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Symposium, Mutual Fund Regulation in the Next Millennium, Commentary on Investor Privacy

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III. INVESTOR PRIVACY

PROF. HAAS: Our next topic is one that we, as consumers, can all sink our teeth into. It focuses on the following two issues: first, how secure is our money in the hands of mutual funds; second, to what extent should the fund industry be allowed to use our personal information for profit-making and other purposes.

With us today to discuss those particular topics and to address your questions are the following: Larry Barnett, professor at Widener University School of Law; Steve Howard, partner at Paul, Weiss, Rifkind, Wharton, & Garrison; Pauline Scalvino, who is a principal and associate counsel at The Vanguard Group; and lastly Jason Zweig from *Money* magazine, who writes a wonderful mutual fund column each month.

What I would like to do first is talk about the security of funds. How secure is our money in the hands of mutual funds, or, for that matter, any other organization, a bank, et cetera? To lead us off on that, we are going to turn to Larry Barnett, who has written an article on this exact topic and has some interesting things to say about that. Larry?

MR. BARNETT: The answer is, "I don't know." But let me begin by pointing out that besides having a background in law, I also have a background in sociology. I have been impressed that one of the things that sociologists have not really considered at length is the issue of trust and the importance, the centrality of trust to the effective functioning of a society.

I would suggest to you that the securities laws exist not just to compensate investors or to protect them. The fundamental purpose of the securities laws is to maintain trust in our financial markets and economic system, without which our society would not function very effectively. And it is within that context I would like to talk about the protection of and the security of shareholder accounts. The maintenance of trust, in other words, I think is absolutely critical.

I do not know how secure the accounts are at mutual funds. I suspect that there are considerable differences between fund families. But what triggered my concern with this issue is an incident that took place in 1994, when a hacker based in Russia was able to penetrate the computer system of Citibank and transfer somewhere between $10 and $12 million of account money to the accounts of accomplices throughout the world.[1]

Now, Citibank maintains that it recovered most of the money.[2] But the incident did take place.[3] The hacker, the last I heard, is sitting in a prison in New York, awaiting trial in federal court.[4] A disquieting aspect of this crime is that a reporter interviewed some of the hacker's acquaintances in Russia and discovered that he was known as having just a third-rate ability as a hacker.[5] Yet he was able to get into the computer system of a major financial institution.[6]

Obviously financial institutions do not publicize such intrusions. I am not even sure they are required to report any such intrusions to the SEC, at least for mutual funds. It seems to me that if a hacker with a third-rate ability as a hacker was able to penetrate the computer system of a major financial institution that we can expect more attempts or actual intrusions in the future. As I recall, the gangster Al Capone many years ago was asked, "Why do you rob banks?" And he said, "That's where the money is."

Between 1990 and 1998 some $1.8 trillion was invested in mutual funds, excluding money market funds.[7] There is a lot of money in mutual funds.[8] The Russian hacker was not skilled, unlike the famous American hacker who was interviewed on "60 Minutes" a week and a half ago and who was recently released from federal prison. In the interview he said it took him just minutes to avoid the firewall of a software company that he was trying to pene-

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1. Jennifer Gould, *Hacker Heist*, THE VILLAGE VOICE, Dec. 23, 1997, at 39.

2. Amy Harmon, *Hacking Theft of $10 Million from Citibank Revealed*, LOS ANGELES TIMES, Aug. 19, 1995, at 1.

3. *See id.*

4. Philip Jacobson, *Focus Crime in the Cyber Age*, THE SUNDAY TELEGRAPH LIMITED, Oct. 19, 1997, at 28.

5. Hugo Cornwall, *The Tale of The Russian Hacker*, THE GUARDIAN (London), Dec. 5, 1996, at 5.

6. *See id.*

7. *New Record Set For Fund Inflows*, FUNDS INTERNATIONAL, May 1998, at 3.

8. Lawrence J. DeMaria, *Dow Rises By 43.84 to 2, 635.84*, N.Y. TIMES, Aug. 11, 1987, at D1.

trate.[9] Given the incident with Citibank, I suggest that perhaps we ought to be concerned about mutual funds. But it is not just the computers of mutual funds with which I am concerned. From what I have read in this area there's a second set of computers involved. As mutual fund investors increasingly use the Internet to access their accounts, their computers may be penetrated.[10] And evidently that is going to be very, very easy.

Business Week has had several articles in the last few months on this subject.[11] Personal computers are apparently at high risk of being penetrated by hackers.[12] It does not take an experienced hacker to go into a personal computer and steal information including passwords. Firewall software is just now becoming available. Even if it becomes widely used, many people will not keep them up to date and many people will probably disable them.

If hackers are able to come into and rummage around your personal computer, what you have on your personal computer at home or in the office may not be all that secure.

It seems to me that mutual funds ought to address this issue and the SEC ought to address this issue much more seriously, because it is much wiser to prevent problems than to try to cure them after they have arisen. Unfortunately, humans have a history of letting things happen and then trying to rectify the problems after they have taken place.

There are some suggestions I have for current practices that I think could be improved. The one I would like to focus on is "PINS," personal identification numbers, particularly when you use automated telephone systems. There is no regulation, as far as I know, on the length of a PIN, a personal identification number. Some fund families allow you to create a PIN of eight digits. Other fund families permit a maximum of four digits. But there is a huge difference in the security supplied between a four-digit PIN and an

9. *60 Minutes* (CBS television broadcast, Jan. 23, 2000).

10. *Mutual Fund Buyers Like The Net*, FINANCIAL SERVICE ONLINE, Feb. 1999.

11. *See e.g.*, Steve Hamm, *Melissa Is Sending You A Warning*, BUSINESS WEEK, April 12, 1999 at 32 (while most corporate PC users have at least rudimentary protection from viruses, fewer than 30% regularly update their antiviruses software to protect themselves from the latest strains).

12. Katherine M. Hafner, et al., *Is Your Computer Secure*, BUSINESS WEEK, Aug. 1, 1988, at 64.

eight-digit PIN. If someone is randomly guessing at a PIN, all four digits of a four-digit PIN will be found just by chance once in every 10,000 attempts. If a person is randomly trying to identify an eight-digit PIN, the correct sequence of numbers will appear once in 100 million attempts. That is a huge difference. Going from a four-digit PIN to an eight-digit PIN reduces the likelihood of someone guessing your PIN by a factor of 10,000.

MR. ZWEIG: Larry, can I interrupt for a second? In a world of Pentium chips, is that difference as significant as it sounds? I mean, if I am a good hacker, shouldn't the only difference between the security on a four digit pin and eight digit pin, be that it might take me a little bit longer to hack the latter?

MR. BARNETT: I do not know; I am not a hacker. However, repeated unsuccessful attempts to access an account may signal a fund's computer to deny access until the fund can investigate.

MR. HOWARD: Jason is.

MR. ZWEIG: Unfortunately not.

PROF. HAAS: I think Jason's referring to the TV shows and the movies, I am familiar with them as well, where the person has this electrical device and they go up to a safe and they stick it in somewhere. I guess there is a safecracker portal that you stick the device in. And you hit a button and it goes through all these different digits and all of a sudden comes up with your PIN number.

MR BARNETT: But insofar as mutual funds are concerned, is it not more likely that mutual funds are going to escape liability in the event of a lawsuit for a loss due to an unauthorized transaction if they permit the use of an eight-digit password as opposed to four digits?

And yet a fund family that allows just four digits probably determines the length of the PIN for its investors who also invest in fund families that allow eight-digit PINS. Because I do not want to remember different numbers for different fund families. If one fund family an investor is with has a four-digit PIN maximum, that is probably what the investor is going to use for all fund families.

MS. SCALVINO: I do not know, though, that I would agree that it is more likely that a firm will escape liability with an eight-digit PIN. I mean, I think it is going to depend on all of the facts and circumstances, just like any analysis of whether you are liable or not. Do you have other protections in place? Does your PIN disable if somebody tries to just put numbers in and after a couple of attempts it fails, which means you now cannot use the automated system? That is a protection you can have in place that would help just as easily with a four-digit PIN as an eight-digit PIN. Does the fund company have procedures in place that say that the check is only going to go to the address of record? So therefore, the person whose account it is, is going to get the check, whether or not they are the one that actually made the redemption in the first place. So I do not know that I would necessarily agree the difference between four and eight digits is going to be determinative in any particular case.

MR. BARNETT: I did not mean to imply that it would. But it is a factor, it is one of those facts that goes into the total mix.

PROF. HAAS: Pauline, let me ask you this question. Maybe Steve, you can jump in as well. What would the liability be for a fund family where a hacker got in and stole $10 million from investor funds? Is it a negligence standard? Is it gross negligence? Any thoughts on that?

MS. SCALVINO: I think that the fund company, whenever it makes a decision as to security issues would consider itself to be subject to a negligence standard.

PROF. HAAS: Simple, mere negligence?

MS. SCALVINO: Simple negligence. What is reasonable? What precautions should we have in place? What is the rest of the industry doing? What are the industry standards?

If you are not living up to those standards, I think you have got a real issue. I think the law would hold us to a negligence standard.

PROF. HAAS: So if someone stole money and you can show that you had certain procedures in place, do those procedures have to relate to the technology that outsiders are using with respect to hacking ability or—I am concerned about fund to fund comparison versus who the threat is. That is, do you have to be reasonable with respect to other funds or reasonable with respect to outside threats?

MS. SCALVINO: I honestly think it is all. I mean, I think you have to look at what everyone else in the industry is doing, but you cannot look at that in a vacuum without understanding what the risks are. You know, do you have consultants who are coming in and saying, "You know what? You are very vulnerable, regardless of what the industry may be doing, because there is this technology out there that makes it easier to get into your systems." So I really think you have to look at what are the hackers doing and where are you at risk. And it goes beyond what the other companies are doing. I think it is the whole picture of what are the threats out there. Maybe not even just in the financial industry, but in other industries as well.

MR. BARNETT: It troubles me that the only concern might be what is it we need to do to escape liability. Because I see a larger issue here and that is the trust factor. How do we maintain trust in the mutual fund industry, which has become such a prominent and important factor in our structure, our financial structure?

MS. SCALVINO: I absolutely agree. I think that the industry recognizes that one of the fundamental, if not the most fundamental, reasons for its success over the past sixty years has been the trust element. And if your shareholders do not trust you and if they do not trust that you're going to be acting in their best interests, they do not trust that you are going to be looking out for them and protecting their funds, they are going to go elsewhere.

The industry understands that. For example, the Investment Company Institute has a committee that looks at security issues all the time. It is probably the one committee where firms disclose more information than you can possibly imagine because of the thought that this is in the best interest of all shareholders for us to get together, talk about the threats, talk about what we are doing to prevent those threats. There is a real recognition that without investor confidence and trust we are not going to be anywhere.

PROF. HAAS: Now, Pauline, many of us have seen the movie, "Entrapment,"[13] with Sean Connery and Catherine Zeta-Jones—excuse me, Mrs. Michael Douglas.

MS. SCALVINO I have not seen it so you will have to explain the plot to me.

PROF HAAS: What happens is they had a plot where they broke into a central bank and they stole one penny from every corporate banking account around the globe. You put enough pen-

13. ENTRAPMENT (Fox Pictures 1999).

nies together and it came out to several billion dollars. Vanguard has how many assets under management at this time?

MS. SCALVINO: $500 billion.

AUDIENCE MEMBER: $500 billion. I do not know if I would want your job, by the way. I am getting nervous just thinking about lawsuits if I were to lose any of that money. What does Vanguard do about that? Are you guys being proactive? What are you doing to protect our funds?

MS. SCALVINO: We are very proactive, and I think most of the industry is very proactive as well. I cannot tell you exactly what we are doing. We have an information security department whose sole responsibility is to make sure that our systems are secure, both the Web and just our general systems. They are there to make sure that only the proper people within Vanguard have access to account information. I do not need to have access to anybody's account information in my job and I should not have that access. Only the people who should have it, have it.

There are procedures in place to make sure you have background checks when you hire people. You have procedures in place to make sure that security access is appropriate for the person's job. We have consultants who come in and look at our systems. We have hackers and companies that we hire to try and break in and to tell us where the potential vulnerabilities are.

I cannot sit here, and I do not think anybody can sit here, and tell you that I can guarantee that a hacker will never get in. Nobody can ever do that. But you take every single precaution that you can. It is a constantly evolving area. The best security practices probably two months ago are no longer the best security practices today. On the Web we use 128-bit encryption, which is the highest standard. That has been criticized by a lot of clients because they do not have browsers to support that. Well, we were not comfortable doing anything less. So it is a constantly evolving area. And I think every fund company, if they want to remain in business, and I know that the larger fund companies are doing this, are very proactive in this area.

Our reputation is on the line. And sure, you can have insurance. We have different kinds of coverage for employee fraud or all the rest of it. But when that article hits the front page of *The Wall Street Journal*, that is it.

PROF. HAAS: Steve, what would you say are the disclosure requirements in this regard? If someone were to break in, would that clearly be disclosable under the '34 Act?[14]

MR. HOWARD: Yes, I think it would be. It depends upon, of course, the circumstances. You'd have to look at how it was done, how much money was taken, that sort of thing. But, yes, I think it would require disclosure. The question is really where would you disclose it, under what circumstances and what documents. But yes, I think it is material in terms of the operations of the fund.

PROF. HAAS: One thing that we did not talk about in terms of disclosure is that there is never any disclosure about the risk of having your funds stolen through a hacker or any other way. If someone were to hack through a system, would that be a mandatory risk factor requiring disclosure going forward, Steve, do you think for that fund?

MR. HOWARD: I think so. Yes, I think so. It's clearly—put it differently. If you were not to disclose it and it were discovered, I think first, just in terms of the trust issues that we are talking about, it would be very detrimental to the investment company. But I think from the SEC's view, you are withholding information that is critical to an investment decision because it is the security of the security, the security of the investment. And it is fundamentally important.

The way I like to think of the trust factor that we are talking about is that back when investment companies first got started there was no way, no how that someone was going to write out a check and mail it across the country to an investment company. That just was not going to happen in the Forties and even in the Fifties and early Sixties. But, starting with the Seventies, Eighties and Nineties, people do not even think twice about taking their life savings or a portion of their life savings, putting it in an envelope and sending it to somebody by the name of Dreyfus or Vanguard who they do not know and have no personal relationship with just because of something that they have read in a newspaper or a magazine, and they have entrusted their livelihood on that basis.

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14. Securities Exchange Act of 1934.

So it really cannot be over-emphasized that trust is what the business, the mutual fund industry lives and dies by and hopefully continues to live by. But disclosure issues like that really cut to the core of this. Any hiding of incidents, I think, would be not only detrimental to that investment company but the whole industry.

MS. SCALVINO: Just to put some numbers around what Steve just said, we have 14 million shareholders. We probably have, if we are lucky, 5,000 of them who have met us, and that is probably a gross overstatement, from coming into our investment centers, and we only have two of them across the country. So people are sending us their retirement savings without ever having seen a face or—you know, they might see Jack Brennan on TV once in a while or Mr. Bogle, but that is it. And they are doing it having spoken to a different person every time they call on the phone. So there's no personal relationship at all.

PROF. HAAS: Jason, could you speak on the trust issue and what your perception is? Do people, when they are sending that check in, do they think they are sending it to a bank, that it is that secure?

MR. ZWEIG: Yes, I think so. I think, oddly enough, our colloquial language in this country has not really caught up with the change in the financial system over the past generation. We still talk about, we say, things like, it is like money in the bank or you can bank on it. And arguably in the past twenty-five years we would have the right to expect people to say, well, you can fund on it or you can put it in a fund, because no one thinks of mutual funds as having the kinds of risks that the other components of the financial system have, absconding, insolvency, bankruptcy, fraud, for that matter.

That is not to say that the mutual fund industry has never had any fraud in it, because it has, had and will continue to have some. But it is certainly far less than virtually any other element of the financial services industry. And I would agree completely with what Steve said. In fact, he took many of the words out of my mouth.

PROF. HAAS: And he was not even on that conference call.

MR. ZWEIG: And he did not even know we had talked about that. What Steve is describing, this experience of a typical American putting his or her life savings into an envelope and sending it off to a stranger, I have always referred to that as the daily miracle of the mutual fund industry. And it is the absolute heart, core and soul of the customer relationship with the mutual fund.

And I think, the other thought-provoking thing in what Steve was saying is that if any of Larry's scenarios ever come to pass and we do have a hacking incident and a fund is broken into and that is disclosed in a fund filing, there will be a public relations firestorm like the fund industry has never seen. And if I were outside counsel to a mutual fund company I would certainly be advising the senior executives to make contingency public relations plans and to study, say, the Johnson & Johnson-Tylenol crisis[15] or the introduction of new Coke or any of the other sort of good and bad examples of how dramatic industry change has been handled by executives. Because it will, as someone mentioned earlier, it will not only be on the front page of *The Wall Street Journal*, but it will be everywhere and it will stay there. And hundreds of reporters will be swarming through State Street in Boston and midtown Manhattan and San Francisco and Chicago trying to find the next one. And you have to plan for this, you have to plan ahead for this, not just on the systems end, but also on the public relations end.

PROF. HAAS: Well, let us move on to our next issue, unless, anyone has any questions about hacking? How do you do it? It's on the Internet. You can go and research it. It's very easy.

MR. ZWEIG: Oh, I am sorry, Jeff. I am sorry, because I did have another thought. I just wanted to add onto something Larry was saying. He mentioned that at the individual shareholder level, another layer of penetrability, I guess we could call it, has been added to the system so that the danger from hackers does not exist just at the fund company level but also at the shareholder level.

I think it is important to recognize that with the increasing levels of disintermediation we have seen in the financial services industry over the past ten years, there probably are, I would argue, at least four levels at which account information could be hacked and probably a half dozen. You have the individual account holder. You have the fund company. But increasingly between them you have discount brokerages like Charles Schwab, Fidelity's brokerage

15. *Deaths from Cyanide Tylenol Alarm Nation; "Madman Sought in Poisoning,"* FACT ON FILE WORLD NEWS DIGEST, Oct. 8, 1982 at 742, A3.

arm, Vanguard's brokerage arm. Waterhouse, any number of other discount brokerages that function as clearing firms for independent financial planners, who themselves have their own computer system, which presumably are less sophisticated.

So you would go from a stand-alone P.C. at the individual shareholder level to sort of primitively networked P.C. at the financial planner level to some kind of well-networked system at the discount brokerage level, on to the fund company, and then beyond to the custodian, the external transfer agent, if there is one, and DTC.[16] So if this happens it could happen at any link of the chain. And you have scores of individual financial planners around the country who each manage several hundred millions of dollars worth, hundreds of millions of dollars worth of mutual fund accounts. So this is not necessarily a one-person office in a strip mall in Keokuk, Iowa. In a lot of cases this is a substantial stand-alone business with a very sizable amount of assets that would be well worth hacking if you are a hacker.

PROF. HAAS: What is the—I think if they were going to attack, they would attack the weakest link. Pauline's done a lot with Vanguard in terms of putting up firewalls, et cetera. How likely is it that someone could take over an individual investor's identity, that is, become them on the computer and interact with, say, Vanguard, Pauline, and basically trick you guys into thinking that they are one of your shareholders?

MS. SCALVINO: The risk is definitely there. You have the risk of identity fraud even not on the computer with someone assuming someone's identity and sending in a check that they have forged. And they open an account and who is going to know?

The risk is there. Again, you take steps to try and mitigate the risk as much as possible. We require a user ID and a password. Again, there is a disabling of your user id if you do not get your password right three times. In addition to that, we have limitations of what you can do online and even if I were able to sit down at Larry's computer and was able to get his password or if he walked away and left the computer on and I was able to sit there and do a transaction, I could not change the address to which the check is sent, I could not change wiring instructions on the account, I could

16. The Depository Trust Company.

not add wiring instructions on the account if they do not already exist. And if they do already exist, they are specifically to Larry's bank account.

So, again, the risk is there, but you try to take as many steps as you possibly can to mitigate the risk or to catch any sort of intrusion that might occur.

PROF. HAAS: That is very comforting to know, that Vanguard has those types of things in place to actually protect the investor from himself or herself, quite frankly.

Why don't we move on to the next issue. And that is something that gets me a little hot under the collar. And that is investor privacy. Poll after poll, as reported in the media, tells us that we think investor privacy, that is, keeping control of our own personal information, is crucially important. Yet we know businesses would like to capitalize on that information and use it in cross-selling efforts to generate additional revenue. And it is kind of interesting, just anecdotal evidence. I receive most of my mail here at New York Law School. And I do that because it is easier to throw out all that junk mail with a huge garbage can. And I can almost just take my mail and dump it right in.

I am always amazed. A few things do make it to my home. And I always like to think about how that happened. How did these people trace me? And one of my favorite things to do is when I am on the Internet and they force me to put in an e-mail address, and I hate to do that unless it's something, an entity that I want to interact with. I like to type in as my e-mail address "yourmama.com." And whoever has "yourmama" as an e-mail address receives lots of stuff for me, I have no doubt. So Pauline, I am going to turn it over to you. And I am a little sensitive to this issue.

MS. SCALVINO: I need my job right now.

PROF. HAAS: Well, you manage $600 billion. How bad could it be?

MS. SCALVINO: $500.

PROFESSOR HAAS: Oh, I'm sorry, $500. $600 next year, do not worry. I am sure it will catch up. Tell us about, I guess, the law in the area, because new things have happened and I know, I think some new guidelines—

MS. SCALVINO: Came out—

PROF. HAAS: —came out just yesterday. What are you guys required to do and do you have any moral compunction to do something beyond that?

MS. SCALVINO: Well, what we are required to do, surprisingly enough, and this surprised me when I first joined Vanguard, until this past November there was no real law that said to mutual funds that you have to keep investor information confidential. Now, although that was the fact and that was the way the law was, mutual funds have kept investor information confidential, and I think that goes back to the trust factor. In November, the Financial Services Modernization Act was signed, the Gramm-Leach-Bliley Act, which did away with the Glass-Steagall restrictions and opened the way for the consolidation of insurance companies, banks, brokerage firms, and mutual funds.[17]

But an important part of that Act, and a part that was very hotly debated were the privacy provisions.[18] And you can really break the privacy provisions down into three parts. One actually has to do with security, and the privacy provisions actually require the various federal regulators to develop rules and regulations regarding the processes and procedures that the mutual fund companies as well as banks and everyone else who the Act applies to must adopt in order to protect shareholder information and shareholder funds.[19] How the regulators will deal with that, I will address in a minute. But that is part of the act.

The second part of the Act has to do with disclosure.[20] And for the first time mutual funds and other financial institutions will be required to tell you what they do with your information.[21] Do they give it to affiliates, and if they give it to affiliates, what kind of information do they give to affiliates? Which affiliates do they give it to or at least in broad categories? Do they give your information to non-affiliates? And again, what are the categories of the information, what are the categories of companies that they provide the information to? What do they do with your information once you

17. *See* Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 1113 Stat. 1338 (1999) (to be codified at 15 U.S.C. §§ 6801-6809).

18. *See id.* at §§ 501-527.

19. *See id.* at § 501(a).

20. *See id.* at § 503.

21. *See id.* at § 503(a).

are no longer a current customer? Is that information being shared? So there is a disclosure requirement and you must secure the privacy notice at the time you become a customer and once a year thereafter throughout the relationship.[22]

The third part of the Act, which is really the part that was the most hotly contested, covers the sharing of information with other parties and any restrictions on that.[23] Can you just give it to anybody you want, and does the shareholder or the customer have any say in the matter? Or do you have to get their affirmative consent to give it out? Or do you have to give them the opportunity to object, but in the absence of objection you can distribute the information?

The way that the law came down and the way that it was passed was as follows: there are no restrictions on the provision of information to affiliates.[24] A company can give your information to its affiliates for the purpose of marketing services to you, offering you new products, without restriction, as long as it is disclosed in the privacy policy that you are provided.[25]

With respect to non-affiliates, the law provides that you have to be given notice about the policy.[26] And you have to be given the opportunity to object.[27] And if you opt out of that disclosure, then the financial institution has to remove your information from whatever is being provided to this non-affiliate.[28] That is the most controversial part of the Act. There were a lot of consumer groups who wanted the law to require an opt in provision for both affiliates and non-affiliates, which would basically require any institution to come to you and get your affirmative consent before releasing your information to anybody.[29]

Now, having said that, there is already a pending bill in the House and the Senate requiring affirmative consent, which would

22. *See supra* note 17 at 503(a).
23. *See id.* at § 502.
24. *See id.* at § 502(e).
25. *See id.* at § 503(a)(1).
26. *See id.* at § 502(a).
27. *See id.* at § 502(b)(1)(B).
28. *See id.* at § 502(b)(1).
29. *See* FDCH Congressional Testimony, July 20, 1999, Testimony of Edmund Mierzwinski House Banking and Financial Services Financial Institutions and Consumer Credit Unions Financial Privacy.

already amend the Gramm-Leach-Bliley Act.[30] It is pretty much sitting in committee right now, and frankly, I do not think it has much chance of passage, because that was one of the most hotly contested parts of the law, and the banking industry and the rest of the financial services industry was really very much opposed to requiring any sort of affirmative opt in requirement.

PROF. HAAS: Pauline, what is the justification—you told me the last time we spoke—what is the justification for sharing information with your affiliates?

MS. SCALVINO: Well, let me just make one other comment, Jeff, before I address that question. I think it is important to keep in mind that in the mutual fund industry, I am not aware of any firm that shares information with a non-affiliate. Mutual funds do not sell the information. They do not view this as a source of revenue where they can get money for releasing the information to other parties. So in the mutual fund industry the provisions that were really the most relevant to us had to do with sharing information with an affiliate. Frankly, the basis for our justification, we believe, is that it is actually in the shareholder's best interest.

When you come to Vanguard, very few clients think of Vanguard as The Vanguard Group, which is the transfer agent of each Vanguard fund or Vanguard Marketing Corporation, which is the broker-dealer, or Vanguard Fiduciary Trust Company, which is the trust services provider. They think of Vanguard as a complex and they expect to get a range of financial services. Therefore, when we send out materials, we think it is perfectly appropriate to send a mutual fund shareholder information about our brokerage services, and to send a brokerage services client information about our trust services. It is really part of the industry's attempt to educate consumers and clients about the information and the services that are available, as well as, frankly, using a shared database with all that information in one place. It is less costly. Further, you can offer clients things like consolidated statements, which everyone wants, showing all of their assets, regardless of what the legal entity is that might be maintaining the relationship.

PROF. HAAS: I have heard what you have to say. And I understand the need to share information with affiliates for the purpose

30. *See* H.R. Con. Res. 3320, 106th Cong. (1999).

of basically servicing an account. I am all in favor of that. And I think there are some synergies in doing that. But why should I have to receive Vanguard brokerage information when I never requested it? Why should I have to learn about your trust services when I didn't request it? I guess the thing that annoys me the most is the only reason you are sending it to me specifically is because you have used information that I entrusted to you for other purposes.

MS. SCALVINO: People have different opinions on this, obviously. Some consumers are going to feel the way you do. If they learn Vanguard does that, they may very well go elsewhere to a fund that does not forward personal information to non-affiliate. We believe, based on our experience with our clients and the demands that they have made that clients are more likely to ask, "Aren't you going to provide additional services? Why can't I get information about this, that and the other thing? You don't do a lot of advertising in order to keep costs down, so the only way I find out anything is when you put it in your newsletter or you send me a brochure about it." We see that side, and we get the most feedback from shareholders who are really seeking the information, want the information, and really look at us as a complex-wide financial institution where you get a broad range of services. They want to be aware of everything that is out there.

If you are not interested you can certainly call us. Right now, we have a financial privacy brochure, which is available for clients, saying that, if you do not want any information other than your account statements, prospectuses, annual reports, semi-annual reports, tell us and we will not send it to you.

PROF. HAAS: Now under the new law you have to send what your privacy policy is once a year.[31] And consumers have the opportunity to opt out, basically say I only want this particular information,[32] don't share other things with me, et cetera. Do you include with that statement of privacy a form on which a customer can opt-out? Do you include a self-addressed stamped envelope in which I can send it back? Or is the burden always on me to try and opt out?

31. *See supra* note 17, at § 503(a).

32. *See id.* at §502(b)(1)(B).

MS. SCALVINO: Well, that is actually going to be addressed in the regulations. What happened yesterday was that the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Reserve Board came out with the regulations, which Congress asked them to enact to implement the law for the banking industry.[33] The SEC is scheduled to come out with theirs by the end of the month.[34] So I do not know exactly what the SEC is going to require of mutual funds, although the SEC staff informed the ICI that they are going to be very comparable to what the banks have done.[35]

Now, the proposed banking regulations, which are out for comment, would not allow a bank to require the shareholder to write a letter.[36] You have to make it easier than that, and they offer a number of options.[37] One option is to provide them a form that they can just check off a box and send it in. The option is provided with a postcard that they can just send back, or provide them with the return postage pre-paid envelope. Another option is give them the opportunity to do it online and just send you an e-mail. So that is really going to be fleshed out in the regulations. The way that the banking regulations have been drafted, it does not really require— it does not say— you have to send the client a card with an envelope, so they can just throw it in the mailbox and send it back.

PROF. HAAS: Does Vanguard have a position yet on what it is going to do?

MS. SCALVINO: No. We have been waiting for the regulations to be adopted.

I can tell you what we currently have is a brochure that explains our privacy policy. You just rip off and you check off a box. I do not think we normally provide that with a postage pre-paid envelope.

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33. *See* OCC News Release, OCC Proposes Rules to Implement Gramm-Leach-Bliley Act Privacy Provisions, *at* http://www.occ.treas.gov/ftp/release/2000-5.txt (Feb. 3, 2000).

34. *See* Privacy of Consumer Financial Information, SEC Release No. 34-42484, *at* 2000 SEC LEXIS 377 (Mar. 2, 2000).

35. *See id.*

36. *See* Joint Notice of Proposed Rulemaking, 65 Fed. Reg. 8779 (Feb. 22, 2000).

37. *See id.*

PROF. HAAS: So you normally do not provide that statement with an envelope that has pre-paid postage. Yet when I get my account statement, there is a little form where I can send in additional money that always has the envelope with the stamp on it.

MS. SCALVINO: That is correct. But you know, there has been more of a demand for that than there has been for an envelope with a statement of privacy.[38] There is one other thing that I need to mention. It is actually in the paper that is included. That is, one part of the Act that has made the financial institution world very nervous, is that the Act does not pre-empt state law with respect to the privacy provisions.[39] The Act says that the states cannot adopt any sort of regulations or statutes that are inconsistent with the privacy provisions under the federal law.[40] But inconsistent does not include greater protections that the states might want to allow.[41]

Now, what is frightening about it is that if you are a national institution doing business in fifty states, you now could be subject to fifty different state requirements on privacy. So, if Jeff can convince New York to enact a law that says, they have to get my affirmative consent to give the information to anybody, unless it is needed to service my account, that is going to be the requirement in New York. Meanwhile, Pennsylvania might say, no, we are happy with the way the law is right now. And suddenly we could be faced with fifty different laws on a privacy policy.

PROF. HAAS: I think that is a troubling point, even for me, who is pro-investor, pro-consumer on this issue. Pauline, one last question that I have, and I would like to hear from Jason and Larry as well about their thoughts on privacy. Why is it—and maybe, I do not know specifically about Vanguard, but why is it when I go to an Internet site and they have that little box that says, if you would like additional information or would like to hear about other products we think you might find useful—and I always wonder why they think I might find something useful—check the box. And I look at

38. Pauline C. Scalvino, The Laws Governing the Privacy, Confidentiality and Security of a Mutual Fund Investor's Information (2000).

39. *See supra* note 17, at § 507(a).

40. *See id.*

41. *See id.* at §507(b).

the box and it is already checked for me. Why do I have to "uncheck" the box?

MS. SCALVINO: We do not have that on our site.

PROF. HAAS: And it is always so small that you barely see it. It is actually underneath like the name of the Webmaster. Why is that?

MS. SCALVINO: We do not have that on our site. But one of the reasons why most people in the financial services industry, and this is especially true on the mutual funds side, is that they are concerned about requiring clients to affirmatively opt into sharing information with affiliates. Based on our client surveys, clients want the information. So, that would lead you to think that everyone's going to check that box and we are fine. Everyone's affirmatively consented.

The problem is that based on doing surveys and on trying to get people to respond, people just do not get around to doing it. And someone who really does not have an objection, someone who does not even have a reasonable expectation that Vanguard's not going to send them information about our brokerage services or our trust services, just will not get around to checking off the box.

PROF. HAAS: Jason, what do you think the pulse of the shareholders of the country is on this particular point?

MR. ZWEIG: Well, I am inclined to lean towards Pauline's position. And I will put this in a way that sounds a little snobby, although I do not mean it that way. I think there are a lot of people who just like to have mail.

PROF. HAAS: Are these the same people who own cats? Sorry, lots of cats.

MR. ZWEIG: No. I grew up in a small farming community in rural New York State. And there are an awful lot of people who are very sad when they walk out to the mailbox and there is nothing in it.

PROF. HAAS: They can have some of mine.

MR. ZWEIG: Well, it would be nice if it worked that way. But that is a wealth-redistribution issue we will have to leave for a different discussion. But at the other extreme, there are an awful lot of people like you and like my wife who, if it were up to her, would make an affirmative opt in provision the next constitutional amendment because my wife will go berserk when anybody sends her junk mail. I mean, she gets physically violent at junk mail.

PROF. HAAS: But do you think a constitutional amendment is feasible?

MR. ZWEIG: I would have to clone my wife and I do not think I am prepared to do that right now. I think that the real issue is that most people, as Pauline suggested, probably like getting this stuff, at least from affiliates, or are neutral toward it. But then there is the small, vocal minority, like you and my wife, who can't stand it. And I do not think this is a legal or regulatory issue, quite so much as it is a business management issue. And it is one issue that the fund industry needs to be sensitive to. The marketplace will probably sort this out reasonably well. And again, I think the Internet will solve a lot of these details better than regulators can.

PROF. HAAS: Do we have any questions from the audience at this point?

AUDIENCE MEMBER: What about selling the information to other companies?

PROF. HAAS: What about selling the information to other companies. Pauline, what's the law once again? Can you sell it to non-affiliates?

MS. SCALVINO: The law is that you can sell it to non-affiliates.[42] But the institution has to tell the consumer.[43] As far as I am aware, no mutual fund company sells the information—we do not want anybody else to have the information. But the law would allow you to do that, except there is an outright prohibition actually in the Gramm-Leach-Bliley Act from selling the information to a third party that is just going to use it for telemarketing purposes.[44] But, if Vanguard suddenly decided that it wanted to sell the information to Fidelity, we could do that, as long as we told you up front that we were doing it and gave you the option to opt out.

AUDIENCE MEMBER: I am just curious about what percentage of the fee shareholders pay goes towards paying for these solicitations?

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42. *See supra* note 17, at § 502 (a).

43. *See id.*

44. *See id.*

PROF HAAS: Whose money are you spending when you send us this junk mail?

MS. SCALVINO: Well, it is an especially interesting question with Vanguard's structure, because Vanguard is owned by its shareholders.[45] So there is no management company, like people were talking about earlier, that takes a profit.[46] All of the costs are passed through the shareholders.[47] So we have got to be able to justify the expense ratios, low as they are because that is a valuable use of your money.

We do not spend anywhere near what other mutual fund companies spend on advertising. We advertise in *The Wall Street Journal* and a couple of magazines. No television advertising whatsoever. So we keep the advertising budget down. We keep the marketing budget down. That is why it is actually cheaper for us to stick in a quarterly statement, to stick in a brochure on something and put it right through the mail to our shareholders, than to have to do a completely separate mailing. It would actually lower costs for everyone if we provide brokerage services, because we think it is ultimately in the interest of all shareholders. If it attracts new money to Vanguard, that ultimately means the expense ratio gets lowered for everybody. Plus it is a service that our shareholders demand.

So, it is valuable to them and it is actually cheaper to do it if you can do it across the board to everybody. Or, alternatively, one of the nice things about being able to share information with an affiliate is that you can target certain mailings. We have certain services that are only available to people with a certain amount of assets. Our trust services are only available to people with a certain amount of assets in Vanguard mutual funds. It would be far more expensive for us to send that mailing out to everybody, or just grab a list from some public location and send out a mailing than to be able to target the people who actually might be interested in the services. Our average expense ratio is twenty-eight basis points and marketing expenses are a minuscule proportion of that.

PROF. HAAS: Other questions? Yes.

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45. *See* A Unique Corporate Structure, *at* http://www.vaguard.com/about / 1_3_1.html.

46. *See id.*

47. *See id.*

AUDIENCE MEMBER: Does Vanguard ever sell shareholders' information to anybody?

MS. SCALVINO: We do not sell your information to anybody. And if it is used by an affiliate, Vanguard is structured so that the Vanguard funds own the management company. And the management company owns the broker-dealer, and owns the trust company. So, if we benefit, the trust company benefits, because you are a shareholder of one and we get you to use our trust services, it all ends up coming back to you as the shareholder. I mean, that is a structural thing for us that we're different than other companies. But we don't sell the information, in any event.

PROF. HAAS: Anything else? Well, I should just say as a final note, not so much with respect to mutual funds, there is a very important court case going on right now. Hariett Jufnick versus DoubleClick, where the plaintiff is suing for misuse of her personal information.[48] The main concern is that personal information that companies gather on the Internet is going to be used for discriminatory purposes. That is, you do not make enough money, your sexual orientation is not what we like, or we do not like your marital status, and companies are going to use that information to specifically target certain people for products and avoid other people. That litigation is going on, I believe, in California right now. Well, I would like to thank the panel very much for coming out today, and we're going to reconvene in about five minutes. Thank you.

48. *See DoubleClick Sued for Violating Privacy Rights,* THE LEGAL INTELLIGENCER, Feb. 4, 2000, at 4; In re DoubleClick, Docket No. 1352, *at* 2000 U.S. Dist. Lexis 11148 (July 31, 2000).

IV. CLOSED-END FUNDS

PROF. HAAS: I have to take blame for this panel because closed-end funds are something in which I am personally interested. I find them quite fascinating. After you learn more about them you might wonder about me. But I do find them quite fascinating. We are going to look specifically at closed-end funds in the context of a statement made by Michael Porter, veteran analyst at Salomon Smith Barney. As he put it, closed-end funds are "a product whose time has passed." That is the issue. And our moderator is none other than Larry Barnett from Widener University.

MR. BARNETT: Our panelists include Karrie McMillan, counsel at Shearman & Sterling, Ed Bergan, General Counsel of Alliance Fund Distributors, Ron Feiman, partner at Mayer, Brown & Platt, and Professor Haas of New York Law School. Given the short time we have for this panel, let me call on the first speaker, Mr. Ed Bergan.

MR. BERGAN: Okay, thank you. I was asked to talk about an issue, which is sort of the "issue du jour" with regard to closed-end funds: what is a closed-end fund and why are so many people interested in it?

The essential difference between closed-end funds and open-end, or regular, mutual funds is that closed-end funds usually trade on one of the national stock exchanges, normally, in fact, the New York Stock Exchange (NYSE). Like any other NYSE-listed stock, they have their own market price, set by the auction floor. The market price is not necessarily the same as, indeed it is usually different from, the fund's net asset value. So for open-ended funds we can, and do, buy and redeem them every day at their per share net asset value (i.e., book value per share). However, in the case of closed-end funds, you purchase them on the open market at whatever the market price is, which may be at a discount or premium to net asset value, and you sell them in the open market through your broker.

Closed-end funds have an important legal difference, as well. They are not offering redeemable shares. They have a fixed number of shares outstanding, subject of course to subsequent offerings, rights offerings or small issuances through dividend reinvestment plans, for example. Structurally they look much more like operating companies, such as Ford Motor Company. They have a listed class of shares outstanding. They have a large constant number of shares outstanding which are not redeemable. Rather, you sell the shares for cash, which then go through the open market in the same way as shares of Ford Motor Company. It's a very different dynamic from the regular open-end mutual fund. Trading closed-end funds do not involve all of the opportunities and pitfalls that you have when trading shares of IBM, Ford Motor, or Cisco. Therein lies the opportunity and therein lies, some people would say, the problem.

Although there are some exceptions, shares of closed-end equity funds by and large, and, at least for the moment, shares of a lot of the closed-end bond funds, trade at significant discounts from net asset value. Much attention has been focused on what you might call global equity funds. Global equity funds are closed-end funds that invest principally in equity securities issued from outside of the U.S. The classic type of closed-end global equity fund (being the "country fund," like a Spain fund or a Southern Africa fund, to name two of ours) invests largely in the equity securities of foreign issuers.

The principal reason why we have such funds in closed-end form, and this is part of the answer to the broad question of whether these funds are outmoded or not, is that they are investing principally in markets where there is not anywhere near the same day-in, day-out market liquidity that you have here in the United States. Here in the U.S., if you have a portfolio of NYSE-listed stocks, you can take on new positions and you can liquidate positions relatively easily. And if, for instance, you are an open-end fund and you get major redemptions and you need to sell portfolio holdings to raise cash in order to meet those redemptions here in the U.S. markets, that's not really a hard thing to do.

In the case of Austria, to take the other extreme, that is very hard to do. There is not a lot of market liquidity in Austria; for all but a literal handful of the largest stocks, it takes time to build up or eliminate positions in Austrian stocks. There is just not enough market liquidity to be able to deal with the relatively sudden inflows or outflows of cash that you can see coming from the U.S. open-end mutual fund market and in relatively volatile markets, in particular. So, at least with regard to many country funds, the answer to the question may be, "No, the funds are not quite yet obsolete."

Discounts trouble people. Relatively few of these funds are very new, so relatively few of these funds have, as any sizable portion of their shareholder base, purchasers in their initial public offerings. So much of what has been said about the plight of the investor in the initial public offering (IPO) may be somewhat beside the point these days because most of the shareholders, a rather large majority of the shareholders, tend to be purchasers who bought their shares at whatever the current market price was one or two years ago, whenever they bought them. And if they bought them in recent years, then they bought those shares at much the same discounts that they happen to be trading at now.

That said, the question is "Why do you have these discounts?" Again, looking at the issue from the standpoint of the global equity fund, which I think presents the starkest cases and which have seen much of the more interesting legal developments in the last two or three years, much of the work done by the analysts suggests that there is (and this ought not to be too surprising), a rather close correlation between the direction of open-end mutual fund flows and closed-end fund discounts. In other words, if open-end global equity funds happen to be selling well here in the U.S., then normally you will see, and this is historically demonstrable, a trend towards narrowing closed-end equity fund discounts, closed-end global equity fund discounts, or even their going premiums. For instance, these funds generally did trade at premiums in the late 1980's, early 1990's. However, when open-end global equity funds are not selling well, closed-end global equity funds tend to trade at larger discounts.

Are those unrelated developments? Well, obviously not. Both open-end equity funds and closed-end equity funds are deriving their buy side appetites from the same universe of U.S. retail investors. When the U.S. retail investor, for all the obvious reasons, is as logically fixated on the U.S. market as U.S. retail investors have been for the last six years, we have a very hard time selling our global open-end equity funds, even though some of them do perform very, very well. And all of our closed-end global equity funds are trading at the same sizable discounts as all the other funds are. It is more of a macro-phenomenon than sometimes you read. I think it has also been demonstrated that there really is no correlation between relative fund performance and relative fund discount. It is, again, rather more macro.

PROF. HAAS: Obviously your company sells a fair number of closed-end funds. When a prospective shareholder buys shares in an IPO of a closed-end fund, which is much like an IPO for a dot.com company these days, there are underwriting commissions and discounts, and other expenses. Is it safe to say that those equal about nine to ten percent?

MR. BERGAN: Less.

PROF. HAAS: A little less than that?

MR. BERGAN: Yes.

PROF. HAAS: Let's say, what do you want to give me, eight percent?

MR. BERGAN: Five to seven.

PROF. HAAS: Five percent? Okay, five percent.

MR. BERGAN: Five to seven, yes.

PROF. HAAS: Five percent off the top. So, when I buy a dollar's worth of closed-end funds in an IPO I only get ninety-five cents in terms of assets?

MR. BERGAN: Yes. Using a five percent spread like that, you would be investing ninety-five cents, indeed.

PROF. HAAS: Why would I want to do that? Why would I want to give you a dollar and get ninety-five cents in return?

MR. BERGAN: In most of the deals done over about the last seven years, you would not have to do that. Bear in mind that it's just the same for a dot.com; nonetheless, it may be more visible with an investment company because of the certainty of the underlying book value. What we, for instance, and the underwriters, and most of the other large closed-end sponsors, began to do about '93 or '94 was to provide that the underwriting spread would not be paid by the shareholder in the IPO. Rather, it would be advanced by the fund's sponsor so that shareholders would not pay that five percent and all 100 cents on the dollar would be going to work right away. The sponsor, over a period of eight or so years, would be gradually reimbursed through the fund's management and other fees.

MR. FEIMAN: Could I step back to answer that question as to the reason why closed-end funds theoretically exist, what it is about them, and what they can accomplish, that makes them more attractive to investors. It's that justification, together with the existence of the discount, that induces shareholders to invest in a closed-end fund. Because they can buy illiquid securities and they don't have to redeem, closed end funds have less invested in cash instruments for defensive purposes. That means, theoretically, that they can achieve a higher return than that of a fund that has fifteen percent of its assets earning money market rates. They can also engage in other strategies that are not permitted to open end funds. They can engage in more leverage: they can offer securities to some investors at rates that are low or floating or are fixed at a certain level. Or they can engage in short selling or other strategies that you might think more common in hedge fund.

There are other examples of closed-end funds that have the same approach. There are a series of funds that invest in bank loans. Bank loans are not as easily traded as other types of debt instruments, so they've adopted a closed-end fund format with, usually, periodic repurchases to reflect the fact that they are illiquid securities and only have to liquidate when they are ready to repurchase.

Because they can buy illiquid securities, closed-end funds have less invested and they don't have to redeem. They have less invested in cash instruments. That means, theoretically, that they can achieve a higher return than that on a fund that has fifteen percent of its assets earning money market rates. They can also engage in other strategies that are not permitted to open-end funds. They can engage in leverage. They can offer securities to some investors at rates that are low or flow or are fixed at a certain level. Or they can engage in short selling and other strategies that you might think are more common in a hedge fund.

Now, by doing so, closed-end funds are telling investors that with a riskier strategy (i.e., through leverage, through investing in illiquid instruments) that they ought to be able to achieve a higher return. The additional risk should result in additional rewards.

And that's why people in theory would be buying at a discount, an initial discount. They would be getting ninety-five cents worth of assets that will grow at a higher rate than the assets that they would invest at 100 cents on the dollar.

PROF. HAAS: So that five cents really is, I guess, the ticket of admission to an investment portfolio that they really couldn't get elsewhere, they couldn't get on the open market.

MR. BARNETT: That's right. That's what's being offered.

MR. BERGAN: That's been the theory.

PROF. HAAS: That's been the theory.

MR. BERGAN: I think, practically speaking, you will not see too many deals done anymore with front-end spreads like that.

MS. McMILLAN: It's also important to remember that many open-end funds also charge loads or they charge a 12b-1 fee, which is a percentage of assets every year. It is more of a hidden charge, but it is still a charge that investors are paying for the distribution costs. In the case of open-end funds, many of them charge a front end load. So, the shareholders' money is not all going to work in the beginning. Or the shareholders pay a 12b-1 fee, which is a fee that's paid out of fund assets each year, say one percent or seventy-five basis points. It's very similar to the traditional spread in a closed-end fund, but you don't find a lot of people saying, "Oh, we should do away with open-end front end loads." It's just the entrance price, for a fund distributed by a brokerage firm.

MR. FEIMAN: In part, that's the answer to why an initial discount might exist. Ed has answered, to some extent, why a subsequent discount exists: namely, that there's a lack of market interest in the particular flavor of that type of security. If you don't want to buy Austrian securities at all, then a fund that holds a lot of them is not going to have the interest that a fund in dot.com companies would have when such stocks are hot. Therefore, you'd expect a lack of market interest to be reflected in the discount.

MR. BERGAN: We are one of the largest closed-end sponsors, although actually about ninety-five percent of our assets are on the open-end side, but we have nine different closed-end bond funds with assets ranging between $100 million and about $1.5 billion. All nine funds, which had been trading by and large pretty near par in the last two months of 1999, suddenly went to sizable discounts virtually in lock step with almost every other closed-end bond fund out there. The reason was that investors were obviously in need of tax losses. 1999 was a rather good year. People were trying to find tax losses. There were not too many places to find them other than closed-end bond funds. It hadn't been a good year in the U.S. bond market, as you know. So you had very substantial discounts, moves of fifteen to twenty percent of underlying book value, rapidly appearing in the last months of the year. They are now in the process of rapidly disappearing. And, again, discounts are coming back to normal levels. I offer that simply as a demonstration that as large as these funds look, they are relatively thin markets.

MR. FEIMAN: Before we get to figure out how to fix the discount, I wanted to throw in a couple of other theories about why they might exist at this point.

One theory is that the stock market has been rising and flows into open-end funds have been steadily increasing. Obviously, at a time where money is flowing into funds, they don't need to maintain the same degree of liquidity that they would during a downturn. Which means that the difference between a closed-end fund and an open-end fund, in terms of preserving a cushion for liquidity, is reduced. Therefore, at the moment, open-end funds can perform more competitively, if not better, than closed-end funds and have done so. When you can invest in an open-end fund or a closed-end fund with the same degree of risk or lack of risk and you can get your money out whole, with the assurance of net asset value from an open-end fund, there is again a market disincentive to invest in the closed-end fund. But should conditions reverse, the impetus for a closed-end fund will again be demonstrated and the discount should be reduced competitively.

PROF. HAAS: A question for the panel. One of the ways companies going public choose a lead underwriter is they have a beauty contest. Underwriters come in and explain what services they are going to provide and why they are particularly good at marketing securities for this particular type of company. One of the ways you distinguish between underwriters is what I call after-market support. That is, what will the underwriter do for your company after it goes public? Will it be out there with research reports? Will it engage in stabilization activities with respect to the stock price? Is there after-market support for closed-end funds? And is that part of the problem? Is that one of the reasons why people are not interested in closed-end funds?

MR. BERGAN: It's a question with a somewhat intricate answer. I mean, there are underwriters who have a historical specialty or strength in doing closed-end funds. Indeed, it's usually the same four suspects. They do provide after-market support in the sense of good analyst coverage, good coverage within their own sales forces which, after all, tends to be where most of the stock stays. And that's good. We get research from underwriting companies all over the Street. The market research they do, though, is it as helpful as analyst coverage and what I'll call the sales system support? No.

I have made a number of presentations over the years on the general proposition that one contributing factor to closed-end discounts, particularly among U.S. equity funds and to some extent the bond funds, has been the practical inability of closed-end funds to pay the sort of ongoing trail commissions that are paid on behalf of open-end funds routinely. That is now starting to change. The law has more or less come around and for once the operation systems trail the law, rather than the other way around. And the operation systems are now starting to come around. So you will see them beginning that change. I am on record as having said that it might make some difference in some cases.

PROF. HAAS: Well, that is certainly going to help going forward, that is, having brokers compensated for, in essence, pushing shares of closed-end funds to their clients.

MR. BERGAN: Yes. And it is basically leveling the playing field between closed and comparable open-end funds. This will take time. It will not come in overnight.

PROF. HAAS: There's no doubt that in the mutual fund world closed-end funds are the Rodney Dangerfields. That is, they don't get any respect. And it is not going to change unless things like this change. Now, the discount. The portfolio of a closed-end fund indicates it is worth $20 per share. However, it is trading at, say, $18.50 on the stock market. Can we do anything to change that to get that market price up to net asset value?

MR. BERGAN: You know, gravity works perspective. How many operating companies, how many listed companies on the

NYSE trade below book? A big, big number. Maybe even more than half. It's not an exceptional circumstance. And when you have assets of an unusually certain value and people wanting to be compensated for taking risk, I think you have got to realize people wanting to get paid for risk don't want to own a fund if they cannot get it for a few points below book.

PROF. HAAS: In the case of funds, closed-end funds that hold illiquid securities, ones that aren't easily disposed of, the discount seems to make some sense in that people are suspicious that the board of that fund is overvaluing those illiquid assets.

MR. BERGAN: That's right.

PROF. HAAS: But how does that explain discounts for your bond funds, which have assets that are liquid?

MR. BERGAN: People are making market calls. If one of our big U.S. bond funds is trading, say at a three percent discount, that's a market call on rates. The bond funds particularly trade to a deal or, more accurately, trade to a projected deal.

MS. McMILLAN: I think you also find that some of it self-perpetuates. For all that you learn about efficient capital markets and rational markets, that's not necessarily the case. And right now you are finding that a lot of arbitrageurs and others are going out to the press and to the public and saying, "Gosh, discounts are a horrible thing. This is the worst thing that's ever happened to closed-end funds. You've got to eliminate the discount." So you have a lot of investors looking around and going, "Closed-end funds, bad thing. Don't want to buy them." You find that the market persona of closed-ends also becomes negative and it just feeds on itself. It is hard to quantify and it is hard to be able to say exactly how much that is contributing to the problem, but I think it is a contributing factor right now.

PROF. HAAS: I certainly agree with that. Let us say I was running an operating company and the share price was trading below book value. I am screaming to the press that you are not valuing my company properly, that is, the intrinsic value is really worth a lot more than my share price. But the market is coming up with an objective price based on a fair amount of information. In situations like this, we have these wonderful things called hostile takeovers where, if a company is not living up to the value of its assets, that is, its intrinsic value, someone can swoop in, buy the shares, oust management, and either run the company better so that share price increases, or break up the company and sell it in bits and pieces and realize value that way. Why don't we have an effective system with respect to closed-end funds where we can basically close discounts right away by taking over the poor performing funds?

MR. FEIMAN: The difference between the operating company and the closed-end fund is that the performance of the operating company is something that shareholders may wish to change. It is the performance of management in managing the underlying assets in the business that they have. Whereas a closed-end fund cannot improve the price of the Austrian security in which it has invested; it is what it is, just as the bond that is trading at par is what it is. Therefore, the discount is not a judgment on management and its capabilities, except to the extent that management is able to reduce the discount. Rather, it's a judgment on the asset class that's being owned by the closed-end fund.

When health care stocks were hot, health care funds would sell at a premium. Now health care stocks are not doing so well and you'd expect a discount. The discount or premium reflects the desirability to investors of owning that type of asset. The discount reflects the volatility of the class. To the extent that the whole purpose of the closed-end fund is to be more volatile than an open-end fund, you'd expect large discounts and sizable premiums as the underlying assets become more or less desirable. I don't think, just theoretically, that the existence of a discount is a negative judgment on management. Clearly, a takeover and an attempt to open-end or to dispose of the assets will allow the arbitrageur to capture the discount. But then he eliminates the opportunity that shareholders have bought for that asset class to turn around. If you believe that such a thing is possible, then you should not be fighting so hard to judge the quality of the fund on the basis of its discount.

MR. BERGAN: Two comments on that. One is that you do see some cases where in fact there have been hostile takeovers and after a certain amount of trial and error, both practically and legally, the hostile takeovers have, I think, found a fairly effective tactic if they are willing to invest. If you are an arbitrageur, this is a definite gulp call. But, nonetheless, you do see those willing to invest two years or about a year and a half, long enough to gain a sizable position take over two classes of a three class staggered board. If you do that, then you can do whatever you want. The reduction in the closed-end equity fund population during the last two years has everything to do with that. So I would say yes, to some extent there is that sort of mechanism working. Why does it work? Well, practically speaking, I think it's a case of relative shareholder value within particular types of fund classes. Or, to put that in less grandiose terms, it's where the arbitrageurs think they can make the most money. So, to that extent, there is self-correction.

The second thing is that, like operating companies, there are some of us who have buybacks running in four different bond funds right now. You use buybacks in less than drastic situations for the purpose of introducing limited corrections to what you see as market inefficiencies, and also for the express purpose of drawing attention to your own fund performance or whatever else. So you will, in fact, use things that way.

MR. FEIMAN: I am speaking on a theoretical basis. Because if you look at closed-end fund performance on the average level it has not achieved the spectacular returns that were projected. In many instances, closed-end funds haven't performed as well as their open-end counterparts. Clearly, you would say that lousy investment selection ought to result in a greater discount. To that extent, as a judgment on the stock or bond picking abilities of the manager, some level of the discount presumably exists to reflect that. I don't believe that the arbitrageurs really intend to turn around the company and operate it as a more successful business doing better stock picking.

PROF. HAAS: Can I add to that point? I've got a quote from some individuals who studied closed-end funds. Lee, Shliefer and Thaler in their 1991 study stated: "Like casinos and snake oil, closed-end funds are a device by which smart entrepreneurs take advantage of a less sophisticated public."[1] I think the evidence has certainly indicated that, in periods of investor euphoria, closed-end funds tend to be put together and sold. However, when investor

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1. Charles M. Lee, Andrei Shleifer & Richard H. Thaler, *Investor Sentiment and the Closed-End Fund Puzzle*, J. OF FINANCE 75, 84 (Mar. 1991).

sentiment is not very favorable you don't see many closed-end funds coming out.

MR. FEIMAN: I think it is a sad but true thing about the markets, that investors tend to want to go into things when they have been successful. But is it more of an evil for investors to jump into a closed-end fund that may suffer a discount when there is a decline in the type of investments that it holds, than for them to invest in an open-end fund that will have to sell its investments in a declining market as investors redeem? Open-end funds are also created during periods of market euphoria.