Section 5 of the Federal Trade Commission Act:
The Most Powerful Weapon Against Competitive Threats

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Chairwoman Velázquez, Ranking Member Chabot and Members of the Committee, I thank you for the opportunity to testify today on ***"Small Business Competition Policy: Are Markets Open for Entrepreneurs?"*** My name is William MacLeod, and in my legal practice I represent many thousands of small businesses, both directly and through their trade associations, throughout the United States. I am also a veteran of the Federal Trade Commission, where I served as Director of the Midwest Regional Office and the Bureau of Consumer Protection. I am not testifying today for any client. Instead I am offering this statement for what benefit these may be from my experience outside and inside the agency.

Even if no other witness has said this directly, the record of this hearing should make one point abundantly clear – the most sweeping authority to protect competition in the United States belongs to the Federal Trade Commission with its power to prohibit unfair methods of competition and unfair acts and practices. This authority has been characterized as the power to intervene in the economy wherever three Commissioners believe they can improve the performance of a market. The Commission has wielded this authority against both titans of industry and corner stores. Big oil companies and small car dealers have felt the sting of Section 5.

The Commission's authority to prohibit unfairness has inspired some commentators to call the Commission the second most powerful legislature in the country. The Commission's more controversial initiatives under Section 5 have raised questions whether the agency had gone beyond protecting consumers and competition, and was pursuing some other objective instead. Getting it right is important, because interventions in markets are seldom neutral for competition; if the intervention does not help, it could do damage. It could hurt small businesses, consumers, and the competition that the Section 5 is intended to protect.

Not surprisingly, the Commission's exercise of its authority has been the subject of frequent Congressional oversight and occasional statutory limitations. The Committee should be commended for continuing this review during this hearing today. If I could distill my testimony to three main points they would be these, and I list each with an important implication:

1. Section 5 gives the Commission more than enough power and flexibility to confront conceivable threats to free and competitive markets that are critical to the vitality and growth of small businesses.

    (a) Grants of specific authority to the Commission ironically can undermine its effectiveness.

2. The size of the Commission's staff is the most binding limitation on its ability to protect entrepreneurs and small business.

   (a) Attorneys tied up in rulemaking proceedings are not out there prosecuting the bad actors.

3. The primary challenge to the Commission is to focus its attention on the worst threats, and the worst threat to entrepreneurs and small business is the barrier to entry.

   (a) Good Section 5 enforcement lowers those barriers; bad enforcement can raise them.

A Brief Background

During my nearly eight years at the Commission, I had the privilege and the responsibility to see that the Commission applied Section 5 where it was needed, and to resist the use of Section 5 where it could get in the way of healthy competition. We brought some of the more conventional and some of the more controversial cases in the Commission's history. We used our authority to open up long-protected taxi systems to new entrants and competition.[1] We invoked Section 5 to stop the sale of equipment that stole television signals,[2] and we used it to stop a company from breaching contracts with thousands of consumers.[3] My tenure at the Commission was called the era of unfairness by one prominent scholar.[4] Since then, the Commission has used its authority in many other ways, as previous witnesses have described. The wide range of cases stems from an extraordinary grant to authority.

The landmark case that confirmed the Commission's latitude to determine what was unfair was the Supreme Court decision against the company that distributed the popular S&H trading stamps. The Commission found S&H's distribution practices to be unfair methods of competition. When S&H appealed and the case reached the Supreme Court, the agency argued that it did not have to find that the conduct in question violated the letter or spirit of the antitrust laws – competition could be unfair under Section 5 *independently.*[5] The Court agreed, holding that unfairness depended on these factors:

> (1) "Whether the practice, without necessarily having been previously considered unlawful, offends public policy as it has been established by statutes, the common law … or other established concept of unfairness;"
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> (2) "whether it is immoral, unethical, oppressive, or unscrupulous;" and

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1 *City of New Orleans*, Dkt. 9179, 105 FTC 1 (1985); *City of Minneapolis*, Dkt. 9180, 105 FTC 304 (1985).

2 *C&D Electronics* (Docket No. C-3212) 1986.

3 *Orkin Exterminating Co., Inc.*, 108 FTC 263 (1986); aff,d., *FTC v. Orkin*, 849 F.2d 1354 (11th Cir. 1988).

4 Stephen Calkins, FTC Unfairness: An Essay, 46 Wayne L. Rev. 1935 (2000).

5 *FTC v. Sperry & Hutchinson Co.,* 405 U.S. 233 (1972).

(3) "whether it causes substantial injury to consumers (or competitors or other businessmen)."[6]

A decision like this would invigorate any agency, and it lit a fire under the Commission.

Adding to the fuel of *S&H,* Congress gave the Commission new authority to write rules, and the Commission proposed over two dozen industry-wide rules from 1971 through 1980.[7] One Chairman of the agency hinted at potential rules to prohibit businesses from hiring illegal aliens, to prevent companies from cheating on taxes, and to require companies with repeated environmental violations to place an environmentalist on their Boards.[8] The most notorious rulemaking of all was one to ban advertising to children. It was not long before members of Congress were hearing from many of the small businesses in their districts – all complaining about new rules and proposals that would make it more difficult for them to compete and make it more difficult for consumers to get what they wanted. In short, the Commission had managed to alienate the constituencies it was supposed to protect.

I arrived at the agency when it was still recovering from a hangover of wild experiments enforcing its unfairness authority. In addition to the proposed rules, the Commission had tried to use Section 5 to dismember cereal companies because they allegedly shared a monopoly, whatever that means.[9] Wisely, the agency abandoned that case. In another case, the Commission was urged to hold that Section 5 prohibited price cutting that offended neither the Sherman Act nor the Robinson Patman Act.[10] Again, the agency wisely declined. And the agency ultimately abandoned many of its rulemakings intended to regulate or ban advertising as an unfair practice. With the help of Congress and the courts, the Commission came to recognize that advertising can actually be beneficial to competition and consumers.[11]

Even after the Supreme Court's green light in *S&H*, the Commission found skeptical appellate courts when it tried to exceed settled limits in the antitrust laws. One Court of Appeals tossed out a case seeking to prohibit parallel-pricing that did not arise to an illegal conspiracy under the Sherman Act.[12] Another Court overturned a Commission decision that took issue with a company that had kept resale prices at suggested levels by refusing to deal with retailers who

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6 *Id.* at 244 (citing Unfair or Deceptive Advertising and Liability of Cigarettes in Relation to the Health Hazards of Smoking, 29 Fed. Reg. at 8355).

7 *See,* MacLeod, et al., "Three Rules and a Constitution: Consumer Protection Finds Its Limits in Competition Policy," *Antitrust Law Journal* (No. 3), 2005.

8 Timothy J. Muris & J. Howard Beales, THE LIMITS OF UNFAIRNESS UNDER THE FEDERAL TRADE COMMISSION ACT 14 (Ass'n of Nat'l. Advertisers, Inc. 1991).

9 *See* How History Informs Practice – Understanding the Development of Modern U.S. Competition Policy, Prepared Remarks of Timothy J. Muris, Chairman, Federal Trade Commission, Before American Bar Association Antitrust Section Fall Forum Washington, DC November 19, 2003

10 *General Foods Corp.*, 103 FTC 204 (1984)

11 *See*, MacLeod, *supra*, note 7.

12 *EI du Pont de Nemours & Co. v. FTC*, 729 F.2d 128 (2d Cir. 1984)

did not follow the suggestions – a practice the Supreme Court had long allowed.[13] Yet another decision held that the Commission could not regulate the business of a dominant company that had committed no illegal acts to achieve its position.[14]

The Commission's record in court is better today than in the 1970s, but courts sometimes still question the Commission's prosecutions under Section 5. For example, the Commission failed to survive appellate review when it tried to invalidate advertising restrictions enforced by a dental association,[15] and failed again when it tried to prevent companies from charging for patents that it found the company had agreed not to assert in a standard setting organization.[16]

At times, even the Commissioners themselves disagree on the merits of an action. In another standard-setting case involving an alleged attempt to collect royalties for patent rights after failing to disclose them in the standard-setting context, the Commission held that the company had committed both an unfair act and an unfair method of competition.[17] The majority looked to the *S&H* case for its broad statement of the Commission's power:

> The Supreme Court … found that the standard for "unfairness" under the FTC Act is "by necessity, an elusive one, encompassing not only practices that violate the Sherman Act and the other antitrust laws, but also practices that the Commission determines are against public policy for other reasons." *FTC v. Ind. Fed'n of Dentists,* 476 U.S. 477, 454 (1986); *see also FTC. v. Sperry & Hutchinson Co.,* 405 U.S. 233, 242 (1972) (FTC has authority to constrain, among other things "deception, bad faith, fraud or oppression").

In dissent, Chairman Majoras, and then Commissioner (and now Chairman) Kovacic argued that the evidence did not support the "deception . . .oppression" that the majority was seeking to stop.[18] This case settled, so we will not know whether a federal court would have agreed with the majority or the dissent.

Section 5 is a Broad Mandate

There are many more examples, but this short summary of a cases and controversies involving the Commission's enforcement of Section 5 should be adequate to demonstrate my first point: the scope of the authority described by the Supreme Court in *S&H* is broad enough to handle any threat that might arise to entrepreneurs, small businesses and the freedom they need to compete. The real challenge for the Commission is to channel that force wisely. Of course, most of the cases the Commission has brought are well within the boundaries of its authority.

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13 *Russell Stover Candies v. FTC*, 718 F.2d 256 (8th Cir. 1983).

14 *Official Airline Guides, Inc. v. FTC*, 630 F.2d 920 (2d Cir. 1980).

15 *California Dental Ass'n v. FTC,* 224 F.3d 942 (9th Cir. 2000).

16 *Rambus v. FTC*, No. 07-1086 (D.C. Cir. 2008).

17 *In the Matter of Negotiated Data Solutions LLC.*, FTC File No. 051 0094.

18 Dissenting statement of Chairman Majoras, Dissenting Statement of Commissioner Kovacic, *available at* http://www.FTC.gov/os/caselist/0510094/index.shtm.

And most demands for action call for a straightforward prohibition of harmful practices and unfair methods of competition that everyone would acknowledge.

This illustration of the Commission's authority also provides the corollary to my first point. It is hard to imagine an agency today getting a grant of authority as broad as that which the Commission received almost a century ago. When the Commission gets special powers today, these are typically narrower than the unfairness authority the agency already possesses. And these replacements of the Commission's fundamental mandate can contribute to the atrophy of Section 5.

Whenever an agency is given a specific grant of authority over a certain industry or a certain practice, it is natural for the agency to use that authority. If that agency is the Commission, a new power means that the power and precedent of unfairness cases will be one step removed from the enforcement of the new authority. Unfairness may still inform the exercise of the new authority, but the tradition of Section 5 – the *stare decisis* – will no longer control. Instead of applying nearly a century of understanding of Section 5, a new statute can put Commission cops on a beat with rules they never enforced. An agency learning how to enforce rules it has just acquired may not be as effective as the enforcer wielding a familiar weapon.

Resources Constrain the Commission

The summary of cases also illustrates my second point. The limits of Section 5 do not lie in the imagination of the officers sworn to uphold it. A far more pressing limit is the number of officers available to patrol the market and prosecute those who try to distort it for their own gain. In my day at the Commission, there was no higher calling than to ferret out the great case, to stop the wrong-doer, to protect the consumer and the market. I know many of the people at the Commission today, and that same dedication pervades the institution. They are eager for the next tip that will turn into the next case.

Of course, resources are limited, and the budget of the Federal Trade Commission cannot stand as an exception. However there is one way to enhance the law enforcement resources of the Commission without spending a dollar of additional funds – that is to relieve the Commission of the obligation to write new rules to implement new mandates that it receives. The agency has devoted considerable resources in the last few years writing rules to regulate behavior that was already understood to violate Section 5.

A good example of the paradox of granting new authority to the Commission can be seen in the recent rulemaking on oil price manipulation. In the Energy Independence and Security Act of 2007 (EISA), Congress gave the Commission the authority to promulgate regulations dealing with deception and manipulation in oil markets. There is little doubt that Section 5 gives the Commission all the authority it needs to investigate deception and manipulation in these markets. In fact the agency had conducted intensive investigations of the practices at many levels of energy supply and distribution. Today, FTC officials who could be investigating and bringing cases are proposing rules, reviewing comments, revising proposals and preparing justifications for their interpretation of the new statute. The immediate effect of the EISA has been to take cops off the beat and to turn them into rule writers. The next effect will occur when

the Commission goes back onto the beat and brings the first cases under the new statute. The prosecutions will be cases of first impression, rather than the latest cases drawing upon a century of enforcement. Given the uneven history of the agency working with new authority, we will have to wait years before we know whether the new rules protect competition, businesses and consumers, as well as the familiar standards of Section 5.

Testing the Effectiveness of Enforcement

The final point that I would like to leave with the Committee is to emphasize what I believe to be the best and most valuable use the Commission could make of its authority with Section 5. The Commission must focus its law enforcement on matters that affect the public. The agency does not have the resources to take sides in every private dispute, no matter how appealing the case. Determining which cases merit the Commission's attention – which cases matter most to the economy – is a critical task for the agency to perform. In every case the Commission brings, we should ask whether the case is worthy of the resources committed to the agency.

Every intervention the Commission undertakes should pass a cost-benefit test. The Commission should not bring a challenge unless the costs of the targeted practices exceed the benefits. And the Commission should not impose a remedy unless the benefits of its solution exceed the costs of the order. To be sure, some practices are so unlikely to have any benefits that they are condemned per se, without needing a cost-benefit test. Naked price fixing is a well known example. Such cases are rare at the Commission, however; they are more likely to fall within the province of the Department of Justice. The more complex cases the Commission brings typically require competitive analysis.

Of course, only the Commission has the information to perform a full cost-benefit test. In most cases, Commission observers must employ a proxy. Antitrust law has long recognized that monopolies and cartels cannot survive if they cannot protect themselves from new competitors. Virtually every lasting injury inflicted on a market and on consumers is also an assault against the entrepreneur and the small business that desires to compete for customers of the entrenched sellers. The *sine-qua-non* of unfair competition – whether practiced by a closed circle of colluding providers or an unscrupulous giant that destroys rivals – is the barrier to entry. It is the most direct obstacle to small business. Commission cases should pass the entry-barrier test – is the prosecution likely to lower barriers that stymie small businesses and entrepreneurs from entering a market? If so, the odds are good that the Commission has helped competition and consumers. If not, the Commission has probably wasted its resources, or worse, tilted the market away from efficient practices.

Sometimes, we may not even know enough to tell whether a case passes the barrier-lowering test. The debate among the Commissioners in the *N-Data* case revolved around this very issue. The dissenters argued that the practice condemned by the Commission was unlikely to have a competitive effect – i.e. raise significant costs to competitors. Unfortunately, the majority did not cite facts that rebutted the dissents. Instead, the Commission referred to facts that it declined to reveal, suggested that the practice had the *potential* to deter entry, but rested its decision on the desirability of transparency in standard setting. That may be a worthy goal, and

may be on that satisfies the subjective standards of S&H, but *N-Data will* remain a rare case that does not tell us whether the Commission had the facts to pass the critical cost-benefit or the entry barrier proxy for it.

Most of the time, however, the proxy I propose can typically be applied to a case on the basis of the information that is made public. Many of the Commission's excesses of the 1970s would have put burdens on companies without compensating benefits for consumers or competition. Small companies would have borne more than their share of these burdens. Many of the Commission's efforts today are designed to reduce those burdens and tear down those barriers. For that we should commend the Commission.

In conclusion, the most effective enforcement of Section 5 of the Federal Trade Commission Act is the prosecution that breaks down the barriers that protect the privileged few from the external forces of innovation and energy. The most wasteful enforcement of Section 5 is the intervention that makes it more difficult for the forces of innovation and energy – the small businesses of the United States – to displace the privileged few. Section 5 gives the Commission the authority to do both. We depend on the wisdom of the Commission, and on the oversight of Congress, to see that the Commission keeps Section 5 on the side of competition.

This concludes my testimony. Thank you, again Chairwoman Velázquez, Ranking Member Chabot and Members of the Committee.