MERCATUS REPORTS

The **Mercatus Center** at George Mason University is an education, research, and outreach organization that works with scholars, policy experts, and government officials to bridge academic theory and real-world practice. The center's Regulatory Studies Program works within the university setting to improve the state of knowledge and debate about regulations and their impact on society. More information about the center can be found on the Web at www.mercatus.org. For the latest federal regulatory developments, visit www.regradar.org.

Financial Privacy Notices

STATUS: Advance Notice of Proposed Rulemaking has been issued.

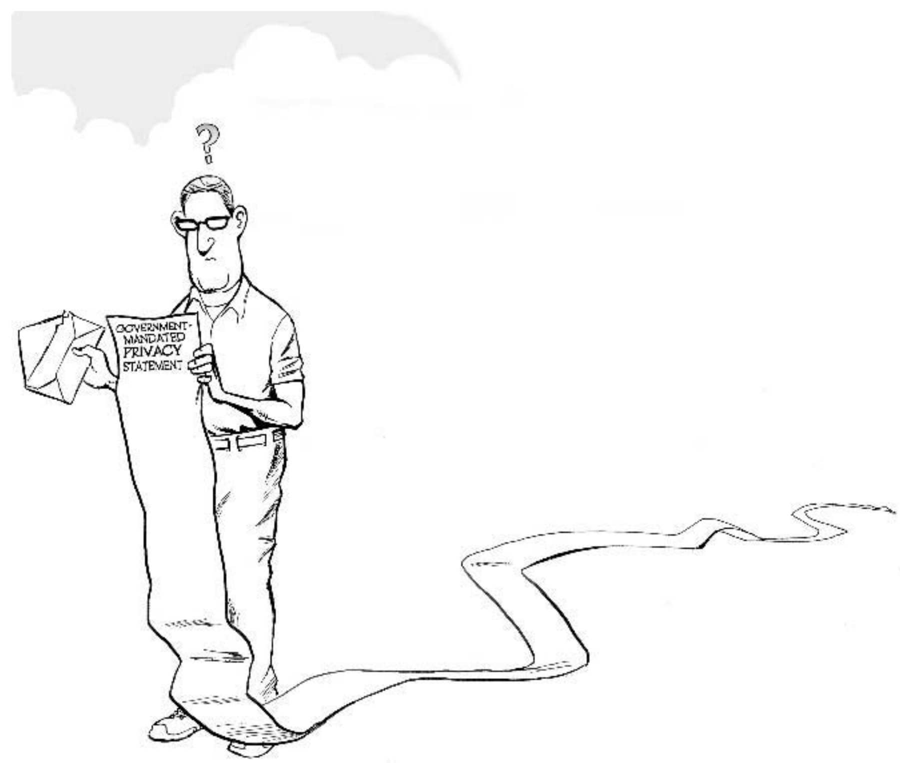
Late last December, a group of eight financial regulators (including Treasury, the Federal Reserve, and the FDIC) published an Advance Notice of Proposed Rulemaking seeking comments on alternative forms of privacy notices that banks and other financial institutions may provide to their customers as part of their privacy protection obligations under the *Gramm-Leach-Bliley Act*. Essentially, the agencies are considering whether to substitute (or add) a shorter standardized notice "that would be easier for consumers to understand."

Based on a jointly hosted workshop, the agencies determined that the flexibility in presentation of privacy policies permitted to financial institutions under the original regulations has resulted in "notices [that] have been difficult to compare, even among financial institutions with identical privacy policies." The agencies contend that shorter, standardized notices are a sound "response to broad-based concerns expressed by representatives of financial institutions, consumers, privacy advocates, and Members of Congress . . . [as to] how financial institutions could provide more useful privacy notices to consumers."

So far, this all sounds nice, but we need to look a little deeper. A strong but unstated premise of the current rulemaking is that consumers must be having difficulty understanding the notices because so few of them are opting out of allowing the banks to use their personal information in various ways (including marketing) after receiving the government-mandated notices that they can do so. In connection with the first part of this premise, private conversations with knowledgeable financial services people indeed confirm that opt-out rates generally run well below five percent and often below one percent. Yet, such low opt-out rates run counter to myriad surveys that uniformly show consumers prefer more privacy to less privacy. What is going on here?

Consumer contradiction? Basic economics resolves the apparent contradiction in consumers' behavior without having to presume on their intelligence. Privacy is a good just like food, shelter, education, or haircuts. Like any other good, in the abstract, human beings prefer more of it to less, other things being equal. In the real world of limited resources, however, other things are not equal. A consumer's available time, money, attention, and other resources constrain his or her preferences for privacy versus other goods. Choice, in short, entails tradeoffs. A consumer who spends time and money opting out of a financial institution's information-sharing program has fewer resources left to devote to other valued activities such as work, family, recreation, and so on.

It also follows that a consumer who does not opt out of a firm's information-sharing process, given the tradeoffs involved, may be assumed to be at least indifferent, if not positively disposed, to the privacy practices of the firms with whom they do business. Such consumers may, for example, be aware of the benefits that accrue to them through secondary uses of their personal information by financial services providers. But even in cases where consumers are unaware of the particulars of a firm's privacy policy, they may still be inclined to give their financial services providers the benefit of the doubt. This inference follows from the observation that consumers of financial services already trust their finan-



KEVIN TUMA (2)

ices already trust their financial institution with a valued resource (their money), and that consumers receive substantial benefits from allowing use of their money in ways they do not know. It seems reasonable, therefore, to conclude that consumers would be similarly trusting with another valued resource (their personal information), because they likewise benefit from its use even if they do not know the details of how their personal information will be used.

Habeas Corpus These observations about real-world consumer behavior may explain why the agencies are unable to produce a body of evidence that the financial services market has "failed" to provide privacy at optimal levels, beyond a vague claim about "broad-based concerns." Indeed, the only evidence they do provide supports precisely the opposite conclusion: The market is working properly in that firms are innovating along the privacy notice dimension. In the agency-sponsored workshop, for example, the agencies noted that "some institutions described results of consumer testing and efforts to make their privacy notices clearer and more useful to consumers. A number of financial institutions have since sought to improve their notices. Additionally, some industry groups have been working to formulate short, consumer-friendly notices that could accompany the longer, legally-mandated notices under the rule." That is exactly how one would expect a properly functioning market to operate. Although the innovations may not be proceeding at the pace or along the precise lines that the agencies might prefer, financial institutions are innovating just the same.

The agencies' tacit admission of a properly functioning market does not keep them from asking for "examples of forms, model clauses, and other information, such as applicable research that has been conducted in this area." While it might be reasonable for academics, communications experts, or consumer advocates to provide evidence from their research in those areas, it is unreasonable to expect competitive, for-profit financial institutions to do so. Financial institutions that are innovating along the privacy and notice dimensions are presumably doing so to gain a competitive advantage, and have incurred costs of research and of creating communications strategies, among other things. Sharing that hard-won information with regulators simply allows competitors to free-ride on the innovating firm's discoveries to the extent such innovations become part of a final rule.

In addition, the innovations produced by for-profit firms are presumably the most valuable because they have been market-tested. The innovations that comport most closely and economically with consumer preferences survive, and the innovations that do not are discarded. Academics, consumer advocates, and other non-market producers of privacy policies, while perhaps well-intentioned, suffer from the distinct disadvantage of not having had their ideas subjected to the crucible of market testing. No amount of *ex ante* probing, surveying, and notice design, no matter how well intentioned or thoroughly considered, can replace the data created through an actual voluntary exchange process.

Undesirable dynamics A shorter, standardized privacy notice could simplify legal and regulatory compliance for financial institutions and improve the efficiency of financial services provisioning. So what is wrong with that? Nothing, as far as it goes; but like most short-run thinking, it misses the dynamic changes that are likely to follow. First, a standardized short notice substitutes a one-size-fits-all solution for the diversity of solutions that a market-based response naturally produces. Such government-enforced uniformity will likely stifle discovery of preferred privacy and financial services combinations by locking in a static approach based on today's preferences and standards. Clearly, the market process is more nimble than the regulatory process, and fostering rather than foreclosing that flexibility is critical to an information-driven economy.

Second, standardized short notices and their prominent placement of the opt-out opportunity seem to set the default condition of notice in favor of consumers who place high values on privacy at the expense of those who do not. This structuring gives an incomplete picture of the benefits and services all consumers may be forsaking when opting for an additional measure of privacy. Such foregone alternatives might include better awareness of financial products and services, better customer service, more efficient and cheaper delivery of services, and so on. If the goal of shorter notices is to facilitate more-informed consumer choice, then presenting the benefits of information sharing on an equal footing with the opportunity for enhanced privacy enables consumers to make more informed choices.

Third, another unstated premise of the rule holds that concise and more prominent information is unambiguously preferable. That is, at best, a debatable proposition. Consider, for example, that more concise and prominently displayed nutrition labeling on food packages has not led to improved eating habits among American consumers (as least as measured by obesity rates). Is there any reason to suppose that shorter privacy notices will do better among American consumers of financial services? Clearly, the agencies have furnished no evidence to support that conjecture. In fact, a prominent emphasis on privacy seems just as likely to tax consumers' already scarce time and attention, generating the perverse result that vitally important communications about fraud, identity theft, or account number scams may not receive the fullest attention they deserve.

In sum, if privacy truly holds a preferred status among a wide cross-section of consumers — as the agencies and privacy advocates suggest — then it should be fairly easy to produce objective evidence of that fact using tradeoffs that consumers have actually made, rather than relying on the preferences consumers say they would indulge in a world without resource constraints. Yet the only evidence the agencies have provided suggests that the market is working — perhaps not as rapidly as one might prefer, but working nonetheless. This result should be unsurprising given that financial institutions have a vested interest in serving their customers along all dimensions that are important to them and for which those customers have demonstrated a willingness and ability to pay. Without objective evidence of a decisive market failure, it would seem the agencies can best serve consumers and financial institutions by simply leaving them alone.

—Jay Cochran III

FTC E-Commerce Studies

STATUS: New report released March 29

The Federal Trade Commission released a staff report on Internet contact lens sales last March that urged states to avoid imposing professional licensing requirements on firms that sell contact lenses but do not perform eye exams. The report also found that releasing contact lens prescriptions to consumers would promote consumer choice and ocular health.

The report has ramifications far beyond the contact lens market. Its issuance suggests that the FTC will fulfill the promise made in its July 2003 staff report on electronic commerce in wine. The conclusion to that report said it is the first in a series of reports examining barriers to e-commerce in a wide variety of industries. The wine report found that state bans on direct interstate shipment of wine to consumers harm consumers by curtailing access to lower prices and greater variety. The FTC staff also concluded that states can deal with policy concerns like tax revenues and underage drinking through methods less restrictive than an outright ban on direct shipment.

The genesis of the reports is a three-day public workshop the FTC held in October 2002. The workshop examined potentially anticompetitive barriers to e-commerce in a wide variety of products and services, including wine, contact lenses, automobiles, auctions, real estate, mortgages, education, prescription drugs, telemedicine, caskets, and legal services.

How many reports the FTC will issue over the next year or so is unknown. But several of these industries seem ripe for consideration:

■ **Automobiles** The FTC has a long history of pointing out the anti-competitive consequences of state auto franchise laws, which require that new cars be sold through local dealerships and frequently prevent manufacturers from creating new dealerships without the existing dealers' permission. The Internet holds out the prospect that consumers could design their new cars online and take delivery direct from the manufacturer or a Web-based national dealer, but the state franchise laws stand in the way.

■ **Prescription drugs and telemedicine** The FTC has shown strong interest in promoting competition in health care, both through antitrust enforcement and vigorous jawboning. A report assessing barriers to e-commerce that affect health care would naturally complement this agenda.

■ **Legal services** States prevent non-lawyers from competing with lawyers through laws and regulations that outlaw "unauthorized practice of law" by individuals who have not been admitted to the state bar. Moves are afoot in many states to define the "practice of law" so broadly that it includes advice or services offered by many other professionals, such as real estate agents, accountants, mortgage lenders, and even software developers. Texas regulators, for example, defined the practice of law so broadly that it took an act of the Texas legislature to legalize self-help legal software in the state. Lawyers in North Carolina even tried to require that a lawyer be physically present at most real estate closings (including *refinancings*), until the FTC and Department of Justice created some embarrassing publicity about the issue. Expansive definitions of the practice of law add to the list of activities that only lawyers can perform, at the expense of consumers and (frequently) lower-cost Internet-based service providers.

The e-commerce project is one antitrust initiative that may not produce a lot of antitrust prosecutions. Several workshop panels provided opportunities to discuss anticompetitive private actions, but there appear to be few significant problems. The principal exceptions may occur where e-commerce concerns intersect with another FTC priority outlined in another voluminous 2003 report: private actions that attempt to avoid prosecution using the fig leaf of state sponsorship or approval. A state can shield private anticompetitive actions from antitrust liability if it "clearly articulates" a policy of displacing competition and "actively supervises" the private parties. But the quoted terms involve a lot of gray areas that the FTC wants to clarify, through litigation if necessary. That is an enforcement initiative all but the most hardened antitrust skeptics can cheer.

—Jerry Ellig

RegRadar.org

Your monitor of new and upcoming regulations

"RegRadar.org does an excellent job tracking regulations through the process, all the way from their initial proposal to their final passage. It serves as a central meeting place where academics, policy-makers, interest groups, businesses, and concerned citizens can access easy-to-understand information about new and forthcoming regulations."

— Aloysius Hogan, counsel to Sen. Chuck Hagel (R-NE)

"This lesson on regulations was quite useful, and reminded me of the "I'm Just a Bill?" Schoolhouse Rocks skit that ran on Saturday mornings."

— Ronald Y. Perez, senior editor of *Water Conditioning & Purification*

The Mercatus Center at George Mason University works within an academic setting to improve the state of knowledge and debate about regulations and their impact on society, ultimately improving how government works in the regulatory arena. Our projects:

- Create knowledge through research on the impact regulations have on society and ways to improve regulatory effectiveness.
- Educate current and future scholars, as well as current and future policymakers, to improve the state of knowledge about the impact rules have on American citizens, and the quality of future debate over regulatory issues.
- Disseminate knowledge to current and future policymakers, opinion leaders, academics, practitioners, and the general public through various avenues, including: publications, courses, workshops, conferences, and analyses of specific rules.

For more information:

e-mail the Center at mercatus@gmu.edu

MERCATUS CENTER

GEORGE MASON UNIVERSITY