

# THE FTC AND VOLUNTARY STANDARDS: MAXIMIZING THE NET BENEFITS OF SELF-REGULATION

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The vast majority of commercial transactions work well, without need for interference of any kind. In some cases, however, the market “fails,” and regulation of some kind is warranted. But this need not be *government* regulation if industry *self-regulation* is superior. In this article I explain the theoretical reasons self-regulation may be superior to government regulation, give some examples of areas where self-regulation is currently working, and discuss the potential anti-trust pitfalls involved in self-regulatory activities.

## Theoretical Advantages of Self-Regulation

Private sector solutions will frequently be superior to the alternative of government intervention, for several reasons. First, self-regulation directly involves the parties who will generally have the best institutional knowledge about the need for action and about the efficacy of various potential actions. Although government can always hire the technical expertise needed to draft complicated regulations, it will almost always be slower in perceiving the need for some action than will the participants in the relevant market.

Second, self-regulation is more flexible, and therefore is less likely to stifle innovation or excessively limit consumer choice. That is, once the government promulgates a regulation, it is more or less permanent. One of the most difficult challenges the administration has faced is changing existing rules. Old rules tend to acquire

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constituencies—on Capitol Hill as well as in the agencies—and it is very tough to change them.<sup>1</sup>

In the private sector, it is a bit different. When a rule becomes unnecessary, no one will follow it. If one set of standards is inefficient, a new organization will offer a substitute. Thus, rules developed through self-regulation are, in effect, subject to a *market test*.

Finally, self-regulation generally results in the costs of such regulation being fully borne in the market in which the regulation is imposed. As we are well aware, the costs incurred by the government for some regulations are large. In most cases economic efficiency would dictate that these costs should be borne in the market that is regulated.<sup>2</sup>

### Examples of Successful Self-Regulation

To be more specific, let me give three examples of areas where self-regulation is producing the kinds of benefits I have been discussing.

#### *Product Standards And Certification*

Consider product standard and certification programs. Today, we have some 32,000 privately developed standards, covering products ranging from nuts and bolts to computers and nuclear reactors. Approximately 700 organizations participate in the standards development process. These organizations bring together individuals who are experts in specific product areas, many of whom are employed by manufacturers or sellers of the products involved.

Private organizations also certify that products have been tested and meet a given standard. Frequently, testing is conducted by third parties such as independent laboratories; Underwriters' Laboratories is a familiar example.

Certification permits manufacturers to demonstrate efficiently that their products comply with relevant standards. One obvious benefit of these programs is to facilitate the introduction of new technology

<sup>1</sup>Mark Crain makes this point nicely in a recent op-ed in the *Wall Street Journal*: "Regulations, like products, become obsolete. Market forces take care of obsolete products, which means they find their way to the junkyard. The same cannot be said for obsolete government regulations, which tend to last long after they are moribund." W. Mark Crain, "Spinning Wheels on Old Safety Checks," *Wall Street Journal*, 25 September 1984.

<sup>2</sup>On a similar point, government agencies faced with budget constraints may act to minimize only the *enforcement* costs of regulation, even where this results in excessive *compliance* costs. This problem does not exist with self-regulation because both types of costs are borne by the market participants.

by enabling innovative manufacturers to demonstrate the safety or efficiency of new products.

More generally, standards and certification programs facilitate communication between buyers and sellers about complex product attributes. For example, consumers purchase motor oil with reference to standard viscosity grades—such as the familiar 10W-40—without having to understand the physics of oil viscosity. Similarly, building contractors can procure steel of desired corrosion-resistance simply by referencing relevant steel standards in a procurement contract—without having to become trained metallurgists. Obviously, transactions costs would be higher if consumers had to become experts in oil viscosity, or contractors in metallurgy. The existence of standards and certification lowers the costs associated with thousands of transactions every day.

Government itself relies heavily on private standards for regulatory and procurement purposes. For example, the Department of Defense refers to approximately 3,300 private standards in its procurement documents. Such federal reliance on private standards is likely to increase. Office of Management and Budget Circular A-119, "Federal Participation in the Development and Use of Voluntary Standards,"<sup>3</sup> establishes a policy preference in favor of the use of private standards and certifications by federal agencies. Its purpose is to increase government efficiency by reducing the need for government standards.

State and local jurisdictions may rely even more extensively on private standards. In most cases, these jurisdictions do not have the resources to undertake independent evaluations of the wide variety of products they use. Reliance on private-sector standards constitutes a cost-effective means of allocating their taxpayers' money.

### *Professional Self-Regulation*

Another area where self-regulation is beneficial is in the professions. Such regulation has a long and honorable history. The American Medical Association (AMA) first established a code of ethics for its members in 1848. Since then, many other professional societies have established professional codes of ethics that can help protect consumers, other professionals, and third parties (such as insurers) from dishonest, dangerous, or otherwise unacceptable conduct. Association codes frequently prohibit false and deceptive advertising, proscribe improper business dealings with patients or clients, and set minimum standards to ensure professional competence. Responsible self-regulation is particularly important in the area of professional services because such services are often highly technical,

<sup>3</sup>See 47 *Federal Register* 49496 (1 November 1982).

and consumers may not be able to judge for themselves either the need for the service or its quality. Consumers would clearly suffer if they could not count on the credibility and competence of professionals.

### *Voluntary Advertising Standards*

A third important area where self-regulation is working well is advertising. Advertisers, advertising agencies, and consumers have a shared interest in protecting advertising credibility, and it is not surprising that some of the most successful self-regulation programs are found in this area. For example, the National Advertising Division of the Council of Better Business Bureaus (BBB) administers a voluntary arbitration and correction mechanism. The BBB system allows for quick and efficient correction of questionable ads without the complicated and time-consuming legal maneuvering that accompanies government intervention.

To sum up, cooperative activities by industry and professional groups such as self-regulation can have substantial benefits for society. In addition, self-regulation is in many cases superior to government regulation.

## Self-Regulation and the FTC

The Federal Trade Commission has worked to avoid impeding beneficial self-regulation. On the contrary, as I will discuss below, the FTC is actively involved in providing information on how self-regulatory groups can structure themselves to avoid problems with the antitrust and consumer protection statutes.

We must also recognize, however, that self-regulation (like government regulation) can be used to exclude competitors and otherwise limit competition. Not only must self-regulatory programs be vigilant against the types of excesses that mar government regulatory programs, they must also combat the temptation to abuse self-regulation to hinder competition. Indeed, where self-regulation involves the concerted actions of competitors, both the self-regulatory mechanism and the government must be especially wary.

There are two major problems that have concerned the FTC in this area. The first is suppression of information needed by consumers to make informed purchasing decisions. The second is the unreasonable exclusion of new products or new competitors from the market.

The best-known FTC action against suppression of information through self-regulation was its suit against the AMA.<sup>4</sup> The AMA's

<sup>4</sup>94 F.T.C. 701 (1979), *aff'd as modified*, 638 F.2d 443 (2d Cir. 1980), *aff'd by an equally divided court*, 445 U.S. 676 (1982) (order modified, 99 F.T.C. 440 (1982) and 100 F.T.C. 572 (1982)).

code of ethics once prohibited virtually all means of disseminating truthful information to consumers. By 1977, the code had been revised to allow certain forms of advertising, but it still prohibited statements that were "self-laudatory" or implied that the advertising physician had skills superior to those of other physicians. The Commission concluded that *all* advertising is to some degree self-laudatory. Thus, the continued ban on self-laudatory advertising really did not represent a very significant change from a virtual total ban. The Second Circuit Court of Appeals specifically upheld the Commission's conclusion that the restraints on self-laudatory advertisements justified the order issued in the AMA case.

In the order, the Commission recognized not only the virtues of truthful advertising, but the harms created by deceptive advertising.<sup>5</sup> Accordingly, it permitted the AMA to adopt and enforce rules designed to prevent such harmful advertising by its members.

Since the AMA case, the Commission has brought a number of other actions challenging private restrictions on the dissemination of truthful information, reaching consent agreements with a number of state and local medical and dental associations.<sup>6</sup> It has also intervened before state professional regulatory boards to suggest that limitations on the use of trade names by lawyers, for example, may hinder rather than help competition.

The potential that self-regulatory activities might be used to exclude new products or competitors is illustrated by two recent cases. In April 1981, the Commission filed an *amicus* brief in *American Society of Mechanical Engineers v. Hydro level*.<sup>7</sup> In that case, a member of the American Society of Mechanical Engineers (ASME) used his position within the organization to injure a competitor who manufactured an innovative boiler safety device. The Supreme Court held that ASME was liable for the anticompetitive actions of its member.

On July 26, 1984, the Commission accepted, subject to final approval, a consent agreement with the American Society of Sanitary Engineering (ASSE).<sup>8</sup> The complaint alleged that ASSE unreasonably

<sup>5</sup>94 F.T.C. 1003.

<sup>6</sup>Washington, D.C. Dermatological Society, 102 F.T.C. 1292 (1983); Michigan Association of Osteopathic Physicians and Surgeons, 102 F.T.C. 982 (1983); Association of Independent Dentists, 100 F.T.C. 518 (1982); Broward County Medical Association, 99 F.T.C. 622 (1982). See also American Dental Association, 94 F.T.C. 403 (1979) (consent order); *modified*, 100 F.T.C. 448 (1982); and 101 F.T.C. 34 (1983).

<sup>7</sup>456 U.S. 556 (1982).

<sup>8</sup>The consent agreement has been accepted subject to final approval in accordance with the Commission's Rules of Practice. Under the Rules, after consent agreements are accepted by the Commission, they are placed on the public record for 60 days for comment. After analysis and consideration of all comments, the Commission decides whether to make the agreement final. The comment period for the ASSE consent agreement closed on 13 October 1984.

restrained trade by refusing to extend standards coverage to an innovative plumbing valve produced by a small business. As a result of ASSE's refusal, sales of the innovative product may have been unduly restricted in numerous state and local jurisdictions that rely on ASSE standards.

I want to emphasize here that exclusion of a potentially competing product is not, by itself, a cause for antitrust action. In the vast majority of cases, the exclusion may be well justified. It is the basis for and extent of the exclusion that is the focus of antitrust analysis. Simply put, the exclusion should not be for the purpose of restraining competition. Nor should the exclusion exceed that which is reasonably necessary to achieve the legitimate goals of the standards or certification organization.

I also want to emphasize that these enforcement actions are not the preferred method of avoiding problems in the area of self-regulation—or, for that matter, in any area. The Federal Trade Commission's concerns are with ensuring compliance with the law and maximizing benefits to consumers. Especially in areas, such as self-regulation, where private action can create substantial benefits, the sue-first-and-ask-questions-later approach can cause great damage.

Indeed, the FTC has worked to promote an atmosphere where responsible industry self-regulation will flourish. One example is the Commission's recent advisory opinion on the American Academy of Ophthalmology's Code of Ethics.

The Academy, an organization of approximately 12,000 physicians who specialize in medical and surgical eye care, decided that it wanted to provide its members with specific guidance with respect to their professional conduct. The Academy wanted not only to address concerns about deceptive advertising, but also to touch on issues such as informed consent, unnecessary surgery, use of experimental procedures, and relationships with other health care providers.

After a draft of the code was approved by the organization's leadership, the Academy asked for a formal advisory opinion from the FTC. That draft—in the view of Commission's staff—*did* raise some antitrust concerns. But Academy representatives and FTC staff ultimately worked out a proposed code that was approved by the Commission in June 1983.

## Conclusion

Self-regulation by the private sector can create substantial benefits by facilitating the efficient organization and policing of market activities. By providing information, discouraging fraud and other

undesirable activities, and providing a forum for market participants to communicate their legitimate common interests, self-regulatory activities ameliorate the problems of market failure emphasized by advocates of government regulation. Thus, self-regulation is in many cases a desirable alternative to government regulation.

The potential for anticompetitive abuses is also present in many self-regulatory activities, and government can and must play an active role in overseeing such activities. In the past, the FTC's oversight activities have emphasized litigation. More recently, the FTC has concentrated on working with self-regulatory organizations to arrive at solutions that provide for effective self-regulation while minimizing or eliminating potential antitrust problems. In so doing, the FTC is attempting to maximize the overall societal benefits from these activities, consistent with its statutory mandate.