AFFIDAVIT OF RICHARD S. BOWER

1. I am an independent economic consultant with an office at the Tuck School of Business at Dartmouth College, Hanover, NH 03755, telephone (603) 646-3579. I am also the Leon E. Williams Professor of Finance and Managerial Economics, Emeritus, at the Tuck School of Business at Dartmouth College. I have been an active faculty member at Tuck since 1962. The courses I have taught include Managerial Economics, Pricing Policy, Financial Management, Regulatory Policy, and Investment Banking. I served Dartmouth College as the Henry R. Luce Visiting Professor of Environmental Studies in 1983 and taught at Kenyon College, 1949-50, Alfred University, 1955-57, and Vanderbilt University 1959-62.

I received my B.A. in Economics from Kenyon College in 1949, my M.B.A. from Columbia University in 1955, and my Ph.D. in Managerial Economics from Cornell University in 1962.

From 1981 to 2001 I was a partner in Bower Rohr and Associates, Economic Consultants. From January 1979 through February 1981 I served as a Commissioner of the New York State Public Service Commission. Over the years I have been Program Chairman, Editor of the Journal, President, and Chairman of the Board of the Financial Management Association. The Association's membership includes practitioners and academicians with interests in financial decision-making. It provides a forum for presentation of new research and discussion of current issues in financial management, investments, financial markets and institutions, and related areas. When the Financial Management Association established its

Fellows Program in 2000 to provide recognition to individuals who have made significant contributions to the profession, I was one of 20 initial inductees.

My résumé is attached along with a list of recent testimony, reports and depositions in court cases where I have been qualified as an expert. The resume is Attachment B. The testimony is Attachment C.

2. I have been retained by the State of Vermont to analyze Plaintiffs' arguments relating to the cost of complying with the insurance privacy regulations promulgated by the State, as these arguments are presented in Plaintiffs' Motion for Summary Judgment and accompanying affidavits. To prepare my testimony, I have reviewed, among other materials, these documents on which I base my opinion: Plaintiffs' Motion for Summary Judgment; Plaintiffs' Statement of Undisputed Facts and accompanying affidavits; Vermont Regulation IH-2001-01: Privacy of Consumer Financial and Health Information Regulation; Plaintiffs' Complaint; Plaintiffs' Response to Defendants' First Set of Interrogatories; Public Hearing Proposed Regulation IH-2001-01; New Mexico Public Regulation Commission Insurance Division, [13.1.3.1 NMAC-N, 1-15-02], Privacy of Nonpublic Personal Information; Kahneman and Tversky, "The Psychology of Preferences" and other articles; Pollack, "Opt-In Government: Using the Internet to Empower Choice—Privacy Application"; Milne and Rohm, "Consumer Privacy and Name Removal Across Direct Marketing Channels: Exploring Opt-In and Opt-Out Alternatives"; Phelps, Nowak, and Farrell, "Privacy Concerns and Consumer Willingness to Provide Personal Information"; Johnson, Bellman, and Lohse, "Defaults, Framing and Privacy: Why Opting In-Opting Out"; Sovern, "Opting-In, Opting-Out, or No Options At All: The Right for Control of Personal Information"; Fox, "Trust and Privacy Online: Why Americans Want to Rewrite the Rules."

3. In a for-profit corporation, management is charged with maximizing profits for shareholders. As a result, management assesses both potential incremental costs and potential incremental revenues when it considers directing its organization to engage in any activity. When an activity's net revenue is positive—that is, the income stream from an activity exceeds the expenses associated with engaging in that activity—the activity will contribute to the profits of the corporation, and managers will consider it favorably.

This same principle holds when management of a financial institution is considering sharing nonpublic personal financial information about its customers with unaffiliated third parties for marketing purposes. It is the net revenue that sharing nonpublic financial information about customers can provide that makes management of a financial institution consider a policy of sharing private information. That is, it is the expectation of revenue in excess of cost that would justify engaging in sharing nonpublic personal financial information about consumers for marketing purposes.

4. The list of customers on whom information can be shared will have an operating and maintenance cost per customer that falls as the list grows longer. Revenue per customer on the list, in contrast, is likely to rise, and almost certainly will not fall as the list grows longer. Because there are up-front costs for policy statements, option notices, and list construction, a financial institution will find a policy of sharing private information worthwhile only if it can build a list long enough that the net revenue from selling private information from the list covers and provides a fair return on the investment in developing the list.

The insurance companies objecting to an opt-in policy in Vermont and to opt-in generally are in essence simply voicing their displeasure at seeing profit opportunities reduced because they may find fewer customers whose private information they can sell.

5. Two forces explain why lists of customers whose private information can be sold will be shorter with opt-in than opt-out. One is *inertia*, and the other is *framing*. These forces would not be of any importance if, as economists sometimes find it useful to assume, people express their preferences exactly the same way no matter how a question is put or how involved it is to answer the question. This assumption is not useful in the case of private policy. Inertia and framing explain why the plaintiffs object to an opt-in policy and why their objection has its origin in lost profits.

Inertia is the force that causes a customer not to bother responding. Many customers simply do not respond to private policy mailings. As a result, a non-responding customer's decision must be assumed. This assumption will determine how a vast portion of consumers will be treated. It is therefore extremely important.

Suppose 40 of 100 customers of a financial institution prefer that their private information not be shared and that 50 of the 100, regardless of preference, don't respond to the opt-out or opt-in question. If the question is "Do you want to opt-out of the list of those whose private information will be shared with third parties?" then the 50 customers who do not respond because of inertia will be assumed to have answered no to the question. Of the 50 remaining customers who do respond, 20 will opt-out. The result, in this illustrative case, is 20 opt-outs among the 100 customers and a list of 80 customers whose private information can be sold by the financial institution. If the question is "Do you want to opt-in?" then the 50 non-responders will be assumed to want off the sharing list, and the list will consist of only the 30 responding customers who answer yes to the opt-in question.

Inertia and the questions asked can determine whether sharing of private information is profitable or unprofitable, because these issues will determine whether the list of customers available for sharing is 80 or 30. And, of course, inertia can be affected by how the institution describes its policy, its discussion of benefits and costs to the customer, and the ease of response. If opt-out is the question, a financial institution will have a profit incentive to aid inertia as a force that reduces the response rate by creating a confusing, hard-to-read form, by making it difficult to respond, and by emphasizing the costs rather than the benefits of opting out.

"Framing"—how a question is framed—also has great significance. Asking "Will you opt out?" versus "Will you opt in?" influences a customer's answer. If a company asks the question in an "opt-out" form, some of those customers with a preference for privacy will feel they are giving something up, and so, even if they do respond, will not choose the opt-out option.

In fact, fewer than 5 percent of customers receiving privacy notices required by Gramm-Leach-Bliley have responded by opting out. (See Attachment A for references.) This is not an indication of the true preference of the population of all customers. It is the result of inertia and framing.

6. The plaintiffs prefer an opt-out to an opt-in regime because of effects of the forces of inertia and framing, the rising net revenue per customer with the length of the sharing list, and the fixed up-front cost of building the list.

The plaintiffs' *argument* against opt-in in Vermont, however, is based exclusively on cost. Their suggestion is that there is substantial incremental cost of a notice presenting Vermont citizens with an opt-in rather than an opt-out alternative. This suggestion is wrong for the following reasons:

a. If the privacy policies of a company are described in the same way, and the advantages and disadvantages of having the company share an individual's private information with others is presented in the same manner, regardless of the option presented, then the only difference in opt-in and opt-out forms will be in the framing of the question to the customer. Questions framed in both ways can be put on the same form with instructions that the question framed as opt-in applies only in Vermont and New Mexico and any other jurisdiction that adopts opt-in.

b. A company may wish to use different notices in opt-in and opt-out jurisdictions to maximize the number of customers who opt in and minimize the number who opt out in order to maximize net revenue from the sale of private information. If so, the forms will differ and, depending on scale economies in printing and one-time costs of composition, there may be a small incremental cost of using opt-in in some jurisdictions.

c. Even these costs will cease to be incremental for Vermont if a company develops unique opt-in forms for New Mexico or another jurisdiction, so that Vermont simply adds to the length of press run for opt-in forms.

7. It is reasonable to see four alternatives for a company faced with the more restrictive, more consumer-oriented, opt-in standard in New Mexico and Vermont and the possibility of enactment of an opt-in standard in additional jurisdictions:

A. Don't engage in marketing disclosure of private information not excepted by regulation in any jurisdiction,

B. Don’t engage in marketing disclosure of private information in Vermont or, perhaps, in any jurisdiction that has an opt-in requirement, but use opt-out in all other jurisdictions,

C. Engage in marketing disclosure of private information everywhere, using opt-in in Vermont and other jurisdictions that require it and opt-out elsewhere,

D. Engage in marketing disclosure of private information everywhere using opt-in in all jurisdictions.

A is a choice that involves no cost or revenue increment. The only cost to the company is that of annually providing notice of its privacy policy. That notice is required by Gramm-Leach-Bliley. This cost is unavoidable no matter what individual states do.

The choice of B, C, or D in preference to A depends entirely on the net revenue expected from each alternative. If B is expected to provide positive incremental revenue in excess of incremental cost, and the excess is greater than that expected of C or D, then B will be chosen. B will provide the greatest contribution to profit. If it is C or D that provides the greatest expected contribution to profit, then C or D will be chosen.

I affirm the foregoing is true.

Richard S. Bower, Ph.D.

Attachment A

References on Opt-Out Response Rate
to Gramm-Leach-Bliley Notices

ABA Banking Journal, February 2002, pp. 51-59:

> "Two major surveys show that the percentage of customers opting out is less than 1% and rarely exceeds 3%"

BusinessWeek, June 18, 2002, p. 81:

> "So far, the opt-out forms are being returned by about 1 in every 20 consumers."

Computerworld, February 11, 2002, pp. 1, 16:

> "In contrast, opt-out offers are usually ignored; only 2% to 3% of consumers opted out in response to federally mandated privacy notices mailed out by financial services firms last summer, according to federal and industry sources."

Newsweek, April 8, 2002, p. 59:

> "Fewer than 3 percent of customers opted out when given the chance last year.…"

(7) **Vermont Mobile Home Owners Association, Inc., et. al, Planntiffs v. Nicole and Andre Lapierre, et. al, Defendants, United States District Court for District of Vermont, Civil No. 2:97-CV-209.**

Memorandum:

On the economic issues related to the allegations of tying in the subject case written to Norman Williams, May 28, 1999.

(8) **Lois Havill v. Woodstock Soapstone Company, Inc., Windsor Superior Court, State of Vermont, Docket No. 147-3-98.**

Deposition:

Testimony: Windsor Superior Court, August 6, 2002.