

# Disclosure—An Unappreciated Tool in the CFPB’s Arsenal

Thomas P. Brown\*  
O’Melveny & Myers, LLP  
Adjunct Professor, UC Berkeley Law School

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## I. INTRODUCTION

Title X of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) establishes the Consumer Financial Protection Bureau (“the Bureau”). Dodd-Frank defines a broad mission for the Bureau. According to the legislation, the Bureau will “implement and, where applicable, enforce Federal consumer financial law consistently for the purpose of ensuring that all consumers have access to markets for consumer financial products and services and that markets for consumer financial products and services are fair, transparent, and competitive.”<sup>1</sup>

The enabling legislation identifies five objectives for the Bureau:

- Provide consumers “with timely and understandable information to make responsible decisions about financial transactions;”
- Protect consumers “from unfair, deceptive, or abusive acts and practices and from discrimination;”

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1. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 § 1021(a) (2010) (to be codified at 12 U.S.C. § 5511(a)).

- Regularly identify and address “outdated, unnecessary, or unduly burdensome regulations” in order to reduce “unwarranted regulatory burdens;”
- Consistently enforce federal consumer financial law without regard to whether someone is a depository institution, in order to “promote fair competition;” and
- Ensure the transparent and efficient operation of markets for consumer financial products and services to “facilitate access and innovation.”<sup>2</sup>

The creation of the Bureau has produced considerable anxiety in the consumer finance industry. Most of the anxiety has focused on two issues: who will head the Bureau and how the Bureau will exercise its newly created power to ban “abusive” products.<sup>3</sup> This Article suggests that the financial services industry should focus instead on a third question: what the Bureau will do with its power to regulate the disclosure of consumer financial services. Dodd-Frank gives the Bureau significant new power to craft disclosure rules for consumer financial services and products. In exercising this power, the Bureau will confront a series of questions that have bedeviled policy makers since the idea of regulating the content of such disclosures was first floated: who the target audience is for the disclosure; how the effectiveness of disclosure should be measured (e.g., whether it is sufficient to make information available or whether it be understood by that audience); and what must be disclosed. As this Article explains, Dodd-Frank grants the Bureau license to answer these questions in a way that would stifle competition and harm consumers by replicating a power thought to have been denied the agency—the ability to force financial institutions to offer only “plain vanilla” versions of their products.

## II. THE OPEN QUESTIONS THAT WILL DETERMINE THE SIGNIFICANCE OF THE BUREAU’S MANDATE TO SET DISCLOSURE STANDARDS FOR FINANCIAL SERVICES

Dodd-Frank makes the Bureau the principal regulator of the form and content of consumer financial products. It gives the Bureau the authority to require that the features of any consumer financial product or service “are fully, accurately, and effectively disclosed to consumers in a manner that permits consumers to understand the costs, benefits, and risks associated with the

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2. Pub. L. No. 111-203 § 1021(b) (to be codified at § 5511(b)(1-5)).

4. With the nomination of former Ohio Attorney General, Richard Cordray, to serve as the Director of the Bureau, the first of these questions has presumably been answered. Remarks by the President in Nominating Richard Cordray as Director of the Consumer Financial Protection Bureau (Jul. 18, 2011) (available at <http://www.whitehouse.gov/the-press-office/2011/07/18/remarks-president-nominating-richard-cordray-director-consumer-financial>).

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product or service, in light of the facts and circumstances.”<sup>4</sup> The Bureau’s authority begins with the initial solicitation and continues “over the term of the product.”<sup>5</sup> Dodd-Frank also gives the Bureau the ability to create a disclosure “safe harbor” through the promulgation of “model forms.” Financial institutions that use these forms would automatically satisfy their disclosure obligations.<sup>6</sup>

As with the much-analyzed “abusive” power provision, the text of the Dodd-Frank Act leaves open how the Bureau might exercise this disclosure power.<sup>7</sup> The Act puts few constraints on the Bureau’s exercise of this power. It instructs the Bureau to consider available evidence about consumer awareness towards, understanding of, and response to disclosures or communications about the risks, costs, and benefits of consumer financial products or services.<sup>8</sup> In exercising this power, the Bureau could limit its attention to the concerns that prompted the passage of the Truth in Lending Act (TILA) in 1968,<sup>9</sup> i.e., the development of a common metric and vocabulary for comparing the costs of credit across different types of credit products.

Or, the Bureau could use its new power to attempt to force providers of consumer financial services to standardize the terms of those products. The statutory language is sufficiently vague that the Bureau will have an unlimited ability to interpret the scope of its disclosure mandate. A court asked to scrutinize the Bureau’s interpretation will only ask whether the interpretation is “based on a reasonable construction of the statut[e].”<sup>10</sup> Under *Chevron*, such a court *must* defer to the Bureau’s interpretation unless it is “arbitrary, capricious, or manifestly contrary to the statute.”<sup>11</sup>

The scope of the Bureau’s power will likely be defined by how the Bureau chooses to answer three questions left unanswered by the statutory language:

- Who must be “permit[ted] . . . to understand” (i.e., what is the relevant universe of consumers)?
- What defines the universe of things that must be “understood” (or, put differently, how would a consumer financial institution determine *what* a consumer must be permitted to understand)?
- What does “permit to understand” mean?<sup>12</sup>

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4. Pub. L. No. 111-203 § 1032(a) (to be codified at § 5532(a)).

5. *Id.*

6. Pub. L. No. 111-203 § 1032(b) (to be codified at § 5532(b)).

7. *See* Pub. L. No. 111-203 § 1036(a)(1)(b) (to be codified at § 5536).

8. Pub. L. No. 111-203 § 1032(a) (to be codified at § 5532(a)).

9. *See* 15 U.S.C. §§ 1601 *et seq.* (2006).

10. *See Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 840 (1984).

11. *Id.* at 844.

12. *See* Pub. L. No. 111-203 §§ 1032(a) (to be codified at § 5532(a)).

The text of the Dodd-Frank Act neither answers these questions nor sheds any light on how they should be answered. Nevertheless, these answers will have significant implications as to the types of products that financial institutions will be permitted to offer consumers going forward. If the CFPB interprets its disclosure authority to require that all consumers understand each attribute of every financial product, it will force financial institutions to simplify products dramatically.

The question of how to define the universe of consumers who must understand a particular financial product presents a benchmarking question that the law must frequently answer. For example, the common law of torts revolves around a standard of care defined by an “ideal individual” exercising “average prudence” or “reasonable sense.”<sup>13</sup> But this is not the only possible standard by which to judge an individual defendant’s prudence in a particular circumstance. The law could require a defendant to exercise the care that the most cautious person would take under those circumstances or excuse liability if the defendant exercised the level of prudence that even one other person had demonstrated in a similar circumstance. Other regulatory regimes set relevant benchmarks based on more targeted populations. Someone seeking to get a pharmaceutical product approved by the FDA need not prove that a compound will be safe and effective for all people, but just for the targeted population. Thus, the compound, thalidomide, which can cause horrific birth defects, has been approved as a treatment for people suffering from painful complications of leprosy and other auto-immune disorders, but not for women seeking relief from morning sickness.<sup>14</sup>

The fact that it is a common question does not make it an easy one for the Bureau to answer. On one extreme, the Bureau could require that every potential consumer understand every consumer financial product offered. Alternatively, it could allow financial institutions to develop disclosures tailored to an idealized composite consumer. This idealized composite consumer could vary depending on the nature of the product, e.g., one “reasonable consumer” for payday loans and another for jumbo mortgages. If, as seems safe to assume, users of different consumer financial products have attained different levels of financial sophistication, this decision will produce very different disclosures.

The answer to the question of *what* consumers (or a hypothesized composite consumer) must understand is not obvious either. As Thomas Durkin, a former Federal Reserve economist, recently explained, this problem has vexed the prior disclosure regime for consumer credit products, the TILA,

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13. Restatement (Second) of Torts § 283, cmt. c (1965).

14. See Scott P. Glauber, *The Real Thalidomide Baby: The Evolution of the FDA in the Shadow of Thalidomide, 1960-1997* (1997) (available at [http://loda.law.harvard.edu/loda/data/389/Scott\\_P\\_Glauber.html](http://loda.law.harvard.edu/loda/data/389/Scott_P_Glauber.html)).

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since before it was passed. TILA was the brainchild of Senator (and former University of Chicago professor of Economics) Paul H. Douglas.<sup>15</sup> When Senator Douglas introduced the first version of TILA, it “consisted of only three and one half pages of large type” and “required only two federal disclosures, total finance charges and ‘simple annual interest.’”<sup>16</sup> Even before the 2009 passage of the Credit Card Accountability Responsibility and Disclosure Act (“CARD Act”) added to the list of TILA’s disclosure requirements, the specific disclosures required by TILA for revolving credit alone had increased by 1500%.<sup>17</sup>

The problem, as Durkin explains, flows from two inextricable aspects of most consumer credit transactions—the divisibility of even the simplest transaction into a myriad of discrete components and the confounding effect of time.<sup>18</sup> Most revolving credit transactions initiated with a credit card, for example, involve five parties—a consumer, a merchant, banks for both the consumer and the merchant, and a network connecting the parties.<sup>19</sup> Fees (or discounts) can arise at many different points in the series of interactions that give rise to a particular transaction and may apply to some types of transactions but not others. The card issuer, for example, might offer certain terms when a consumer uses the card to complete a multi-currency transaction.<sup>20</sup> But the merchant may offer its own terms to convert a transaction offered in a foreign currency into the cardholder’s native currency.<sup>21</sup> Moreover, not all consumers take advantage of all the features of a particular financial service. A consumer who has never traveled abroad and has no plans to do so is likely not going to choose a card issuer based on a comparison of fees imposed on multi-currency transactions.

Time introduces still more complexity. From a consumer’s perspective, time is what principally distinguishes revolving credit from installment credit. With an installment (or closed-end) loan, a consumer receives a loan and, assuming a fixed interest rate and a fixed repayment period, makes set

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15. Thomas A. Durkin, *Should Consumer Disclosures Be Updated?*, 2-3, 15 (Understanding Consumer Credit, A National Symposium On Expanding Access, Informing Choices, and Protecting Consumers, Working Paper No. UCC08-10, 2007) available at <http://tinyurl.com/4qh213b>.

16. *Id.* at 15.

17. *Id.* at 30-31.

18. *Id.* at 15.

19. William F. Baxter, *Bank Interchange of Transactional Paper: Legal and Economic Perspectives*, 26 J.L. & ECON. 541, 545 (1983).

20. See Federal Reserve Board’s Truth in Lending Official Staff Commentary to Regulation Z, 12 C.F.R. Pt. 226, Supp I (2011) (“Any charge imposed on a credit cardholder for making a purchase or obtaining a cash advance outside the United States, with a foreign merchant, or in a foreign currency is a finance charge, regardless of whether a charge is imposed on debit cardholders for such transactions.”).

21. See, e.g., 12 C.F.R. § 226.9(d) (“Any person, other than the card issuer, who imposes a finance charge at the time of honoring a consumer’s credit card, shall disclose the amount of that finance charge prior to its imposition.”).

payments over time.<sup>22</sup> With a revolving line, on the other hand, a consumer receives the right to borrow up to a particular threshold.<sup>23</sup> So long as the consumer has not exhausted the limit, he or she can increase the amount owed by making additional purchases. This difference makes it very difficult to compare the terms of an installment loan with those of revolving credit. A consumer who borrows \$2,000 on a twelve-month installment plan at a 20% simple interest rate owes the lender \$200 a month. A consumer with a revolving credit account limit of \$2,000 who does not have outstanding charges will owe nothing.

The many possible definitions of “permit to understand” invest the Bureau with additional interpretative authority. The Bureau could interpret “permit to understand” to require a consumer (either idealized or actual) presented with a disclosure to be able to extract certain information from that disclosure. That is, “permit to understand” could mean something close to “likely to understand.” Alternatively, “permit to understand” could simply be interpreted to require a financial institution to make truthful and accurate information available to consumers.

### III. PROFESSOR WARREN’S WRITINGS AND SPEECHES PROVIDE SOME HINTS AS TO HOW THE BUREAU MIGHT ANSWER THESE QUESTIONS.

The statutory framework provides the Bureau with an extraordinary degree of discretion. On the one hand, the Bureau could build on TILA’s existing foundation, requiring that some information be disclosed clearly and conspicuously, but otherwise simply identifying information that firms must provide to consumers.<sup>24</sup> On the other hand, the Bureau could wield this power to remake the consumer financial industry by forcing firms to restructure consumer financial products into forms that all consumers can actually understand. The academic writings of Elizabeth Warren, the law professor who the President charged with bringing the Bureau into existence,<sup>25</sup> suggest that she sees disclosure as a tool for remaking the industry.

The Bureau’s power to dictate how firms disclose their products to consumers flows directly from Professor Warren’s criticism of the consumer financial services industry. Professor Warren has long been critical of the way lenders disclose their products to consumers. She has accused consumer credit

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22. *See, e.g.*, Wisconsin Department of Financial Institutions, *What Is Credit?* (June 26, 2011), [http://www.wdfi.org/wca/consumer\\_credit/credit\\_guides/what\\_is\\_credit.htm](http://www.wdfi.org/wca/consumer_credit/credit_guides/what_is_credit.htm) (explaining that closed end credit is extended for specific amount and a set time period).

23. *See, e.g., id.* (explaining that open-end credit allows a consumer to make repeated purchases without having to obtain a new loan from the same lender).

24. *See* Pub. L. No. 111-203 § 1032(b)(2), *to be codified at* § 5532.

25. *See* Jackie Calmes & Sewell Chan, *Obama Picks Warren to Set Up Consumer Bureau*, N.Y. TIMES, Sept. 18, 2010, at B5.

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companies of “deliberately buil[ding] tricks and traps into some credit products so they can ensnare families in a cycle of high-cost debt.”<sup>26</sup> In her view,

Creating safer marketplaces is about making certain that the products themselves don’t become the source of trouble. This means that terms hidden in the fine print or obscured with incomprehensible language, reservation of all power to the seller with nothing left for the buyer, and similar tricks have no place in a well-functioning market.<sup>27</sup>

Professor Warren often uses credit cards as an example to illustrate her concerns about the current regulatory regime and explain how a new regime might work. According to Professor Warren, “disclosure that runs on for pages is not real disclosure—it’s just a way to hide more tricks.”<sup>28</sup> She believes that eliminating the fine print and informing consumers of the price and the risk of financial products up front will allow consumers to compare products more effectively and make better choices. Perhaps most noteworthy, Professor Warren has suggested that credit card disclosures should be understood by approximately *ninety-five percent* of users.<sup>29</sup>

Professor Warren has also signaled how “regulatory safe harbors” of the sort built into Dodd-Frank can be used to limit product differentiation. She has suggested that a financial institution can limit its compliance burden by developing “plain vanilla” products that use “off-the-shelf” disclosure templates. Such a financial institution satisfies its regulatory obligations simply by “filling in the blanks for interest rates, penalty rates and a few other key terms.”<sup>30</sup> Such a regime effectively imposes a tax on any financial institution that wants to offer a product with features not found on the model form. The disclosure safe harbor provides a route to achieve plain vanilla consumer financial products and services.

#### IV. EVEN ASSUMING THAT CURRENT DISCLOSURES ARE LESS THAN PERFECT, MORE GOVERNMENT REGULATION WILL NOT NECESSARILY MAKE THEM BETTER

The potential reach of the Bureau’s disclosure power has received little if any attention. The most extreme use of the Bureau’s disclosure power would mark an epochal shift in the consumer-finance industry by forcing financial

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26. Elizabeth Warren, *Making Credit Safer: The Case for Regulation*, Harvard Magazine, May-June 2008, at 35, available at <http://harvardmagazine.com/2008/05/making-credit-safer.html>.

27. *Id.*

28. Elizabeth Warren, *Three Myths about the Consumer Financial Product Agency*, THE BASELINE SCENARIO, (Jul. 21, 2009), <http://baselinescenario.com/2009/07/21/three-myths-about-the-consumer-financial-product-agency>.

29. *Id.*

30. *Id.*

institutions to standardize their products. But such a shift has not been justified. Although a consumer may not make perfectly rational decisions when it comes to assuming revolving credit, available empirical evidence suggests that their decisions are far from irrational.

There is ample empirical evidence that consumers make sensible choices about how they use consumer credit. One recent study examined how consumers make choices among different credit cards with different features. One card had an annual fee and a comparatively low interest rate. The other had a higher interest rate but no annual fee.<sup>31</sup> The study looked at how two hundred thousand consumers chose between the cards initially and whether they switched between the cards when given the opportunity to do so.<sup>32</sup>

The study found that, on average, consumers chose the most appropriate credit contract.<sup>33</sup> And, “while relatively few consumers switched contracts,” when given the opportunity, “those who made larger errors in their initial contract choice were more likely to subsequently switch to the optimal contract.”<sup>34</sup> Although the credit card contracts offered during this experiment were simpler than most, the results suggest that consumers are capable of making logical credit decisions, and even re-evaluating and changing their decisions when necessary.

But there is a larger point at work. Professor Warren’s critique of how the consumer financial industry works is based on a comparison between the actual and a hypothesized perfectly competitive version of that same industry. In a speech that Professor Warren gave in December 2010 to the Consumer Federation of America in Los Angeles, she illustrates this point:

[T]he sellers of credit (banks like this) and the buyers of credit (American families) too often make deals with two very different understandings of the basic economics of the deal . . . . This doesn’t work. If the two parties to a contract don’t actually have the same transaction in mind, then the fundamental premise of an efficient market—we both understand the deal and engage in deals that we think are good for us—is missing.<sup>35</sup>

The final sentence captures the premise of Professor Warren’s criticism of the industry: that the market cannot protect consumers unless those consumers are fully informed about the consequences of their choices.

Although it is true that the model of perfect competition, familiar to anyone who sat through an introductory economic class in college, assumes the existence of fully informed consumers, that model does not illustrate how

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31. Sumit Agarwal, et al., *Do Consumers Choose the Right Credit Contracts?* 1 (Social Science Research Network, Working Paper No. 843826, 2006), available at <http://ssrn.com/abstract=843826>.

32. *Id.* at 13.

33. *Id.* at 4.

34. *Id.* at 5.

35. Elizabeth Warren, Remarks at the Consumer Federation of America Financial Services Conference: Priorities for the New Consumer Financial Protection Bureau (Dec. 2, 2010), available at <http://tinyurl.com/4dtn2cv>.

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competition is supposed to work.<sup>36</sup> Rather, the model emerged to support a critique of government policies that granted monopolies to private actors. It demonstrates that under highly stylized assumptions, a decentralized model of resource allocation could ensure an efficient distribution of resources.<sup>37</sup> The absence of the conditions under which competition achieves the “efficient” outcome does not, however, imply that government control over the form and content of communications between financial institutions and their customers will better protect consumers.

There are many differences between the real world and the world of perfect competition. Indeed, most of the things that characterize the real world are assumed away by the model of perfect competition, including transaction costs, differentiated products, and differentiated consumers.<sup>38</sup> But the most important difference between the real world and the hypothesized world, at least for purposes of thinking about how the Bureau might exercise its disclosure power, is the recognition that information is a good. Firms and consumers produce, exchange, and consume it. The choices that firms and consumers make about how much information they choose to produce, exchange, and consume reflect decisions about the value of acquiring additional information and the opportunity costs associated with that acquisition.<sup>39</sup>

Consider, for example, the cost-benefit calculation facing a consumer who is considering obtaining a credit card. As noted above, someone who has never been outside of the United States and has no plans to leave the United States is likely not interested in comparing credit cards on the basis of the fees imposed on foreign transactions. Even if a financial institution makes information about that dimension of its credit card contract available, it is by no means clear that the consumer would read that aspect of the disclosure, or retain that information even if he or she did read it. And it seems obvious, at least within the confines of the hypothetical, that financial institutions should not be precluded from offering credit cards that work outside the United States (and charging a fee specific to that use) simply because that feature (and the price) are not of interest to, and are therefore not understood by, all consumers (or ninety-five percent of them).

Indeed, the last significant attempt by the federal government to correct the failure of financial institutions to communicate with their customers, the CARD Act of 2009, demonstrates just how difficult it is to ensure that the features of a consumer financial product or service are “fully, accurately, and effectively disclosed to consumers.” When President Obama signed the CARD Act into

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36. See Harold Demsetz, *Information and Efficiency: Another Viewpoint*, 12 J.L. & Econ. 1, 19 (1969).

37. See *id.* at 19.

38. See *id.*

39. See *id.* at 10.

law, he highlighted a provision of the Act that requires financial institutions to disclose how much a consumer would need to pay each month in order to retire his or her debts in three years.<sup>40</sup> In February 2011, at a conference hosted by the CFPB to celebrate the CARD Act, Professor Warren praised this same provision.<sup>41</sup> Both the President and Professor Warren neglected to mention, however, that the government-mandated calculation does not actually tell consumers what they need to pay in order to pay off their credit cards. The federally mandated disclosures have a hidden flaw: the three-year calculation is prospective. It is based on the current outstanding balance, the current interest rate, and a three-year term from the date of that statement.<sup>42</sup> Someone who wants to pay off a card in three years actually has to stop using the card (or pay off all new charges) and pay the “three year” amount on the first statement in order to retire the debt in three years. Otherwise, the debt will linger indefinitely into the future (or at least until the “three year” payment falls below the card issuer’s monthly minimum).<sup>43</sup>

This does not deny the government, through the Bureau or some other agency, a role in helping to devise better means of communicating information about financial products to consumers. Much of the content of existing disclosures of credit products is a function of Federal mandates. The Federal government is the only institution that can roll back those requirements.<sup>44</sup> Rather, it recognizes the enduring truth of the “nirvana fallacy”—the fact that real world market outcomes fall short of idealized market outcomes does not suggest that real world governments will achieve better outcomes than real world markets.<sup>45</sup>

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40. President Barack Obama, Remarks by the President at Signing of the Credit Card Accountability, Responsibility and Disclosure Act (May 22, 2009), *available at* <http://tinyurl.com/pew2no>.

41. Elizabeth Warren, Remarks on The CARD Act: The CARD Act: One Year Later (Feb. 22, 2011) *available at* <http://www.treasury.gov/press-center/press-releases/Pages/tg1074.aspx>.

42. See 12 C.F.R. Pt. 226 App. M1(d) (“When calculating the estimated monthly payment for repayment in 36 months, a card issuer must calculate the estimated monthly payment amount that would be required to pay off the outstanding balance shown on the statement within 36 months, assuming the consumer paid the same amount each month for 36 months.”).

43. One columnist who previously touted the three-year disclosure as a major step forward for consumers described the point when she realized the problem with it as “one of those slap-myself-on-the-forehead-moments.” See Gerri Detweiler, *How 3-year Debt Payoff Plan Takes Twelve Years* (April 21, 2011), *available at* <http://www.credit.com/blog/2011/04/how-a-3-year-debt-payoff-plan-takes-twelve-years>.

44. Congress assigned the Bureau the task of simplifying mortgage disclosures. The Act requires the Bureau to combine the two federally mandated mortgage disclosures into a single form. Pub. L. No. 111-203 § 1098(2)(a) (to be codified at § 2603) (“The Bureau shall publish a single, integrated disclosure for mortgage loan transactions (including real estate settlement cost statements) which includes the disclosure requirements of this section and section 5, in conjunction with the disclosure requirements of the Truth in Lending Act that, taken together, may apply to a transaction that is subject to both or either provisions of law . . .”).

45. See Demsetz, *supra* note 36, at 1. The phrase “nirvana fallacy” is attributed to this famous paper by Demsetz, but the phrase does not appear in the paper. Although the paper identified three fallacies, none is labeled the “nirvana fallacy.” Instead, the paper uses the phrase “nirvana approach.” *Id.*