

Entrepreneurship, Competition, and Copyright

Final Paper

IS 296A – P2P Technology: Legal and Policy Challenges

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June 8, 2005

Senator Sam Brownback

303 Hart Senate Office Bldg.

Washington, DC 20510

Dear Senator Brownback,

I am writing you to discuss a topic that is very important to me: support for creativity in this country. I am not writing you as an artist or even as a supporter of the arts, but as a business person. I am an MBA student at the Haas School of Business at UC Berkeley, focusing on entrepreneurship and digital media. I represent the interests of a number of young entrepreneurs with ideas and passion for innovation in the entertainment industry, a group that finds its ability to create new business models limited by the efforts of the dominant players in the industry to control future innovation by influencing copyright policy. I am concerned because these efforts are economically and culturally shortsighted, as well as anti-competitive. As the chairman of the Commerce Subcommittee on Science, Technology and Space, with jurisdiction over technology, innovation, and competitiveness policy, you are in a unique position to encourage a new category of technological growth focused on innovation in the entertainment industry. I encourage you in your proceedings and policy recommendations – starting with your consideration of P2P file-sharing and digital rights management (DRM) technologies – to weigh the issues I outline in this letter against the major players' efforts to retain control of the market supply of resources available for supporting creativity and creative individuals.

Our creative industries find themselves at a unique time in their own history. Content companies' business models are being challenged by players from the technology industry, as well as by upstart ventures with no allegiances to any one industry or business model. As digital technologies threaten the status quo, and thereby the profit margins of the large content companies, the music and film industries in particular have not responded by attempting to adapt to the new environment, but have "focused their initial energies on protecting traditional roles and revenue streams through the legal system."¹ In particular, the focus has been on increasing the total cost to the user of p2p file sharing services and strengthening the capabilities and restrictiveness of DRM technology. The motive for each of these is an attempt to transfer old business models, which were based on selling physical media product, to the new, digital age.

Meanwhile, many new entrants have begun to recognize a long-term opportunity to leverage the benefits of the new media environment to compete with the traditional players. In doing so, they have the potential to redraw the industry structure in a way that spurs enormous growth and at the same time allows a broad artistic environment to flourish in a way that has never before been commercially viable. Copyright policy lies at the center of these efforts, and the large content companies' particular priorities regarding the future of copyright are intended to establish an additional barrier to entry for new players.

¹ *Content and Control: Assessing the Impact of Policy Choices on Potential Online Business Models in the Music and Film Industries*, The Digital Media Project of The Berkman Center for Internet and Society at Harvard Law School, January 7, 2005

As you know, the relative handful of companies that currently dominates the entertainment industry has recently made strategic moves to consolidate and vertically integrate in a continuing battle for the American public's attention. Fewer and fewer companies are coming to produce and own more and more of the media the public consumes, and while some cultural critics are tempted to decry this trend as an evil in and of itself, the truth is that these moves are natural and predictable extensions of the industry's dominant business models. The entertainment industry is a hit-driven business. Record labels, TV and cable networks, and film producers tend to rely on a small percent of their bets hitting "home runs" to pay for the rest that tend to under-perform. Consolidation and vertical integration can reduce certain risks and pressures that contribute to the success or failure of a creative production. For example, when Time Warner purchased AOL, it did so partly to control the terms of innovation across new media platforms. When Sony and BMG music merged, they eliminated a source of potential price pressure on CDs, and also strengthened their bargaining position for raw materials at a time when their margins were being threatened by alternate distribution methods. That these moves result in further limitations on the range of creative works available to the public is a byproduct of what are fundamentally appropriate and necessary responses to prevailing market conditions.

However, there is another trend that should be noticed and prioritized: the tools of creativity are simultaneously becoming better, easier to use, and cheaper. Walter Murch, the legendary film editor whose credits include "Apocalypse Now" and "The English Patient," indicated this when he chose to edit "Cold Mountain," an \$80

million film, on Final Cut Pro, a \$1000 off-the-shelf software product from Apple. PC technology and software are bringing home recording studios within the reach of essentially every musician, and are allowing more amateur filmmakers to produce professional quality films. The internet also allows artists to connect and build relationships with audiences. According to a report by the PEW Internet & American Life Project: Artists, Musicians, and the Internet², two-thirds of the 2,755 musicians surveyed say the internet is “very important” in helping them create and distribute their music. 87% use it to promote their music online; 83% offer free samples online; 77% have their own Web site; 69% sell their music online; 67% claim that the internet has had a big effect on improving their ability to communicate with their audience and fans; and 72% report that the internet has helped them to make more money from their music.

More and more Americans have access to the tools of creativity, but they have found themselves in a media environment controlled by a few companies that can support fewer and fewer creators. These trends are obviously misaligned. The status quo allows only a limited number of artists to create professionally-produced works and to market them effectively. Despite that fact, a large number of artists continue to constitute a "long tail" in the entertainment business – most of those artists have relatively small audiences, but taken as an aggregate they represent billions of dollars in sales and millions of consumers. To the major players in the entertainment industry, the scale of these artists' success is commercially

² http://www.pewinternet.org/pdfs/PIP_Artists.Musicians_Report.pdf

uninteresting, and so the bulk of the resources available to generate exposure for artists are reserved for a handful of potential hit-makers.

If the resources were available, hundreds of thousands of creators would be empowered to focus on their art, build stronger relationships with audiences, and have realistic access to the public's attention. Amateurs would be enabled to become professionals by spending more of their time and energy producing creative works, and a truly sustainable creative class of society would emerge, larger and more influential and more inspiring than any that our society has ever seen. The tools exist to enable a new, digital renaissance where art and business are aligned by virtue of new business models for media that grow the size of the pie and allocate it in a way that allows more and more people to make careers as creative professionals. At present, the entertainment industry is ill-equipped to monetize the "long tail" of creative individuals. This is partly because, as Chris Anderson says in now ubiquitous article from Wired magazine, "Many of our assumptions about popular taste are actually artifacts of poor supply-and-demand matching - a market response to inefficient distribution."³ Put another way, the era of physical media created products that were rival (meaning that consumption by one person limits consumption of another), and excludable (meaning that once the product exists, the benefit can be limited to those who have paid for it).⁴ In the digital era, where media is not tied to a physical product, entrepreneurs should not be forced to work with the

³ <http://www.wired.com/wired/archive/12.10/tail.html>

⁴ Rachna Dhamija and Frederik Wallenberg, *A Framework for Evaluating Digital Rights Management Proposals*

same constraints. The dominance of physical media models in the digital media age represents an enormous market inefficiency.

This inefficiency is at the core of the opportunity currently presenting itself to entrepreneurs like myself. The music category of the entertainment business serves as a strong example here. It has become conventional wisdom that the current business models in music are in flux, and players large and small are on the move to redefine the playing field. Many of these companies are focused on the dissemination of music through new, digital channels. Napster, for example, has reemerged as a copyright-protected subscription service that allows subscribers to transfer the playlists they create online onto their portable devices – the first ever effort of its kind. Microsoft, whose Janus DRM software enables this functionality, is quickly establishing partnerships with consumer electronics companies to define the standard for digital distribution of music. Startups such as Weedshare, and Wippit are focusing on legitimizing p2p technology; firms like Snocap, Grouper, and Mercora are developing “legal sharing” services; intermediaries like The Orchard and Digital Rights Agency, and Ioda are aggregating independent music for digital distribution through services like Rhapsody and iTunes; and countless new sites and technologies for music discovery and promotion have emerged, from consumer preference systems like Savage Beast and Music Match to social networks such as MySpace.com and Tribe.net. Most of these efforts have focused on creating innovative ways for consumers to find and purchase music. Such developments indicate a groundswell of opportunity based on addressing the supply-demand mismatch and monetizing the long tail of music. Venture capitalists and private equity

firms such as Dimensional Associates and Walden VC have committed entire funds to investing in new digital media ventures. A large group of entrepreneurs and investors is currently at work proving Anderson's thesis that the value deep in the long tail, if it is unlocked by ventures such as these, will ultimately outweigh the value of the hits being produced by the major labels.

But as long as copyright policy continues to serve the interests of the traditional leaders in this industry, whose business models and core skills fit perfectly with the pre-PC and internet era but who have failed to adapt to the new technological environment, these entrepreneurial efforts will be unable to compete on their own terms, and will come to rely on the current leaders for their success. Without it, they will certainly fail. The result will be compounded market inefficiency, a legacy of stifled innovation, a weaker competitive position in the global marketplace for creative works, and an enormous growth opportunity missed.

Of course the music industry is only one of many categories within the entertainment industry. Similar trends are occurring in film, television, gaming, and publishing. The success of entrepreneurial efforts to bring long tail strategies into these categories requires neutral application of copyright law in order to compete with major, established players.

I believe there are two tangible actions that Congress can take in order to ensure that our copyright policy is not unduly influenced by large content companies, in order to encourage innovation and the tremendous growth it will bring in the digital media industry:

- 1) Clarify and uphold the safe harbor provision set forth in the Sony Betamax Supreme Court case, and decline to legislate further on secondary liability for p2p file-sharing networks;
- 2) Introduce legislation that establishes a moratorium on any new, protective, legislative measures for physical media business models.

Sony Safe Harbor

MGM v. Grokster, currently under review by the Supreme Court, will likely be deferred to Congress because of a lack of clarity in the Copyright Act relative to the key issues in this case. In particular, the Court may look to Congress for clarification of the Copyright Act's treatment of secondary liability. Although it may not seem completely obvious, the safe harbor provision in the Sony Betamax case provides an excellent foundation for Congress' consideration of secondary liability. This provision has contributed to growth in the technology industry, and in the U.S. economy as a whole. It has provided a clear and certain policy environment within which entrepreneurs have been able to innovate, and drive a boom in the technology industry over the past 20 years. The Sony Betamax decision has proven to establish a robust standard for determining the conditions of secondary liability, and in the process has enabled growth in the technology industry, and ultimately in the entertainment industry as well.

It may be tempting to treat the new challenges posed by p2p technologies differently from the issues raised in the Sony Betamax case. MGM has argued that, "Sony-Betamax did not purport to decide how principles of secondary liability apply in

circumstances like those present here...”⁵, and that the issues of “non-infringing use” are completely different in the two cases. MGM claims that the Ninth Circuit was not critical enough of Grokster’s and StreamCast’s efforts to establish “substantial non-infringing uses” of their services. MGM also attempted to differentiate the two cases by saying, “The Predominant use of the Betamax machine... was fair use. The predominant use of the Grokster and StreamCast services is undisputed infringement.”⁶ By trying to establish this new concept of “primary use,” MGM is entering very dangerous territory, and these claims and the implications of their adoption should be treated critically.

This type of standard – where the primary use of new technologies is independently assessed, contradicts many of the market conditions that enable technology firms to develop successful product strategies. Platform technologies, for example – such as operating systems, pluggable devices, and communication networks (including the internet itself) -- are a highly valuable category of technology product, while the end use of these technologies is often impossible to predict. Further, convergence of features and functionality is often a design requirement for new technologies; when a product is designed for multiple uses, the concept of “primary use” is meaningless. Allowing another industry to map such concepts onto the technology landscape would result in a dictated way of thinking about technical design that is different from the patterns that have naturally evolved in the technology industry. The standard that MGM would like to use to judge the substantiality of a

⁵ MGM Petition to the U.S. Supreme Court for a Writ of Certiorari, page 2

⁶ Ibid, page 21

non-infringing use of a new technology, therefore, is at best structurally unfit for application to the technology industry. If it were applied anyway, such a redefinition of the Sony Betamax safe harbor would destabilize the investment environment and prevent the development of valuable new technology products, criminalize developers of p2p technologies, and place control of innovation more firmly in the hands of major entertainment players, destroying incentives to innovate by any player, old or new.

Accepting MGM's definition of secondary liability would skew copyright policy even further in favor of the major players in the entertainment industry. It is not enough to say that the content industry as a whole will benefit from outlawing p2p services, however. In describing the "ambiguous theoretical effect" of file sharing on record sales, a recent Harvard Business School study also claimed that, "...file sharing allows users to learn about music they would not otherwise be exposed to.... This learning may promote new sales."⁷ The study also found that 80% of a group of file sharers surveyed reported that they bought at least one album after first sampling it on a file sharing network. The *PEW Internet & American Life Project: Artists, Musicians, and the Internet* study found that two-thirds of the musicians surveyed feel that file-sharing poses a minor threat or no threat at all to their ability to sell their own music.⁸ Many musicians surveyed in the PEW study claim to have benefited from posting their music online – for artists who do not have access to traditional channels

⁷ F. Oberholzer and K. Strumpf, *The Effect of File Sharing on Record Sales: An Empirical Analysis*, Working paper, March 2004, pages 2-3

⁸ http://www.pewinternet.org/pdfs/PIP_Artists.Musicians_Report.pdf

to promote and distribute their work, the internet and file sharing technologies are tools that artists can use to create a market for their work.

While p2p networks may benefit major labels as much as independent musicians, the majors have determined that such ambiguous benefits should be ignored since they do not come close to outweighing the costs associated with ceding control of distribution to a third-party. Their response has been to take legal efforts to shut down the p2p networks, despite evidence that many content owners and creative individuals benefit from them. If the majors are successful, entrepreneurs will hesitate to develop other tools that can be used to shift the balance of power away from the major players, for fear of successful retaliation. Copyright issues are so fundamental to the design of such systems that as long as large entertainment companies are allowed to influence the terms of copyright policy, they will also control technological innovation. This will continue to limit the public's access to a rich variety of creative voices, and will prevent the enormous growth that is possible if new entrants are encouraged to develop long-tail solutions that take full advantage of new technologies.

Alternative Business Models

File sharing networks are just one category of venture that has emerged to challenge the control of major content owners. While the legality of these services is of course under question, one important aspect about them is that they operate on a completely different set of assumptions about media from the large media companies'. Outside of file sharing networks, most digital media ventures to date have centered around business models have that sought to either 1) make the

product *rival*, i.e., impossible to share; or 2) make the product excludable, i.e., allow only those who pay for it to use it. As Rachna Dhamija and Frederik Wallenberg point out, there is a third approach to the problem of converting old, physical media models into new, digital ones: “accept that a product is a public good that is non-rival and non-excludable.”⁹ Regardless of the legality of file sharing services, they fall into this last category. Grokster, Kazaa, and the other networks use an alternative yet familiar business model – advertising – to generate revenue from their media distribution services. In addition, their cost of distribution is much lower than that of traditional media companies, further contributing to the competitive viability of these businesses. Treating copyrighted material as a public good is a completely foreign concept to large media companies, which have built their businesses around tight control of copyright via the natural rivalry and excludability provided by physical media. Their business models will only work in the digital age if the same sort of control can be established in the digital space.

One could imagine a variety of other services that recognize the public good nature of digital media, allowing perfect copies to be freely distributed. The Committee for Economic Development has suggested that, “The development and testing of new business models for the distribution of creative content should be given the highest priority by the content industries. We should not turn to law or regulation to protect any particular business model.”¹⁰ The report also suggests that

⁹ Rachna Dhamija and Frederik Wallenberg, *A Framework for Evaluating Digital Rights Management Proposals*

¹⁰ COMMITTEE FOR ECONOMIC DEVELOPMENT, *PROMOTING INNOVATION AND ECONOMIC GROWTH: THE SPECIAL PROBLEM OF DIGITAL INTELLECTUAL PROPERTY (2004)*

the best business models for the digital age are those that recognize these “natural laws” of the digital economy, and employ them to address consumers’ needs. However, not only are the large companies’ efforts to strengthen copyright protection distracting them from experimenting with new models themselves, they are preventing new entrants – who recognize the natural laws of the digital economy and who are unencumbered by old business models – from developing services that appropriately address the needs of the current market.

The content industry’s favored policy initiatives, which it is pursuing in order to gain legal protection for their business models, involve strengthening the allowable restrictions provided by DRM technologies, and improving the enforceability and penalties related infringement laws. I encourage you and the rest of Congress to resist any legislation that attempts to set government standards for DRM technologies, or to increase government involvement in enforcing infringement claims. Further, I encourage you to introduce legislation that serves to clarify the government’s role in protecting copyright and encouraging innovation by establishing a three-year moratorium on Congress’ ability to introduce legislation that provides any new protective measures for old business models.

It should be Congress’ position that a market solution to the current challenges will emerge if no single constituency is given undue protection or support for their existing source of competitive advantage. The types of protection that the content industry would like to see mandated – more restrictive DRM technologies,; looser definitions and harsher punishments for secondary infringement; assistance in

targeting and receiving remuneration from primary infringer; extension of copyright terms -- all contribute to the industry's efforts to apply physical media models to the digital age, and are all within the jurisdiction of Congress' oversight of the Copyright Act. If these policies are allowed, an industry's revenues may be secure, but growth will be limited to the levels that were possible in the physical media world. Indeed, if the content industry is able to map its old models onto the new technology environment, and thereby stabilize itself, it will have no incentive to experiment with new models, even once its future is secure. An opportunity will have been missed.

This experimentation will occur naturally by new entrants into the content industry, as long as the protective measures described above are not enacted. The music industry alone is a \$32 billion business worldwide,¹¹ and with so many obvious avenues of growth, entrepreneurs will work hard to develop new services that meet consumers' needs.

Conclusion

The transition from physical to digital distribution of media is now in progress, and this transition has important commercial and cultural implications. While copyright policy has shifted over the years, usually to the increased benefit of content owners,¹² we are at a point in history where continued strengthening of copyright protection will not necessary produce a net economic benefit to society. Copyright protection surely benefits the traditional leaders in the content industry, which explains these companies' all-consuming efforts to influence the direction of copyright

¹¹ Recording Industry Association of America website: www.riaa.com

policy in their favor. However, a new category of players is poised to respond to customer demand and leverage advantageous technologies, in order to develop new media distribution products and services that could ultimately combine to dwarf the content industry as it currently exists.

“Digital advancements have exacerbated the historic tension between copyright holders (generally the entertainment industry), technology providers and consumers, especially for recorded music, movies and print.¹³ As an entrepreneur and a consumer, I see tremendous value in the new category of media technologies that can be developed as long as copyright protection does not become more restrictive. I welcome an opportunity to continue this conversation with you, and I hope I have provided a vision of what is possible if entrepreneurs are given the freedom to respond to market dynamics and capture emerging value in the new digital media environment.

Sincerely,

Peter Vlastelica

Haas School of Business, UC Berkeley

¹² *Copyright and Digital Media in a Post-Napster World (and International Supplement)*, Gartner | G2 and The Berkman Center for Internet and Society at Harvard Law School, January 2005

¹³ Ibid.