

## Responses to Additional Questions For the Record

J. Howard Beales III  
Professor, Strategic Management and Public Policy  
George Washington School of Business

### Additional Questions for the Record

#### **The Honorable Lee Terry**

1. In 1975 and 1980, this Committee placed safeguards on the FTC's authority following a number of large and significant rules the agency issued in the 1970's, including a very controversial rule to regulate children's advertising. These rules have been in place for about 35 years in order to ensure the Commission can promulgate the best rules possible for all businesses and consumers. Congress acted in part because the FTC (unlike some other agencies that have narrower jurisdiction) has vast authority to identify and sanction unfair and deceptive acts or practices across nearly every sector of the economy, and it doesn't focus on specific industry technology or practices. In fact, former FTC Chairman Kovacic has said that "no regulatory agency in the United States matches the breadth and economic reach of the Commission's mandates."

a. Do you think the FTC has been effective in protecting consumers during the 35-plus years since the FTC Act was amended and changed the procedures for their rule writing authority?

Since 1980, the Commission has developed a sound, effective, and largely bipartisan program for protecting consumers. Its considerable efforts to pursue fraudulent practices have returned substantial sums to injured consumers. Its efforts to work with the criminal authorities to put fraudsters in jail can help increase deterrence of fraud beyond what civil remedies alone can provide.

b. Do you agree that, as current law requires, the FTC should ensure that its rules are narrowly tailored, based on sufficient information, and able to withstand appropriate judicial review?

Case by case law enforcement provides more flexibility than rigid rules, and can more easily adapt to changing circumstances, changing business practices, and changing priorities. Because rules apply across the board, they should be narrowly tailored to address common problems in the most cost effective manner possible. Doing so requires systematic evidence of the nature and frequency of the problems the rule seeks to prevent, and careful analysis of the costs of the remedy.

2. Here are some of the differences between the FTC Act and the "notice-and-comment" rulemaking that is undertaken by some other agencies.

- **Prevalence:** The FTC must identify a pattern of activity – a prevalence, as opposed to one instance – before engaging in a rulemaking. There is no similar requirement in notice-and-comment rulemaking.
- **Disputed issues.** If the FTC concludes that there is a disputed issue of material fact in a rulemaking, the agency must permit cross-examination of witnesses in a pre-rulemaking hearing and afford the right to offer rebuttal comment. That gives all parties the opportunity to participate. Those requirements don't apply notice-and-comment rulemaking.
- **Economic effect.** When the FTC issues a rule, it is required to provide "a statement as to the economic effect of the rule, taking into account the effect on small business and consumers." That seems eminently reasonable to me, yet it is not required by notice-and-comment rulemaking.

Do you agree that these are good protections both for consumers and businesses?

Since 1981, notice and comment rulemaking at executive branch agencies has been subject to Executive Orders requiring that the benefits of the rule are sufficient to justify the costs. Because the FTC is an independent agency, it is not subject to this requirement. Nevertheless, it should only regulate if the benefits are sufficient to outweigh the costs. The statutory requirement for prevalence helps to assure that problems are sufficiently common that regulation could produce significant benefits. The requirement to address the economic effects of the rule requires the Commission to consider the costs of its actions. Precisely because the FTC is not subject to the cost-benefit requirements that govern executive branch agencies, these provisions are particularly important.

When key facts are in dispute, cross-examination is a widely recognized and widely used method of getting at the truth. Rebuttal comments serve a similar purpose, allowing all participants in the rulemaking the opportunity to address the logical and factual flaws in the arguments offered by other parties. Although wide-ranging cross examination can be time consuming, the Commission can avoid this problem with carefully crafted rulemaking proposals. If proposed rules are narrowly drawn, with clear theories of why a practice is unfair or deceptive, the inquiry can be limited to the key factual matters that the Commission must resolve to determine whether the rule is appropriate.

Thus, all three protections – prevalence, disputed issues, and economic effects – are important, particularly for an agency with the breadth of authority and jurisdiction as great as that of the FTC.

3. It appears to me that those who argue for the FTC to have general notice-and-comment rulemaking authority under the APA must believe that the FTC does not possess sufficient authority today to identify, penalize and prevent bad actors from taking actions detrimental to consumers. Yet we've heard testimony today and in the past repeatedly about how effective the FTC is, so that doesn't seem consistent. What are your thoughts here?

The Commission has the tools it needs to address bad actors. In particular, the ability to obtain restitution for consumers usually offers far greater monetary relief than civil penalties for rule violations would provide. Rules can be useful to set bright-line standards to make clear that a violation has occurred, thereby simplifying prosecution in some cases. In most cases, however, establishing that the challenged conduct is unfair or deceptive is not particularly onerous.

4. In some specific areas, the Congress has given the FTC targeted authority to use notice-and-comment rulemaking. Some of these instances include the Telemarketing and Consumer Fraud and Abuse Prevention Act (1994), the Children's On-Line Privacy rulemaking required in 1998, and the Gramm-Leach-Bliley Act (1999) regarding financial institutions and consumer privacy. This "case-by-case" approach to notice-and-comment rulemaking ensures that, where it is needed, the FTC can address a specific issue in the manner that Congress has determined.

- a. Do you agree that these specific directions from Congress have been working well?

Notice and comment rulemaking has generally worked well when used to implement a specific statutory scheme that Congress has devised. In many such instances, the issue is not whether to regulate, because Congress has required rulemaking. Rather, the question is how best to implement the statute. Such rules are generally narrower in scope than rules defining, and attempting to prevent, unfair or deceptive practices that may cut across numerous industries.

- b. Would you agree with former FTC Chairman Kovacic when he stated that this is the best approach to FTC rulemaking, given the broad subject matter authority and economic effects that FTC decisions can have across the economy?

When Congress desires that the Commission address specific questions regarding the implementation of a statute, notice and comment rulemaking is an appropriate means of regulating. When the issues are broader, the extra protections of the prevalence requirement, designated issues, and the requirement to address economic effects are appropriate.

5. You have articulated that restricting advertising because some consumers will misunderstand will leave the majority of consumers in relative ignorance. You state the Commission needs to return its focus to the average viewer. How would this help consumers? How do we get the FTC to change its focus?

An advertisement that provides accurate information to the average person who sees the ad effectively increases the number of informed consumers in the marketplace. When the average consumer understands the advertisement correctly, the average consumer can make better choices. If the Commission prohibits that advertisement because a minority of

consumers might misunderstand the message in a way that is misleading, it is likely reducing the number of informed consumers in the marketplace. That is clearly harmful to the consumers who lose information that they correctly understood. It is harmful to other consumers as well, because competition for informed consumers assures that all sellers must offer consumers the best possible combination of price and quality.

Of course, in some instances, it may be possible to reduce the number of people who take away a misleading message without compromising the information that the majority of the audience receives, but that is not always the case. In all probability, some people will always discount or ignore qualifications that are included in an advertisement or on a label. In such cases, it is necessary to balance the interests of the majority in knowing about promising or emerging evidence against the potential costs to those who ignore the qualifications.

The Commission's position on claims that energy-efficient windows can save "up to" a certain amount of energy are a good example of the problem. Because it was concerned that a minority might be misled by such claims, it warned manufacturers that they could not make such claims unless almost all consumers would experience the result. Even the average savings would not satisfy this standard, since in general about half of consumers would experience below average results. Nor is this a case where the misimpression can easily be corrected. The Commission's copy test found significant misunderstanding of *all* versions of the advertisement that it tested.

Congress should ask the Commission to explain how ignoring the information needs of the majority of consumers helps protect either consumers or the market.

6. The FTC's recent path on advertising substantiation for dietary supplements has required two randomized, placebo controlled, double blind clinical trials to satisfy the substantiation requirements.
  - a. What effect will that requirement have on the ability of supplement manufacturers to advertise?

Virtually no claims for dietary supplements are supported by two clinical trials that meet the standards the Commission has been insisting on in recent cases. If the Commission continues to insist on this standard, supplement manufacturers will be able to tell consumers what their product is, but they will not be able to say why anyone might be interested in using it. That information will have to come from elsewhere.

- b. Does the new requirement effectively displace the Commission's guide: "Dietary Supplements: An Advertising Guide for Industry"?

The Dietary Supplements Guide follows the Commission's traditional approach to advertising substantiation, which balances the risks of mistakenly allowing false claims against the risks of mistakenly prohibiting truthful claims. Using this approach, the

Guides require that claims be supported by “competent and reliable scientific evidence.” The two clinical test requirement essentially abandons that approach. Although the Commission maintains that only “bad actors” are subject to the new standard, no responsible manufacturer can ignore the fact that recent orders uniformly require two clinical trials.

- c. Are consumers harmed by restricted advertising? How?

A wide variety of empirical studies, including those conducted by the FTC itself, establish that restrictions on advertising tend to increase product prices, discourage product improvements, and widen the gaps between different demographic groups. The FTC’s study of the introduction of health claims for high fiber cereals in 1984 found that the claims led to the largest increases in fiber consumption for non-whites and single parent households. Earlier studies of the effects of restrictions on eyeglass advertising found that prices were higher for everyone, with the least educated consumers paying the highest prices.

- d. What would the effect on consumer welfare be if the same standard were applied to advertising claims for “healthy” food?

Applying a requirement for two clinical trials to claims about the relationship between diet and disease would deprive consumers of valuable health information. Many FDA-approved health claims are based largely on epidemiological evidence, as is much of our knowledge of the relationship between diet and disease. Clinical trials to determine whether increased calcium consumption in young adults reduces the risk of osteoporosis, for example, would require following young women for 50 to 60 years. Such trials are simply not feasible. Similarly, many recommendations in the government’s Dietary Guidelines for Americans 2010 are not supported by clinical trials. The recommendation to eat more fruits and vegetables, for example, cites an association between higher levels of consumption and reduced risk of chronic diseases, but no clinical trials. Applied to foods, the two clinical trial requirement would deprive consumers of this important information.

- e. Have the FTC’s new substantiation requirements effectively reversed Congressional intent established in the Dietary Supplement and Health Education Act? If yes, what should Congress do to fix this?

The two clinical testing requirement effectively reverses DSHEA. Congress sought to remove dietary supplements from the new drug approval process, but the FTC has adopted essentially the same evidentiary requirements. Congress could clarify that “competent and reliable scientific evidence” constitutes a reasonable basis for claims about dietary supplements.

7. You stated the recent expansion of the 13(b) authority the FTC may use to freeze assets or force disgorgement of ill-gotten gains --historically used in fraud cases – is being used for consumer redress in cases involving questions about substantiation in national advertising campaigns. Your testimony mentioned this threatens to undermine the FTC’s consumer protection mission. Could you please explain why? Why do you say it is wrong as a matter of law?

The Supreme Court has said that if a court can issue an injunction, it can also exercise any of its equitable powers, including redress and disgorgement, unless Congress clearly intended otherwise. The Commission first received the authority to obtain injunctions in a “proper” case, and two years later received the authority to obtain redress if the conduct was dishonest or fraudulent. Both provisions, however, were initially part of the same bill. Clearly Congress did not think that the injunction authority included redress authority, or the separate redress provision would have been wholly unnecessary. We therefore believe the Commission’s reading of the statute as allowing redress in any case it brings is incorrect.

The danger to the Commission’s consumer protection mission is twofold. First, the statutory foundation of the fraud program is uncertain, given a careful reading of the legislative history. Attempting to obtain redress in cases that do not involve fraudulent or dishonest conduct runs the risk that courts will reexamine the extent of the Commission’s authority in fraud cases as well, and find it lacking. Second, in fraud cases, the Commission and the courts have generally treated the respondent’s total revenue from sales of the product as the measure of damages that must be returned to the consumer. That measure, however, is unreasonable when applied to traditional substantiation cases for well-established products. Courts will need to develop more sophisticated measure of damages, which may in turn reduce the amount of money the Commission can obtain in fraud cases.

8. When the Commission pursues substantiation cases for products whose majority of sales are not related to the claim, what is the opportunity cost? Is the Commission neglecting actual fraud cases?

Any case has an opportunity cost, and there are always more fraud cases than the Commission can bring. Nonetheless, preventing deceptive claims even when there are other, legitimate reasons that many consumers purchase the product is useful. That is particularly the case when competing products actually have the feature or attribute, because, but for the deception, consumers could have actually obtained what they wanted.

The problem is not pursuing the substantiation case in such instances; rather, it is pursuing money. Total sales are not a reasonable measure of damages, because many consumers purchase the product for reasons that are completely unrelated to the misleading claim, and therefore are not injured by the claim. Redress should only reflect the sales attributable to the deceptive claim, rather than all sales.

9. You referenced the Commission's Deception Policy Statement adopted in 1983. What prompted the development and adoption of this policy statement? What was the effect of issuing the policy statement?

Early Commission cases were based on the notion that the Commission should seek to protect the ignorant, the unthinking, and the credulous from every possible misinterpretation of an advertisement, a standard that was known as the "fools test." The result was many cases that challenged bizarre interpretations of advertisements that consumers were highly unlikely to share in any significant number. This approach often made it difficult for advertisers to tell consumers about important product features, because there is always some risk of consumer misinterpretation. As noted in my testimony, academic studies of brief communications find that whether the message is an advertisement or editorial content, 20 to 30 percent of consumers misunderstand the message.

As the Commission came to recognize the important role of advertising in providing information to facilitate competitive markets, it shifted its focus away from the fools test. Indeed, it essentially abandoned the fools test in a 1963 case. Instead, later cases focused on the meaning of the advertisement to the ordinary viewer, or the average listener, or the reasonable consumer. The Deception Policy Statement sought to synthesize these cases into a coherent summary of the law of deception, making clear that the Commission was no longer using the fools test.

When the Deception Policy Statement was adopted in litigated cases and endorsed by the courts of appeal, it became the standard for finding a claim deceptive. It has worked well for many years, and generally has kept the Commission's efforts focused on claims that are likely to mislead the typical recipient of the claim.

In its most recent cases, however, the Commission has let the exception swallow the rule. Without even discussing how ordinary consumers are likely to interpret a message, and without any attempt to distinguish between real deception and the background noise that attends any communication, the Commission has simply asserted that at least a "significant minority" of consumers shares the interpretation of the advertisement that it is challenging. This represents a significant move back towards the fools test that the Commission abandoned in 1963.

10. What is the practical effect of issuing guidelines? For instance, you referenced the "privacy framework" the Commission recently adopted. Should we be concerned that such guidelines or frameworks become a de facto standard or rule – one that is born outside of the rulemaking process?

The Commission has issued a number of Guides that indicate how it will use its enforcement discretion in deciding which practices to challenge. For example, the Guides for the Use of Environmental Marketing Claims explain how the Commission approaches environmental

claims, and identifies the kinds of qualifications of claims that may be necessary to avoid deception. “Dietary Supplements: An Advertising Guide for Industry,” is a similar guide. These and other Guides do not have the force of law; in any case brought challenging a practice identified as deceptive in a guide, the Commission must establish that the practice is either unfair or deceptive. Guides such as these identify practices that the Commission believes are law violations, and are generally adopted through a notice and comment rulemaking process.

Other “guides,” such as the privacy report, are Commission documents adopted after, for example, a workshop addressing the issues. The Privacy Report recognizes that some of its recommendations are beyond what the Commission has the authority to require, but it is often unclear about the difference between what the law requires and what the Commission considers “best practices.” Business education materials based on the report simply address the recommendations, without acknowledging that some are beyond what the law would require. There are grounds for concern that the Commission is attempting to set a standard without rulemaking, and, as it acknowledges, beyond its authority.

11. You point out that while too stringent regulation or enforcement can stifle innovation in the technology space, too little regulation or enforcement increases the risk of consumer harm in terms of privacy, so it is a question of balance. How do you believe the FTC is doing in performing this balancing act?

Some recent cases give cause for concern. The Commission’s HTC America consent is a relatively heavy handed intervention in the competition between open mobile operating systems such as Android and proprietary systems such as Apple. One of the inherent advantages of proprietary systems is that the provider can update them quickly and easily, because it has no need to customize the software for different wireless carriers or networks. In contrast, updates on open systems may require coordination of several parties. Such systems also allow more freedom for innovation, however, because other service providers can add their own unique features. The Commission’s consent seeks to make open systems behave more like closed ones, which will likely reduce the innovation advantages of open systems. That, however, is a choice that should be made in the marketplace.

12. You suggest that one way to reduce the risk of overregulation or enforcement is “by focusing on real and identifiable harms.” How would you define this? Is this something Congress needs to do or is the FTC equipped to do this?

Tort law has a long history of insisting on harm as a necessary element of a tort, and has reasonably clear concepts of what constitutes an actionable harm and what does not. The Commission should focus on the kinds of harms that are necessary for recovery at common law, not more subjective standards of what kinds of practices are “creepy.”