Testimony of

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I. Introduction and qualifications

Mr. Chairman and members of the Committee, my name is Howard Beales. I am currently a professor of strategic management and public policy in the George Washington University School of Business.

I have long experience with the FTC, where I have held 5 different positions of progressively increasing responsibility. Most recently, I was the Director of the Bureau of Consumer Protection from 2001 through 2004. During my tenure, we created the National Do Not Call Registry, one of the most popular government consumer protection measures ever undertaken. We also launched an aggressive enforcement campaign against fraudulent infomercials, based on challenging false claims in federal court. Through these positions, as well as my academic writing on the FTC, I have studied the agency's approach to consumer protection issues for more than thirty years. I was one of the two principal staff draftsmen of the Deception Policy Statement and the Advertising Substantiation Policy Statement, the guiding documents for the Commission's approach to the consumer protection issues relevant to today's hearing, discussed in more detail below. I thank the Committee for asking me to discuss these important issues. Although I have consulted with Goldline on issues related to their marketing practices under the FTC Act, the views I express in this testimony are my own.

II. The FTC's Approach to Deception

The basic principles of the FTC's approach to advertising are well established. I first discuss two key documents detailing those principles, the Deception Policy Statement and the Advertising Substantiation Policy Statement. These statements apply to all of the

Commission's consumer protection activities, whether the product or service involves investments, dietary supplements, or well established consumer products.

Issued in 1983, the Commission's Deception Policy Statement stated that an act or practice is deceptive if it is likely to mislead consumers, acting reasonably in the circumstances, about a material issue. In adopting this statement, the Commission made clear that it was rejecting earlier case law inconsistent with this approach, including cases that allowed the Commission to condemn advertising based on unreasonable interpretations that ordinary consumers were unlikely to share. Moreover, the Commission made clear that it would always consider well-conducted external evidence, such as surveys of consumer interpretations, and would not ignore such evidence based on its own "expertise." Importantly, to be actionable, the challenged claim must be material, i.e., likely to affect the consumer's choice of or conduct regarding the product.

The Advertising Substantiation Policy Statement affirmed that advertisers must have a "reasonable basis" for objective claims about products or services. The Statement firmly roots the substantiation doctrine in the Commission's deception jurisprudence, noting that objective claims also carry an implication that the marketer has evidence to support the proposition. The amount of evidence necessary to constitute a reasonable basis depends on the specifics of the claim, balancing the risks of mistakenly prohibiting truthful claims against the costs of potentially allowing false claims.

The FTC has relied on the development of common law principles, supplemented with occasional rules and guides. The cornerstone of the FTC's consumer protection mission ís the fraud program, through which the Commission has returned hundreds of millions of dollars to defrauded consumers.

Although many do not think of them as such, these common law principles *are* rules, providing a crucial part of the institutional framework that helps our market economy to function. In most circumstances, these common law rules provide both clear guidance to the business community and an adequate basis for FTC enforcement actions. The common law process is also well suited to develop new policy. For example, the Commission has used this process to formulate general rules to protect the security of sensitive consumer information.

III. The FTC Has a Long History of Activity Against Deceptive Investment Claims

The FTC has sued many companies making deceptive investment claims, including the sale of gemstones, oil and gas lease lotteries, cellular license lotteries, and rare coins. These cases covered a broad range of deceptive investment claims from guaranteeing the success and profitability of securing a license to the false grading of coins. As demonstrated by these cases, the FTC has sought to identify clear violations involving deceptive advertising and practices that mislead and in many cases provide patently false information. Many of these cases are prompted by the Commission receiving a disproportionately large number of significant consumer complaints about a particular company and its practices.

Let me briefly discuss these cases and their key factual allegations.

- **Gemstones Cases**

  The FTC challenged false claims that a diamond company was claiming its diamonds were a "risk-free investment" and that its prices were "below normal retail levels." (*FTC v. International Diamond Corp*. (1982)). It charged another company with falsely claiming that diamonds and rubies were highly liquid and often accepted as cash. (*FTC v. Thomas L. Baker, Inc*., *et al*. (1982)).

- **Oil and Gas Lease Lottery Cases**

  The Commission filed suit against a number of companies offering filing services for oil and gas leases that the U.S. Department of the Interior offered through a lottery system. In these cases, the defendants falsely represented the likelihood that a customer would obtain a lease, claimed that the customer would only be competing with a few individuals when in fact there were hundreds of applicants for each lease, and falsely claimed that they would make filings only on parcels known to have oil and gas. Misrepresentations of the likelihood of success are comment in many investment cases. (*See, e.g. FTC v. First Petroleum Corp. of America* (1982); *FTC v. J&R Marketing Corp. et al.* (1983); *FTC v. Leland Industries, Inc. et al.* (1983); *FTC v. Oil and Gas Corp. et al.* (1983)).

- **Cellular License Lottery Cases**

  The FTC also charged several companies with falsely representing the investment potential of cellular network licenses, and the likelihood or securing such licenses through a federal government lottery system. The companies charged falsely represented that consumers were practically guaranteed a license and made false claims about the profitability of the licenses. (*FTC v. American National Cellular, Inc. et al*. (1985); *FTC v. Continental Communication, Inc. et al*. (1988)).

- **Rare Coin Cases**

  The Federal Trade Commission has challenged many firms involved in the sale of rare coins. In *FTC v. Rare Coins of Georgia, Inc. et al.* (1987), the FTC filed suit against two Georgia firms involved in the marketing or sale of silver coins. Among other violations, the companies issued grading certificates sold along with the coins that overstated the coins' quality and grade. Coins worth $30 to $60 were sold to investors for $300 to $400. In *FTC v. Security Rare Coins, Inc. et al.* (1989), the FTC filed suit against a New York firm and its president that sold coins as investments. Defendants claimed that "[t]here is virtually no limit to the gains that can be made," and projected returns between 200% and 850% over a period of 3-5 years for some coins. The defendants also allegedly claimed that this investment performance was "more than possible, it is probable." In *FTC v. Certified Rare Coin Galleries, Inc. et al.* (1989), the FTC challenged claims that coins were being sold at or near market value, when, in reality, the prices were routinely more than double the wholesale value of the coin. Similarly, in *FTC v. Oak Tree Numismatics, Inc. et al.* (1991), the FTC filed suit against three New Jersey firms and several individual defendants that claimed that the investments were low risk and that the coins were being sold at "impossibly low" prices with "low markups." In fact, the coins were sold at prices that were 7 or 8 times their market value.

Common themes in the Commission's investment cases are false claims that high returns are virtually certain in a short period of time. The cases involving commodities also feature misrepresentations, usually express, of the relationship between the selling price and the market value of the item, combined with grossly inflated prices. As discussed in the next section, such claims are a far cry from Goldline's practices.

IV. Practices and Claims the FTC Has Challenged Differ Dramatically From Goldline's Practices[1]

Goldline's advertising and sales practices do not resemble the FTC's cases against firms involved in the sale of rare coins, gemstones, oil and gas leases, and cellular licenses.

The basis of the FTC's actions for deceptive and misleading advertising or practices is just that -- they must be deceptive and misleading. Deceptive and misleading advertising or practices generally contain false guarantees, promises, or claims, and may involve outright fraud. Such deceptive advertising generally does not contain prominent disclosures for the consumer to consider before purchasing, nor other safeguards.

In contrast, Goldline's marketing and sales practices encompass extensive disclosures that encourage a consumer to consider carefully his or her purchase. As described in

[1] I reviewed a sampling of Goldline's radio and TV ads, as well as its printed marketing materials; risk disclosures booklet, *Coin Facts for Investors and Collectors to Consider*; Account and Storage Agreement, and related materials.

more detail below, Goldline's sales process and the characteristics of its buyers are not conducive to deceptive practices. Goldline does not make the kinds of claims that typify past FTC cases. Finally, the company provides clear disclosures and cautious advice.

1. Goldline's Sales Process and the Characteristics of its Buyers are Not Conducive to Deceptive Practices.

Goldline's advertising relies on consumers calling the company or visiting its website to get additional information. Goldline does not make "cold calls" to solicit customers who are not considering the products. Typically, customers call with initial questions, and call back several times over a period of days, and sometimes weeks or months, before making a purchase. Thus, they have both time and the opportunity to check out competing sellers and other sources of information. The fact that a sale typically takes several calls suggest that consumers are exercising the kind of due consideration that should be given to a purchase typically in the range of $15,000 to $20,000 for first time buyers.

Moreover, Goldline's typical customer likely understands the value of becoming informed and knows how to do so. The typical buyer is in a professional or technical job, and most buyers have a college education or some graduate school. Customers are disproportionately from high net worth households (over $250,000) and households with incomes of at least $90,000. The most common customer is 45 to 55 years old.

Goldline provides potential customers with a clear, well-written disclosure document, *Coin Facts for Investors and Collectors to Consider*, explaining the market and the company's practices in detail. In my experience, Goldline's pamphlet is a vast improvement over the disclosure documents that typically accompany other investment opportunities. In addition, all first-time buyers of Goldline's higher margin products have an unconditional seven-day cancellation period (longer in some states), providing significant time for any consumer to consider their potential purchase, compare prices and offerings among other precious metal sellers, and access information from readily available sources on the value, prices, and risks of rare coins and precious metals.

Even sophisticated customers, of course, can be misled. Goldline, however, is very different from the type of company typically found engaging in deceptive investment promotions. It has a 50-year history of offering precious metals to consumers. Roughly half of its sales are repeat purchases, which only occurs when customers are satisfied with the products and the service they have received. Goldline also has an A+ rating from the Better Business Bureau.

2. Goldline Does Not Make the Claims Typical in Past FTC Cases.

Goldline's advertising and sales materials do not guarantee or promise a profit or specific return. In contrast to the quick profit claims that are the hallmark of past cases, Goldline advises consumers that "rare coins and currency should be held for <u>at least</u> 3 to 5 years, and, preferably, 5 to 10 years (underlined in original)."

Goldline makes no representations that it is selling at wholesale or the "lowest price," unlike the advertising and practices found in many of the FTC's past cases. Instead, Goldline provides a straightforward disclosure that its spread on bullion coins ranges from 5 to 20 percent, and that its spread on semi-numismatic and numismatic coins is 30 to 35 percent. It also provides a very clear example of how this differential would affect a consumer's purchase of a coin from Goldline and how much that coin would have to increase in value for the consumer to earn a profit. Rather than illustrating a best case scenario, the example is based on Goldline's maximum spread, where the necessary appreciation is greatest. This is a meaningful explanation and illustrative example that consumers can readily understand.

Goldline generally uses the two largest coin grading services, Professional Coin Grading Service and Numismatic Guaranty Corporation, to grade and certify the coins it offers for sale. To my knowledge, there have been no allegations of overgrading involving Goldline.

3. Goldline Provides Clear Disclosures and Cautious Advice.

Goldline's advertising and sales practices are qualified in their representations and filled with sound cautions. Among others, these cautions include that consumers should consider their own investment needs, balance their portfolio, place no more than 5-20 percent of their portfolio in precious metals, and plan to keep any precious metal purchase for at least three to five years or longer, preferably five to ten years. Consumers are advised that because coins and bullion can decline in value, "you should have adequate cash reserves and disposable income before considering acquiring" such products. Many advertisements ask consumers to "read Goldline's important risk information about buying Gold to see if it is right for you."

Goldline provides clear written disclosures that it requires all customers to indicate they have read before completing their purchase from Goldline. Its disclosure document, *Coin Facts for Investors and Collectors to Consider*, is written in a large, easy to read font. These disclosures also are sent with all marketing materials, and are prominently available on Goldline's web site. Similar disclosures are part of every Goldline Account and Storage Agreement. Moreover, Goldline expressly advises consumers that its Account Executives are generally commissioned salesperson and that their commissions usually vary by the type of product they sell.

In short, Goldline is the antithesis of the "get rich quick" seller that uses frequent gross misrepresentations so common in past FTC cases.

V. The proposed legislation would do little to help consumers, and could even be harmful.

H.R. 6149, the Precious Coins and Bullion Disclosure Act, would require presale disclosure of any fees if the transaction is consummated, "the purchase price, the melt value, and the reasonable resale value of the coin or precious metal bullion," and other information that the FTC may require by rule. Disclosure of fees and the purchase price are already required under the FTC's Telemarketing Sales Rule, so the real issue is the disclosure of reasonable resale value and melt value. Disclosures must be clear and conspicuous, and, in telephone solicitations, made orally. Essentially, these disclosures would reveal the seller's markup on the product.

In every other market, we rely on competition to police seller markups. In retailing, for example, it is not disclosures of the markups at full service department stores that keeps markups low, it is competition from department stores and other retailers such as WalMart. What matters to consumers is the cost of the transaction, not the seller's markup. As long as information about prices at competing sellers is readily available to consumers who are interested, and it certainly is in the coin and precious metal markets, there is no reason to disclose the seller's markup.

Although providing consumers with more information almost always sounds appealing, it can in fact increase consumer confusion, rather than reducing problems. For example, the FTC's Bureau of Economics conducted an experimental study of the effect of disclosing the yield spread premium in mortgage transactions, which is essentially part of a mortgage broker's compensation for the transaction. When the disclosure was included, consumers apparently focused on the disclosure, rather than the overall cost of the transaction. As a result, they were less able to identify the low cost mortgage.[2]

The reasonable resale value disclosure in H.R. 6149 may create similar problems. Like the yield spread premium disclosure, it risks focusing consumer attention on an aspect of the transaction that is not relevant to the overall cost. Confusion seems particularly likely when the resale value is disclosed along with the melt value. The melt value is simply

[2] J. Lacko and J. Pappalardo, *The Effect of Mortgage Broker Compensation Disclosures on Consumers and Competition: A Controlled Experiment*, Bureau of Economics Staff Report, Washington: Federal Trade Commission (2004).

irrelevant, because it will always be reflected in the reasonable resale value of any product whose value is tied to spot prices.

Moreover, in a market where prices change constantly, consumers may misunderstand what the "reasonable resale value" disclosure means. For the consumer who expects to sell an investment position several years down the road, the price at a substantially different point in time is simply irrelevant. If consumers understand the disclosure as a claim that they can actually expect to resell the item at the disclosed price, they may be seriously misled. The risk of this misinterpretation is increased because consumers will almost inevitably assume they are being provided with this information because it should be important in their decision.

As drafted, the "reasonable resale value" disclosure is particularly burdensome to sellers. A seller must determine the price that *another* dealer would pay to purchase the item, *on the date* when the item is sold to the consumer. In a market where prices change continuously even within the course of a trading day, compliance would be exceedingly difficult. Unlike virtually all other disclosure requirements, this provision would require disclosures with the sale of a particular item that change every day, and that are different for every individual item sold.

To obtain "reasonable resale value" information, the industry may well develop mechanisms to share real time information on a daily basis. From an antitrust perspective, such information exchanges have frequently raised concerns because they may contribute to industry efforts to fix or stabilize prices. A reduction in price competition, particularly in the price dealers are will to pay to buy back coins, can hardly be in the interests of investors.

Finally, H.R. 6149 exempts the sale of collectable coins, if the precious metal content is a "limited or insignificant portion of the overall value," *and* "whose value is not affected by the increase or decline in the value of such precious metals." As a matter of economics, however, it is difficult to imagine a coin that would meet the literal terms of the second requirement. If the precious metal content is *any* portion of the overall value of the coin, as it most likely is, the price will be affected by changes in precious metal prices. If the metal content is a limited or insignificant portion of the overall value of the coin, changes in metal prices will likely have a limited or insignificant effect on the value of the coin, but they will have an effect. Thus, the second condition for exemption appears to take away what the first provision grants.

VI. Conclusion

The Federal Trade Commission has an important role as a referee in policing the market economy. Like other products and services, the best protection remains the common law principles that the Commission enforces. Goldline's practices are entirely consistent with these principles. The proposed legislation is at best unnecessary; and it may in fact create consumer confusion.

Mr. Chairman, thank you again for the opportunity to testify today. I look forward to answering any questions you may have.