The FTC and Privacy Regulation: The Missing Role of Economics

George Mason University Law and Economics Center

Briefing on Nomi, Spokeo, and Privacy Harms

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Joshua D. Wright[*]

[*] Professor, George Mason University School of Law and Director, Global Antitrust Institute.

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INTRODUCTION

Good morning, I am pleased to be here today for the Law and Economics Center's Briefing on Nomi, Spokeo, and Privacy Harms. I want to thank the Law and Economics Center for the invitation to speak with you today, and especially my colleague James Cooper. I'm very excited about his work here at the Law and Economics Center on privacy and economics. And it is nice to finally be able to give a speech where I do not have to begin with a disclaimer about how the things I am about to say are not the views of the Commissioner or any of its Commissioners.

Privacy is an ever-evolving and remarkably important regulatory landscape and it has been, unfortunately in my view, even more remarkably resistant to the influence of economics. As an antitrust economist, law professor, and practitioner, I see close parallels between privacy regulation and competition law and policy. The problem is that the closest parallels are to antitrust in the 1960s – before the influence of economics had made that body of law coherent as a consumer welfare prescription. That resistance to economics is harming consumers. We can do better. The FTC has the tools to do better right now.

I'm going to focus my remarks on how the FTC can and should integrate economics in assessing privacy regulation. I will also focus more specifically upon the FTC's settlement with *Nomi*. In particular, as I argued in my dissent in that case, why a consumer-welfare focused and economic approach to privacy regulation requires that promises in privacy policies be proven rather than presumed material to consumers. Presuming materiality when actual evidence of consumer behavior suggests otherwise is even more misguided.

ECONOMIC ANALYSIS OF PRIVACY AT THE FTC

A primary goal of my tenure at the FTC was to encourage a deeper integration of economics and cost-benefit analysis into the consumer protection framework at the Commission. The hesitancy to fully incorporate economic tools into consumer protection analysis is discouraging, but not completely surprising given the Commission's portfolio of consumer protection work. It is important to understand where the reluctance and resistance comes from in order to know how to fix it.

The issue is not whether economics will influence privacy regulation, but when. So let me start with what is intended to be a provocative proposition: economic analysis of privacy will exert a significant influence on the development of law and regulation in this area within this decade. In the 1960s and 70s, antitrust lawyers and agencies too were reluctant to allow economic analysis to seep into their body of law. But as was the case with antitrust, it will simply be impossible for privacy – which is inherently economic regulation – to remain impervious to the insights from economics, such as how firms compete with respect to privacy protections, the effect of privacy regulation on consumer welfare and competition, and consumer preferences for privacy.

So let's begin with why the FTC has rejected an economic view of privacy thus far. The vast majority of work that the Bureau of Consumer Protection performs simply does not require significant economic analysis. In most consumer protection cases, the business practices at issue create substantial risk of consumer harm but little or nothing in the way of consumer benefits. A team of Ph.D. economists, or even one, is usually unnecessary in a simple fraud case. The FTC's consumer protection arm has "grown up" around its deception authority. The consumer protection enforcement culture at the FTC remains at its core one that contemplates its role as smiting out business practices that always harm consumers. That approach is substantively correct, intellectually coherent, and efficient when applied to business conduct like fraud that always harms consumers.

Applying economic theory in the consumer protection realm at all is a fairly recent development. Only in 1980, when the Commission adopted the Policy Statement on Unfairness, did it begin considering the benefits of various business practices on consumers. Under this revised standard, and as subsequently codified by Congress in 1994 in Section 5(n) of the FTC Act, the agency may pursue enforcement action on the basis of "unfairness," in cases where an act or practice "causes or is likely to cause substantial injury to consumers which is not reasonably avoidable by consumers themselves and not outweighed by countervailing benefits to consumers or competition." In reformulating its unfairness standard, the Commission recognized that in utilizing its authority to deem an act or practice as "unfair" it must undertake a much more rigorous analysis than is necessary when it uses its deception authority. However, even deception authority is not immune to the need for analysis. It too has a proxy for analysis of whether an unavoidable injury occurred – the "materiality" requirement codified in the Commission's 1983 Policy Statement on Deception, which I will discuss in a moment.

There are technological and economic forces that point toward an inevitable conflict between the old, fraud-based consumer protection culture at the FTC and the realities of the digital economy. For example, as we become fully immersed in the digital age, and as the Commission considers policy issues relating to topics such as the "Internet of Things," this conflict becomes apparent. On one hand, there are innumerable gains to consumers from new and enhanced products and services resulting from the Internet of Things, all of which depend critically upon the free flow and exchange of data. While on the other hand, there are privacy and data security concerns that may arise *because* of that free flow and exchange of data.

An economic approach to privacy regulation is guided by the tradeoff between the consumer welfare benefits of these new and enhanced products and services against the potential harm to consumers, both of which arise from the same free flow and exchange of data. Unfortunately, government regulators have instead been slow, and at times outright reluctant, to embrace the flow of data. What I saw during my time at the FTC is what appears to be a generalized apprehension about the collection and use of data – whether or not the data is actually personally identifiable or sensitive – along with a corresponding, and arguably crippling, fear about the possible misuse of such data.

This generalized fear of data takes many forms. And it has many costs. Any sensible approach to regulating the collection and use of data will take into account the risk of abuses that will harm consumers. But those risks must be weighed with as much precision as possible, as is the case with potential consumer benefits, in order to guide sensible policy for data collection and use. The appropriate calibration, of course, turns on our best estimates of how policy changes will actually impact consumers on the margin, not whether we can identify plausible yet speculative narratives about how particular business practices might result in consumer harm.

The failure to engage in a thorough and appropriate cost-benefit analysis that incorporates recent economic insights can lead to serious policy errors. And, unfortunately, this failure has remained all too common in the FTC's consumer protection work involving the digital economy generally, and privacy regulation specifically. If the benefits of these welfare-enhancing business practices are not weighed correctly against the harms they present to consumers, we run the risk of squelching innovation and depriving consumers of these benefits. There is still serious resistance to adequately accounting for the full economic costs and benefits of various business decisions and practices.

The tendency appears to be to discount benefits, as is the case in the Internet of Things Report. As I noted in my dissent, the Report only "pay[s] lip service to the obvious fact that the various best practices and proposals . . . might have both costs and benefits," and places far too much emphasis on speculative and anecdotal risks without adequately assessing whether the benefits of these new technologies outweigh the concerns. Indeed, the Report seems to go out of its way to avoid discussing key components of how the Internet of Things is already improving society – for example, not adequately considering how consumer-facing Internet of Things devices fuel the development of smart cities, smart grids, and other socially beneficially technologies.

Other times, the Commission simply asserts that consumer benefits do not exist, as the Commission chose to do in justifying its settlement with Apple. In Apple, the Commission found unlawful Apple's decision to allow the entry of a password upon a first transaction to trigger a 15-minute window during which users could make additional purchases without reentering the password. The Commission's clear disregard for rigorous cost-benefit analysis in Apple is also apparent in various recent Workshop Reports produced by the FTC – for example, the Data Broker Report or the Internet of Things Report – that disseminate best practices and legislative recommendations without conducting such an analysis. In other contexts, the FTC relies upon slogans like "data minimization" and "security by design" to guide policy decisions – but those slogans and catchphrases simply don't bear any meaningful analytical content and their pursuit at any cost will simply mean higher prices and less useful products for consumers.

This is simply not good enough; there is too much at stake for consumers as the Digital Revolution begins to transform their homes, vehicles, and other aspects of daily life, not to mention the potential for addressing societal problems on a broader scale. What is needed to guide consumer-welfare enhancing privacy regulation is an economic and evidence-based approach sensitive to key tradeoffs between the value to consumers and society of the free flow and exchange of data and the creation of new products and services on the one hand, against the value lost by consumers from any associated reduction in privacy.

I've been fairly critical of the FTC to this point. But it is important to note that I do not view the problem with privacy regulation at the FTC to be a lack of talent or leadership. The FTC has a collection of highly talented consumer protection lawyers and the best collection of economists in any government agency. The issue is that the FTC is at a crossroads when it comes to consumer protection in the digital economy generally. An ever-increasing proportion of the business practices the FTC is asked to engage with on a daily basis are no longer the types of practice that can simply be dismissed as fraud and enforced without the fear that aggressive enforcement might chill virtuous competition.

While the FTC must always remain vigilant in identifying and prosecuting fraud, it is critical that it develop a sensible and more nuanced approach to business practices that might produce benefits for consumers. When it comes to privacy regulation, the fraud-based culture of the FTC's consumer protection mission cannot be robotically and mechanically employed where that framework no longer makes sense. Adapting the culture within any institution to recognize these changes and develop the human capital and skills to deal with them is always a tricky problem; and perhaps at its trickiest when that institution is a government agency. It will be no surprise that an economist who was formerly an intern within the Bureau of Economics believes that the key to changing the culture within the agency is to empower the economists. And I will close with a few suggestions along those lines.

But for now, I'd like to turn to *Nomi*, which is an important case with significant implications for privacy regulation, but is also in my view a misguided attempt to retrofit the fraud-based FTC consumer protection culture to an area of privacy regulation that requires economic analysis.

FTC v. NOMI TECHNOLOGIES

Nomi was a startup company that provided analytics services to retailers based upon data collected from mobile device tracking technology to brick-and-mortar retailers through its "Listen" service. Nomi uses sensors placed in its clients' retail locations or its clients' existing WiFi access points to detect the media access control (MAC) address broadcast by a consumer's mobile device when it searches for WiFi networks. Nomi passed MAC addresses through a cryptographic hash function before collection and created a persistent unique identifier for the mobile device. Nomi did not "unhash" this identifier to retrieve the MAC addresses and Nomi did not store the MAC addresses of the mobile devices.

The FTC's case against Nomi rested on a single line within its privacy policy that stated "Nomi pledges to . . . Always allow consumers to opt out of Nomi's service on its website as well as at any retailer using Nomi's technology." Nomi did allow consumers to opt out of its service on the website, but the FTC argued that because some retailers did not have the ability to allow consumers to opt-out of tracking within the store, this statement was deceptive.

Importantly, yet completely ignored by the FTC majority, Nomi did not track individual consumers – instead, Nomi's technology recorded whether individuals are unique or repeat visitors, but it did not identify them. The information collected was used only to provide analytics to Nomi's clients. The data provided by Nomi's Listen service can generated potentially valuable insights that allowed retailers to measure how different retail promotions, product offerings, displays, and services impact consumers. In short, these insights help retailers optimize consumers' shopping experiences, inform staffing coverage for their stores, and improve store layouts, all without knowing the identity of those visiting the store.

Let's talk about the law. Section 5(b) of the FTC Act requires us, before issuing any complaint, to establish "reason to believe that [a violation has occurred]" and that an enforcement action would "be to the interest of the public." In my dissent, I argued that the Commission did not meet the relatively low "reason to believe" bar because its complaint did not meet the basic requirements of the Commission's 1983 Deception Policy Statement. This failure has significant economic consequences because it runs the risk of deterring industry participants from adopting business practices that benefit consumers.

The fundamental failure of the Commission's complaint is that the evidence simply does not support the allegation that Nomi's representation about an opportunity to opt out of the Listen service at the retail level – in light of the immediate and easily accessible opt out available on the webpage itself – was material to consumers. This failure alone is fatal. A representation simply cannot be deceptive under the long-standing FTC Policy Statement on Deception in the absence of materiality.

The Policy Statement on Deception makes this requirement clear, observing that the "basic question is whether the act or practice is likely to affect the consumer's conduct or decision with regard to a product or service." It is important to understand the economic function of the materiality requirement. Once again, the FTC's own Policy Statement on Deception does our work for us when it describes materiality as an evidentiary proxy for consumer injury: "[i]njury exists if consumers would have chosen differently but for the deception. If different choices are likely, the claim is material, and injury is likely as well."

Now why would the FTC choose to enforce only those misrepresentations that are material – that is, misrepresentations that cause consumers to make choices that reduce their welfare? The answer is that this essential link between materiality and consumer injury ensures the Commission's deception authority is employed to deter only conduct that is likely to harm consumers and does not chill business practices that makes consumers better off. This link also unifies the Commission's two foundational consumer protection authorities – deception and unfairness – by tethering them to consumer injury.

Historically, the FTC has applied its deception authority in the context of advertising. In the advertising setting, the Commission enjoys a legal presumption of materiality. The underlying logic of that presumption is that advertising communications reflect the judgment and investment of the advertiser that the communication will indeed affect consumer behavior. But that logic simply doesn't fit in the context of privacy policies. Unlike advertising, privacy policies are not designed by marketers to influence consumer behavior, rather they are often drafted by attorneys and included on websites to comply with state laws or industry self-regulatory regimes. The logic of the materiality presumption built for advertising simply does not fit when evaluating representations in privacy policies.

The practical reality is that, while privacy policies do serve valuable functions, most consumers do not read privacy polices and when they do, they do not understand them. Researchers have shown that it is virtually impossible for consumers to read and understand all the privacy policies typically encountered, given the time commitment required. It is not surprising that according to a recent Pew Research Center survey, half of Americans believe that when a company posts a privacy policy, it ensures that the company keeps confidential all the information it collects on users. The point is not that privacy policies should be *presumed* immaterial; it is that privacy policies are so fundamentally different than mass advertising communications from a consumer perspective that it makes sense for the Commission to bear the burden of proof of demonstrating materiality.

Nomi illustrates why the materiality requirement is so important. The FTC Act does not legally obligate Nomi to produce a privacy policy or to publish one at all. It did. And the FTC's case against Nomi rested on a single line within its privacy policy that stated "Nomi pledges to . . . Always allow consumers to opt out of Nomi's service on its website as well as at any retailer using Nomi's technology." The FTC argued that because some retailers did not have the ability to allow consumers to opt-out of tracking within the store, this statement was deceptive. However, Nomi did provide consumers the ability to opt-out of being tracked through it's website. The fundamental failure of the Commission's complaint is that the evidence simply does not support the allegation that Nomi's representation about an opportunity to opt out of the Listen service at the retail level – in light of the immediate and easily accessible opt out available on the webpage itself – was material to consumers. In other words, the Commission did not show any evidence, empirical or otherwise, that consumers would not "have chosen differently" but-for the allegedly deceptive representation.

In fact, the evidence strongly implies that specific representation was not material and therefore not deceptive. Nomi's "tracking" of users was widely publicized in a story that appeared on the front page of The New York Times, a publication with a daily reach of nearly 1.9 million readers. Most likely due to this publicity, Nomi's opt-out rate (3.8%) was significantly higher than the opt-out rate for other online activities. This high rate, relative to website visitors, likely reflects the ease of a mechanism that was immediately and quickly available to consumers at the time they may have been reading the privacy policy. This behavior indicates that consumers that were interested in opting out of the tracking service took their first opportunity to do so. To presume the materiality of a representation in a privacy policy concerning the availability of an additional and more onerous in-store opt-out mechanism requires one to accept the proposition that the privacy-sensitive consumer would be more likely to bypass the easier and immediate route (the online opt out) in favor of waiting until she had the opportunity to opt out in a physical location.

Untethered from the materiality requirement, the FTC's consumer protection efforts in privacy regulation are no longer about consumer harm – or promoting consumer welfare – they are about micromanaging privacy policies and placing broad sectors of the digital economy under the thumb of a single agency. And in Nomi in particular, the approach is about micromanaging privacy policies for firms that do not need to have one in the first place. Firms in Nomi's position or those reading the complaint and consent carefully have an increased incentive to take down voluntary privacy policies or not generate one. This will leave consumers and privacy watchdogs with even less information than they are already receiving about website activity—exacerbating the very problem the FTC was attempting to solve. This unintended consequence is one that is easily foreseeable; and one that is obvious to most economists. But the Commission's analysis simply ignores these tradeoffs.

By enforcing the FTC Act against trivial misstatements in privacy policies that nobody reads, the Commission has been able to put an increasingly large number of firms in the digital economy under 20-year orders. Putting businesses under order for 20 years, including intrusive monitoring and reporting requirements, seems especially questionable in the digital economy in which a firm's half-life is closer to two years than 10. What's more, the FTC can obtain substantial monetary penalties for violations of orders and certain statutes—*Spokeo* will pay $800,000 for violations of the Federal Credit Reporting Act.

Not only does this approach threaten to chill innovation in the digital economy, they will deter firms from engaging in voluntary practices that promote consumer choice and transparency – the very principles that lie at the heart of the Commission's consumer protection mission. If the benefits of these welfare-enhancing business practices are not weighed correctly against the harms they present to consumers, we run the risk of squelching innovation and depriving consumers of these benefits. Indeed, innovation in new privacy-enhancing tools and technologies might be at risk – if a company might face legal action for incorrectly yet harmlessly describe an opt-out feature they did not need to provide in the first place, then why bother? So long as economic analysis is a marginal player in privacy regulation at the FTC, this unfortunate equilibrium will remain.

Let me conclude with a few remarks on how to set the FTC on a course toward embracing the intersection of economics and privacy rather than resisting it.

RECOMMENDATIONS

Recommendation #1: The Bureau of Economics must serve the Commission, not the Bureau of Consumer Protection, when those two conflict.

This is quite simple but bears repeating. The question of how to best organize economists within regulatory agencies is one that has attracted a significant amount of attention from legal scholars, economists, practicing lawyers, and regulators. One possible conception of the relationship between the

Bureau of Consumer Protection and the Bureau of Economics is that the latter should be a litigation and research support team for the former. And to be sure, the economists within the agency have an important function in conducting economic analyses to facilitate investigations and enforcement. But sometimes the objectives of the FTC and the Bureau of Consumer Protection should be in conflict from an economic perspective. Sometimes, from an economic perspective, the direction the FTC is going in terms of consumer protection enforcement does not make economic sense.

When such a conflict exists, it is important that the institutional design structure of the agency makes room for the economists – indeed, encourages the economists – to have a voice in terms of policy and case selection. A structure that subordinates economists to lawyers runs the risk of not only encouraging economically misguided privacy policy, but also a reduction in alternative information flow to the Commissioners, poorer staff skill retention, and inefficient use of economists with specialized skills or knowledge.

BE must not become a mere input supplier to the Bureau of Consumer Protection. While the economists – like the smaller group within any bureaucracy – must pick their battles wisely and economize on their own scarce reputational capital within the agency, the Commission as a whole must recognize that the optimal level of economist and lawyer conflict over the direction of privacy regulation is not zero.

Recommendation #2: The FTC Should Be an Intellectual Leader in the Movement to Create Economically Coherent Privacy Regulation

The FTC is at its best when it combines its unique combination of institutional features. Perhaps the most unique is that the FTC's statutory mandate includes a research and reporting function that distinguishes it from many agencies. The Commission has a long and well-regarded history of conducting its own research and using its authority to produce public reports that examine novel, emerging or otherwise important issues. Privacy should be no exception. The case for strengthening the incentives within the agency for FTC economists to produce their own research, and to be active and engaged scholars in the field of privacy economics, is quite clear. But I do want to be elaborate a bit about what we mean when discussing the type of report that the FTC should be producing.

The Commission will often seek information using its Section 6(b) authority to compel private parties to submit information for review. Commission staff reports often are the result of extensive research, rigorous investigation into certain industry sectors, practices or products, and economic analysis. Reports taking advantage of the Commission's unique ability to collect and analyze data and to conduct economic analyses to form the basis of its recommendations predictably have had significant impact on public policy debates.

Reports that do not meet that standard of research and analytical rigor should not make legislative recommendations at minimum and, frankly, ought not be published at all in many cases. The track record of rigorous reports and research show that the issue here is not capability but discretion. The FTC Bureau of Economics has housed some of the most influential consumer protection economists in history and can claim many of the most influential papers as its own. Reports that do not meet this standard detract from the agency's limited reputational capital and its ability to perform its missions.

The FTC has the legal authority, the human capital, and the economic talent to be a leader in the economic approach to privacy. It should do so. An obvious candidate is to set forth a comprehensive and rigorous research agenda for understanding the economics of privacy policies.

Recommendation #3: The FTC Should Require the Bureau of Economics to Make Public Its Views in All Consents

I continue to believe that the FTC should consider interpreting or amending FTC Rule of Practice 2.34 to mandate that BE publish, in matters involving consent decrees, and as part of the already required "explanation of the provisions of the order and the relief to be obtained," a separate explanation of the economic analysis of the Commission's action. This is especially important in the area of privacy regulation where most of the Commission's work takes place in consents.

The public-facing documents associated with this rule are critical for communicating the role that economic analysis plays in Commission decision-making in cases. In many cases, public facing document surrounding consents in privacy cases either do not describe well or at all the economic analysis conducted by staff or upon which BE recommended the consent. In cases where there is no economic analysis to explain, the Commission should make the information public as well.

The additional explanation I have in mind would be a BE document, not requiring approval of the Commission. Aside from a high-level and general description of the economic analyses relied upon in recommending or rejecting the proposed consent order, the BE explanation could also provide the more general economic rationale for its recommendation. Requiring BE to make public its economic rationale for supporting or rejecting a consent decree voted out by the Commission could offer a number of benefits at little cost. First, it would offer BE an avenue to communicate its findings to the public. Second, it reinforces the independent nature of the recommendation that BE offers. Third, it breaks the agency monopoly the FTC consumer protection lawyers currently enjoy in terms of framing a particular matter to the public. The internal leverage BE gains by the ability to publish such a document may increase conflict between bureaus on the margin in close cases, but it will also provide BE a greater role in the consent process and a mechanism to discipline privacy consents that are not supported by sound economics.

Thank you very much for your time today. I am happy to take any questions that you have for me.