NDAs from their legal right to an audit every three years so they have clarity on the streaming rates being achieved.

- 7. Equal share of equity for artists:** The record companies receive significant dividends from their investments in DSPs. Artists are cut out from this revenue stream despite creating the value upon which the profits of both DSPs and record companies are derived. It is important that music creators are compensated fairly, i.e. pro rata to the masters that forged the deal.

These points are explained in more detail below.

Hipgnosis would be very happy to support the committee with their inquiry as it progresses.

Merck Mercuriadis
CEO, Hipgnosis

Inquiry Questions

Question 1: What are the dominant business models of platforms that offer music streaming as a service?

Music streaming is provided by DSPs such as Spotify (32% of the market), Apple Music (18% of the market), Amazon Music (14% of the market) and Tencent Music. Alongside these dominant players, there are many other popular services such as Deezer, YouTube Music, Pandora, SoundCloud and Tidal Music.

Due to the contracts that exist between artists, record companies and DSPs, artists are receiving a disproportionately small proportion of the royalties when their music is streamed. This is not a new issue, although the growing popularity of streaming services has increased awareness of it.

The dominant business model for DSPs is defined by record company contracts, which typically means that DSPs take approximately 30% of the royalties for themselves and pay the remaining 70% to the rights holders of each music track. This 70% is then divided between the record company and the artists, with the record company taking the lion's share of the revenue. In real terms, if the total royalties of a track equals £1, at least 58.5p out of that 70p goes to the record company, leaving just 11.5p – one sixth of that 70% – for the song creator.

Several recent campaigns focusing on the topic of artist remuneration, such as #BrokenRecord¹, are focused on reducing the 30% cut taken by the DSPs. However, in Hipgnosis's view, more attention

¹#BrokenRecord is an online campaign created by Tom Gray from the Mercury prize-winning band Gomez, who is also a director of the Performing Rights Society, a group that ensure musicians get paid by radio stations and when their music is played in pubs and hotels. The campaign highlights the issue of royalties paid to artists by music streaming services.

needs to be paid to the contractual relationship between the major record companies and artists, which allow record companies to retain a disproportionately large percentage of the revenue from streamed music.

This is compounded by the fact that the three major record labels – Universal Music, Warner Music and Sony – own the three major music publishers – UMPG, Warner Chappell and Sony ATV – creating a serious conflict of interest in remuneration negotiations. These publishers, who are meant to represent the interests of their artists and songwriters, are instead controlled by the interests of their parent record companies. As it stands, when a song is sold the average percentage of revenue taken by a rights holder is c. 80%, whereas the publisher only takes c. 15%. As the record companies own the rights/Masters to the songs, they have a vested interest in increasing income earned by a sale.

It is time that the record companies recognised the unjustifiable imbalance between the revenue they receive and that received by artists and adjusted their models to better account for the growing popularity of streaming services.

This is the most significant problem, but there are several other factors at play that work against the interests of songwriters and artists:

- **Artists and songwriters do not have a seat at the table in remuneration discussions.** The control that the three main record companies have over the largest publishers means that artists are not properly represented. When contracts are negotiated with DSPs, it is crucial that artists and songwriters have better representation and can express their views directly.
- **A stream is sometimes considered a sale by DSPs and record companies when it should be a license.** In artists' contracts with record companies there is an important legal difference between a sale and a license which significantly impacts the proportion of the royalties paid to the artist versus the record company:
 - A **sale** is a reproduction royalty, which is a set rate agreed with the dealer. In the case of iTunes, artists were remunerated by sale as it was possible to quantify per download. Sales are calculated by:

$$(\text{number of units}) \times (\text{published price to dealer}) \times (\text{royalty rate}) = \text{sales.}$$

The royalty rate is usually between 18% and 30%.

- A **license** is a profit participation. The distribution amongst the participators is done on the same basis that the revenue was received. Profit is typically split 50:50.

In short, a license gives the artist 50% of the royalties for a song whereas a sale gives artists between 18% and 30%.

However, many older record contracts that were signed before the advent of streaming do not properly account for royalties earned from digital sales and streams. As a result, the record companies have been able to retrofit outdated contractual obligations onto digital streams, usually to the detriment of the artist or songwriters.

For example, Enrique Iglesias was paid at the 50% license royalty rate on streams for two years. However, it then dropped to the sale rate without any explanation. Iglesias took Universal Music to court and demanded his contractual right to inspect Universal's books. Universal refused so Iglesias' lawyers asked the court to enforce his contract's 50% streaming royalty rate, order a fair accounting of royalties earned by Iglesias, and award Iglesias the royalties which Universal had refused to acknowledge or pay². The case was settled out of court under NDA.

However, Seal, who has sold millions of albums for Warner Brothers, also has a contract that does not reference digital sales. It lists vinyl, CD and 'all other formats in the universe', but not digital specifically as it preceded music streaming. Fortunately for Seal, the record label decided to err on the side of caution and pay him at license rate for streams to ensure they maintained the income. This demonstrates the inconsistency of approach.

Hipgnosis argues that, under the subscription model used by streaming companies, a stream cannot be equivalent to a sale because there is no set price per unit. Additionally, the complex way in which subscription models operate mean that it is an example of profit participation, and therefore a license.

There may be a compromise to be found at a rate between a sale and a license to account for a stream as it is unlikely that the industry could be convinced to move all the income to a 50%/50% distribution. However, this may be problematic as it would mean changing agreements which would need to be agreed by external sources and implemented by law.

- **Streaming platform revenue models are not user-centric.** The majority of streaming services operate on a pro-rata system which means that royalties are pooled and then divided according to the artist's proportion of overall streams. For example, if an artist – e.g. Drake – accounted for 2% of streams in a given period then his rights holders would receive 2% of the total royalties pool. However, this means that 2% of the royalties from every individual subscriber's monthly payment is going to Drake's music, even if they didn't listen to it.

A more user-centric model that divided the royalties proportion of a user's monthly subscription between the rights holders of the artists listened to by the user would be fairer. One of the major streaming platforms that has investigated this model is Deezer, which has outlined a plan to launch a user-centric model in France with domestic labels.

Another supporter of the user-centric model is Emmanuel de Buretel, founder of Because Music. In July 2019, he explained his rationale to Les Echos, stating that "some services may like to say it won't make too much difference, but that does not matter as much as being able to tell artists 'this system is fair, and this is how it works'".

- **Data inputs and sources are not secured.** When a song is created it should be given an International Standard Musical Work Code (ISWC), which identifies a composition and connects to music streaming platforms, and an International Standard Recording Code (ISRC), which identifies a sound recording and connects to the relevant publisher. The data for these two codes should match, but the process for doing so is unreliable at best. This means that records can be sold to DSPs without an ISWC, which can result in artists and songwriters losing up to 25% of the income due to them.

² <https://www.musicbusinessworldwide.com/files/2018/01/Enrique.pdf>

It is the responsibility of DSPs to tell major labels that both ISWCs and ISRCs are required when signing contracts. Doing so would encourage the record companies and the publishers to come together to find a new and improved system for creating and assigning ISWCs that ensures that artists are fairly recognised and remunerated for their work.

- **The proportion of 'breakage' given to artists is unclear.** 'Breakage' refers to unallocated, non-recoupable advances paid by the DSPs to record labels to license their catalogues. If the streaming data falls below the advance this creates a surplus called 'breakage' (not to be confused with the prior use of the term in music which referred to returns of broken or damaged CDs and vinyls). The breakage appears on artists' royalty statements, but with little explanation.

The formula for how breakage is calculated is under NDA as part of the DSP agreements with the major labels. Auditors want breakage to be explained transparently like any other sale should be, with income at the offset, the data which created the surplus, and the methodology for calculating the distribution of the surplus.

A kite mark would be helpful to certify to artists that all surplus revenues from advances were distributed across to the artists they relate to. To gain a kite mark, record labels would be required to allow an independent auditor to verify the income has been distributed correctly.

The grey area of breakage payments has to be closed out with proper regulation and confirmation that all income gained in this way by the major labels is distributed fairly and appropriately.

- **Non-disclosure agreements (NDAs) between record labels and the DSPs prevent artists and songwriters from knowing the value of their songs and block their legal right to audit.** As a result of these NDAs, the data trail for approximately 98% of streaming income received by record companies is obscured. Artists and songwriters, as well as their representatives, are being prevented from knowing the value of their songs or the terms under which the deal was made.

NDAs also prevent the disclosure of proof of sales figures which, in turn, block an artist's legal right to audit every three years. This makes it almost impossible to prove whether money is missing or has been incorrectly allocated. Audits where these NDAs remain in place are useless in the majority of cases, and at best allow only a low-level audit which should not be acceptable.

In the USA, litigators like Brian D. Caplan have been successful at persuading judges to remove the NDA and release the DSP deal so that artists can audit their streaming rate. However, the cost of legal action falls on the artist in full unlike regular audit costs, which are largely refunded to the artist.

The major labels should not be allowed to sign an NDA with a DSP if they know it blocks an artist's right to audit.

- **Artists are not properly compensated for record companies' equity share in streaming platforms.** When streaming services were in their infancy, record companies invested heavily in DSPs. For example, Universal Music bought a 4.8% share of Spotify in 2009. As of June 2020, it is estimated that Universal's share was worth \$2.2 billion.

The record companies now receive significant dividends from their investments. Their equity share in streaming companies is much larger than the royalties they receive from songs, but artists are completely left out of the economic equation.

The true value of DSPs is their access to a wide variety of songs along with the technology that delivers the consumer experience. It can reasonably be expected that consumers would leave a streaming platform if it failed to host the songs that they want to listen to. Therefore, it is important that artists are properly compensated for creating the value upon which the profits of both streaming platforms and record companies are derived.

This includes the equity given in return for a deal. Any equity gained belongs pro rata to the masters which closed the deal with the streaming services; there is no other reason for the deal. High profile examples of artists taking action on this issue include Taylor Swift's campaign to make sure that artists are properly compensated when Universal Music Group sell their share in Spotify³.

Question 2: Have new features associated with streaming platforms, such as algorithmic curation of music or company playlists, influenced consumer habits, tastes, etc?

When streaming users passively listen to a song – meaning that it has been delivered to them through an algorithm or a playlist – the royalties need to be delivered at the broadcast rate rather than a sales rate so that songwriters are properly compensated.

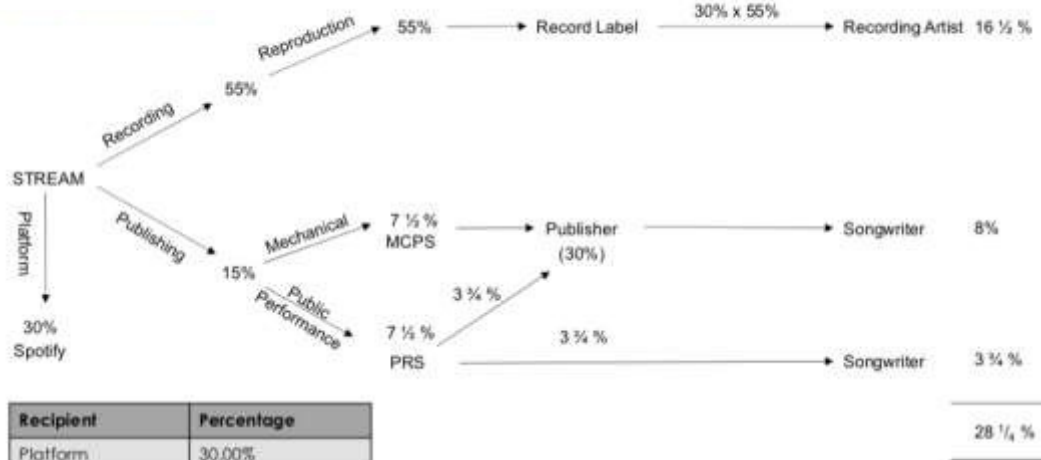
The method by which consumers come to a song – searching for it or having it recommended to them – impacts the payment received for the song. Therefore, the algorithms that DSPs use influence the music that consumers play and significantly impact the revenue earned on a given song. Hipgnosis strongly believes that streaming services should be more transparent with data showing when users have actively searched for a song versus when they have listened to it passively via an algorithm or a playlist.

As outlined in our response to Question 1, when a song is searched for and streamed via a DSP it should be considered a license. However, when a song is delivered to a user through an algorithm this should be paid for on the 'broadcast' rate. Our view is backed by Daniel Ek, the founder of Spotify, who describes the platform as 'radio'. It is fitting for songs to be paid for on the broadcast rate if they are listened to without a specific search by a user.

Currently, the streaming services do not publish information on the different pay rates for these streams, despite it significantly impacting artists and songwriter remuneration. However, under the current model where streams are considered a sale, artists are more generously remunerated compared to songwriters (see Diagrams 1 and 2 below). Moving to a broadcast rate for passive listening would significantly increase the proportion of the royalties paid to songwriters (11.75 % to 29.75%), and incrementally increase those paid to artists (16.5% to 17.5%) with the difference taken out of the record label's pocket.

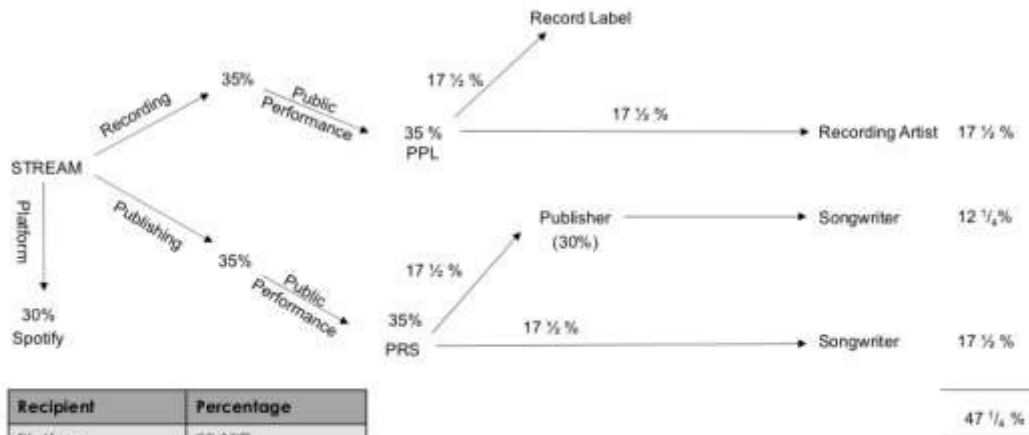
³ <https://www.nytimes.com/2018/11/19/arts/music/taylor-swift-record-deal-universal-republic.html>

Diagram 1: Current situation



Recipient	Percentage
Platform	30.00%
Record Label	38.50%
Recording Artist	16.50%
Songwriter	11.75%
Publisher	3.25%
	100.00%

Diagram 2: If streaming were to be reclassified as broadcast



Recipient	Percentage
Platform	30.00%
Record Label	17.50%
Recording Artist	17.50%
Songwriter	29.75%
Publisher	5.25%
	100.00%

Question 3: What has been the economic impact and long-term implications of streaming on the music industry, including for artists, record labels, record shops, etc?

The music industry was saved by the invention of streaming and the DSPs. However, the contractual relationships between the major record companies and artists fail to account for the increasing dominance of streaming services and must be rebalanced to better reflect the value created by artists.

Streaming has moved music consumption from a luxury purchase to a utility purchase made each month through a relatively cheap monthly subscription. This has benefitted the industry hugely, not least because consumers have moved from pirating music to purchasing it.

Globally, there are more than 400 million paid subscribers to streaming services, compared to 341 million at the end of 2019 and just 50 million in 2016. This growth is expected to continue, with the global streaming market projected to reach \$28bn by 2030.⁴

There remains significant potential for growth as more people convert to subscription services. This can only be seen as a good thing for artists because increasing the number of subscribers will also increase the income paid to artists. However, without action to tackle the dominance of the major record companies and the disparities in how royalties are allocated and paid when music is streamed online, artists will not fully benefit from this growing consumer trend.

Question 4: How can the Government protect the industry from knock-on effects, such as increased piracy of music? Does the UK need an equivalent of the Copyright Directive?

It is vital that music intellectual property rights are properly protected and enforced. As such Hipgnosis supports the findings of the US Copyright Royalty Board (CRB) and believes something similar should be implemented in the UK.

The impact of streaming in moving consumers away from downloading music illegally cannot be understated. However, piracy still exists, and artists should be protected by strong, enforceable intellectual property rights.

The European Union and several other countries have introduced legislation to ensure copyright is protected in the digital age, which could act as a reference point for stronger regulation in the UK.

By way of example, the United States has taken specific steps to increase songwriters' revenue. In 2019, the US Copyright Royalty Board passed a law that will see share of revenue given to songwriters increase by 44% by the end of 2022, which in turn will see streaming royalty rates rise from 10.5% to 15.1%. Hipgnosis supports this decision and believes that something similar should be implemented in the UK and across the globe.

Question 5: Do alternative business models exist? How can policy favour more equitable business models?

Hipgnosis Songs Fund Limited ("Hipgnosis") was founded by Merck Mercuriadis to give the investment community access to extraordinarily successful hit songs by culturally important artists, and to establish songs as an uncorrelated asset class with attractive risk-adjusted returns.

⁴ Hipgnosis Songs Annual Report 2020 - Goldman Sachs (Equity Research) 'Music In the Air' update 2019

A little more than two years later, the company has graduated from the Specialist Funds Segment of the London Stock Exchange (LSE) to a Premium Listing, to now being a £1 billion market cap FTSE 250 company and one of the biggest yielders on the index.

Mr Mercuriadis is a music industry expert with decades of experience. He is the manager of music legend Nile Rodgers and formerly managed award-winning artists and songwriters such as Sir Elton John, Guns’N’Roses, Iron Maiden and Beyoncé. Mr Mercuriadis also served as Director and CEO of The Sanctuary Group PLC from 1986-2007, an independent music management company.

Hipgnosis is disrupting the industry by delivering value for our investors and, crucially, our artists. We see ourselves as ‘Song Managers’ – we act as custodians for the songs we own. Compared to the major music publishing houses, we are viewed as a real and safer alternative who can protect the meaning and legacy of songs as well as securing a song creator’s financial future.

Our business model relies on buying the rights to popular songs and then collecting dividends from their sales and prospective future earnings. When an artist sells the rights to their songs to Hipgnosis they get paid 15 years of royalties up front. This is because we recognise that songs are a unique asset class, protected by copyright for 70 years after the last composer’s death. Therefore, a song can be copyright protected for over 100 years. This long-term security enables Hipgnosis to pay royalties in advance, and ensures that artists are fairly compensated for their work.

An important part of our strategy is obtaining some of the most culturally important and commercially successful songs of all time. To date we own the rights to hits like:

- Sweet Dreams (Are Made of This) - Eurythmics
- Don’t Stop Believin’ – Journey
- Closer – The Chainsmokers
- Let’s Stay Together – Al Green
- ‘Shape of You’ and ‘Castle On The Hill’ – Ed Sheeran
- Uptown Funk – Mark Ronson feat Bruno Mars
- Back To Black – Amy Winehouse
- Shallow – Lady Gaga and Bradley Cooper
- Livin’ on a Prayer – Bon Jovi
- What About Us – Pink
- Love Yourself – Justin Bieber
- Stitches – Shawn Mendes
- Higher Love – Steve Winwood
- Go Your Own Way – Fleetwood Mac
- All I Want for Christmas is You – Mariah Carey
- Gimme Some Lovin’ – Spencer Davis Group
- I’m Not In Love – 10cc
- Teenage Dream – Katy Perry
- Heart of Glass – Blondie

- Good Times – Chic
- We Are Family – Sister Sledge
- U Can't Touch This – MC Hammer
- Brass In Pocket – Pretenders
- Love Shack – B52
- Single Ladies (Put A Ring On It) – Beyonce
- What Makes You Beautiful – One Direction
- Umbrella – Rihanna
- In Da Club – 50 Cent
- Can't Find My Way Home – Blind Faith
- Just Dance – Lady Gaga
- Set Fire To The Rain – Adele
- Locked Out Of Heaven – Bruno Mars

We co-own five of the “Top 10 Songs of the Decade” announced last year by Billboard Magazine, including four of the top five. This was further cemented through the recent acquisition of Mark Ronson’s catalogue, which includes the record-breaking Number 1 hit of the decade ‘Uptown Funk’.

These acquisitions demonstrate how we are putting our strategy in place but, crucially, highlight the fact that these hugely successful artists trust Hipgnosis with their songs.

On a technical level Hipgnosis earns income on our songs through several different revenue streams:

- **Mechanical royalties** – paid to the owner of the composition copyright. Mechanical royalties are also collected by royalty collection agents or the portfolio administrators whom the copyright owner appoints;
- **Performance royalties** – these are collected by various performance rights organisations (“PROs”) worldwide which represent songwriters and other copyright owners; and
- **Synchronisation fees** – these are typically paid directly to the owner of the relevant copyright or its publisher, on the terms and in the amounts agreed with the relevant film or television production company, advertising agency or end customer

Hipgnosis’s alternative business model has proved popular with investors and artists alike. Since our Initial Public Offering on 11 July 2018, and subsequent issues in April 2019, August 2019, October 2019, July 2020 and September 2020, we have raised a total of over £1.05 billion in gross equity capital, demonstrating the market confidence in our business model.

Like the rest of the music industry, streaming is a crucial income generator for Hipgnosis and our artists. Royalties from streaming account for 87% of digital income and approximately 39% of total income (Mechanical accounts for 9%, Performance 35%, Digital 45%, Synchronisation 9% and other 2%).

Looking ahead, streaming represents the largest income growth opportunity seen in the industry for decades. It has saved the music industry by providing a growing revenue stream for rightsholders.